Approved Prep Provider CFA Institute

Overview of Equity Portfolio Management

2020 Exam

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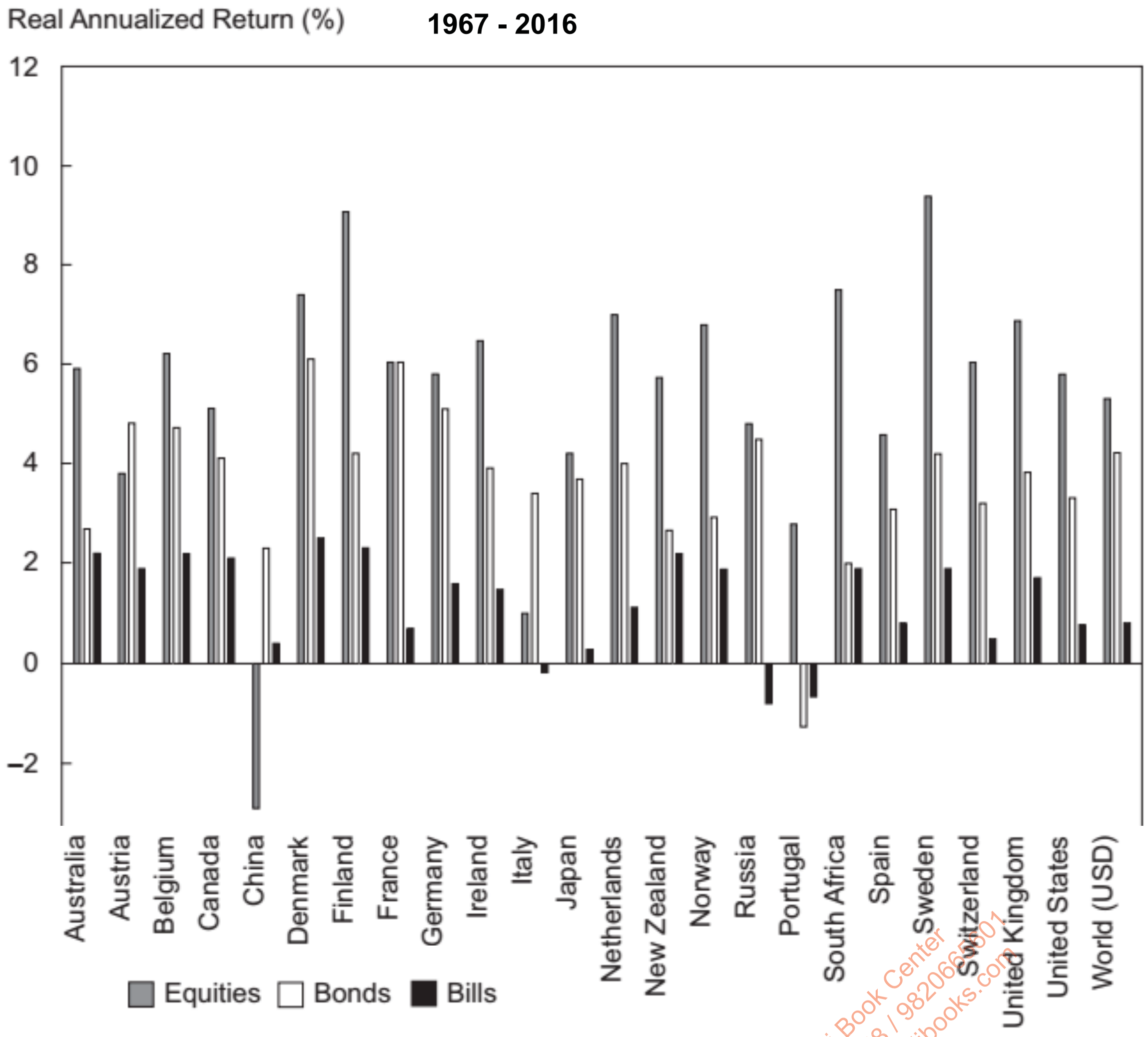
2. The Roles of Equities in a Portfolio

1. Capital appreciation
2. Dividend income
3. Diversification with other asset classes
4. Hedge against inflation

Capital Appreciation

High capital appreciation relative to other asset classes

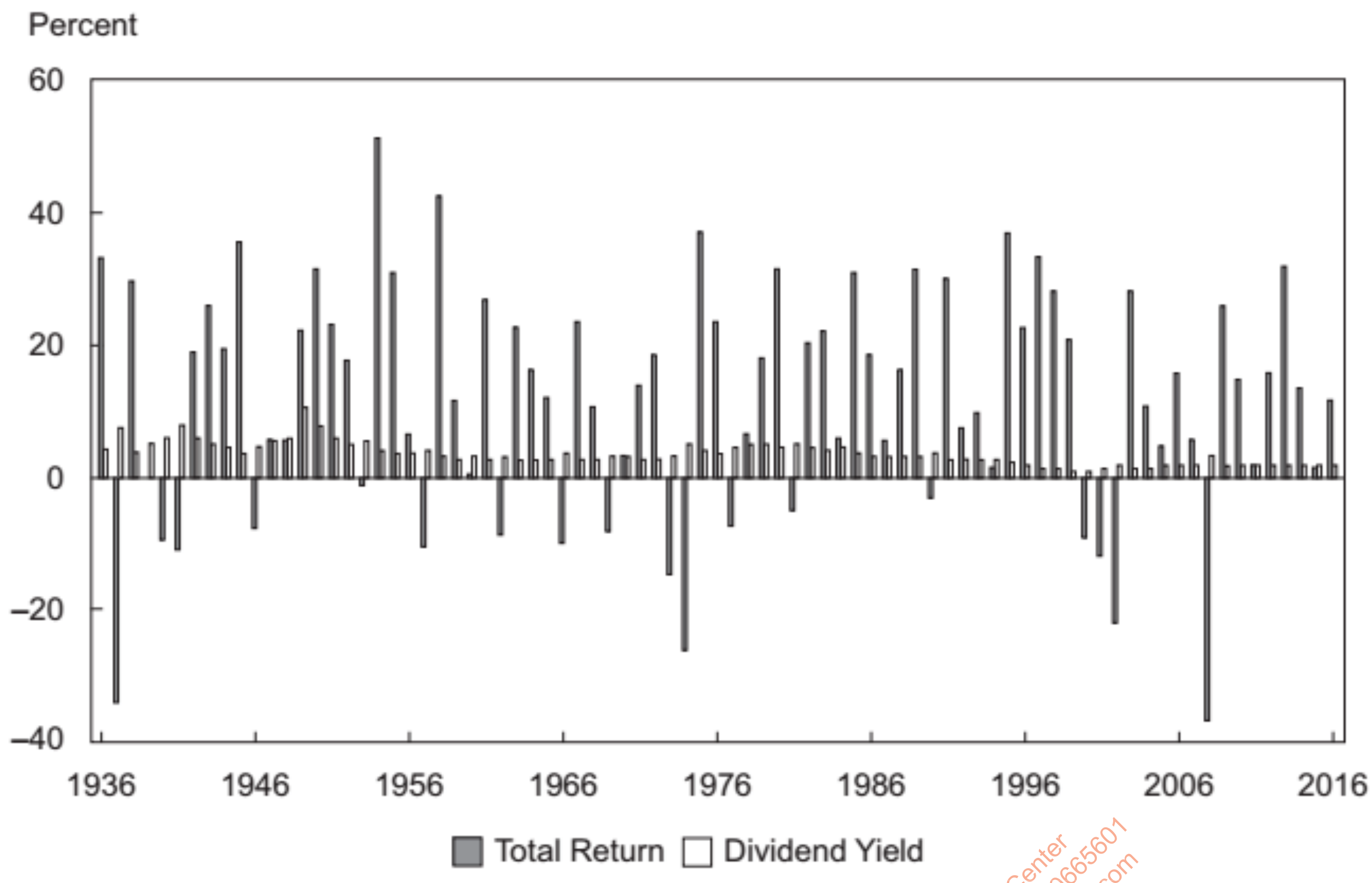
Outperform during strong economic times



Source: Credit Suisse Global Investment Returns Yearbook 2017, Summary Edition.

Dividend Income

Exhibit 2 S&P 500 Dividend Contribution (1936–2016)



Diversification with Other Asset Classes

		MSCI World	MSCI ACWI	MSCI EM	MSCI EAFE	MSCI AC Far East	MSCI BRIC	S&P 500	Bloomberg Barclays Global Aggregate Bond	Bloomberg Barclays Global Treasury	Bloomberg Barclays Global Credit	S&P GSCI Commodities	S&P GSCI Gold	FTSE EPRA/NAREIT Global REITs
Equity Indexes	MSCI World	1.000												
	MSCI ACWI	0.998	1.000											
	MSCI EM	0.858	0.889	1.000										
	MSCI EAFE	0.969	0.971	0.864	1.000									
	MSCI AC Far East	0.831	0.848	0.866	0.877	1.000								
	MSCI BRIC	0.814	0.846	0.958	0.829	0.827	1.000							
	S&P 500	0.969	0.960	0.786	0.881	0.732	0.732	1.000						
Other Indexes	Bloomberg Barclays Global Aggregate Bond	0.317	0.331	0.369	0.364	0.389	0.365	0.245	1.000					
	Bloomberg Barclays Global Treasury	0.162	0.174	0.213	0.258	0.222	0.210	0.057	0.526	1.000				
	Bloomberg Barclays Global Credit	0.564	0.580	0.592	0.639	0.579	0.582	0.448	0.818	0.753	1.000			
	S&P GSCI Commodities	0.406	0.422	0.460	0.445	0.412	0.486	0.317	0.133	0.203	0.400	1.000		
	S&P GSCI Gold	0.109	0.133	0.268	0.153	0.203	0.294	0.031	0.254	0.475	0.409	0.312	1.000	
	FTSE EPRA/NAREIT Global REITs	0.577	0.575	0.466	0.572	0.494	0.391	0.555	0.374	0.291	0.475	0.198	0.025	1.000

Equities tend to be highly correlated with each other

Hedge Against Inflation

- Some stocks can provide a hedge against inflation
- Strength of inflation hedge depends on the degree to which increase in costs can be passed on to customers
- Companies that produce broad-based commodities can benefit from increases in commodity prices
- Correlation between equity returns and inflation gives an indication of how well equities provide a hedge against inflation

Client Considerations for Equities in a Portfolio

- Two broad decisions with respect to inclusion of equities in a portfolio: 1) what percentage of portfolio and 2) what type of equities
- These decisions are based on the IPS
  - Risk and return objectives
  - Constraints: liquidity, time horizon, tax concerns, legal and regulatory factors, unique circumstances
- ESG considerations
  - Negative screening
  - Positive screening
  - Thematic investing
  - Impact investing

EXAMPLE 1

Roles of Equities

Alex Chang, Lin Choi, and Frank Huber manage separate equity portfolios for the same investment firm. Chang's portfolio objective is conservative in nature, with a regular stream of income as the primary investment objective. Choi's portfolio is more aggressive in nature, with a long-term horizon and with growth as the primary objective. Finally, Huber's portfolio consists of wealthy entrepreneurs who are concerned about rising inflation and wish to preserve the purchasing power of their wealth.

Discuss the investment approach that each portfolio manager would likely use to achieve his or her portfolio objectives.

3. Equity Investment Universe

1. Segmentation by Size and Style
2. Segmentation by Geography
3. Segmentation by Economic Activity
4. Segmentation of Equity Indexes and Benchmarks

Segmentation by Size and Style

		Investment Style		
		Value	Core	Growth
Company Size (Market Cap)	Large Cap	Large Cap value	Large Cap core	Large Cap growth
	Mid Cap	Mid Cap value	Mid Cap core	Mid Cap growth
	Small Cap	Small Cap value	Small Cap core	Small Cap growth

Source: Morningstar.

Advantages

- Portfolios which reflect desired risk, return and income characteristics
- Diversification
- Performance benchmarks
- Reflect company's maturity and potentially changing growth/value orientation

Disadvantages

- Categories may change over time
- Categories may be defined differently

Segmentation by Geography

Developed Markets

Americas	Europe and Middle East	Pacific
Canada	Austria	Australia
United States	Belgium	Hong Kong
	Denmark	Japan
	Finland	New Zealand
	France	Singapore

Emerging Markets

Americas	Europe, Middle East, and Africa	Asia Pacific
Brazil	Czech Republic	China
Chile	Egypt	India
Colombia	Greece	Indonesia
Mexico	Hungary	Korea

Frontier Markets

Americas	Europe and CIS	Africa	Middle East	Asia
Argentina	Croatia	Kenya	Bahrain	Bangladesh
	Estonia	Mauritius	Jordan	Sri Lanka
	Lithuania	Morocco	Kuwait	Vietnam

Advantage

- Diversification

Disadvantages

- Lower than expected exposure
- Currency risk

Segmentation by Economic Activity

Level/System	GICS	ICB	TRBC	RGS
1st	11 Sectors	10 Industries	10 Economic Sectors	9 Economic Sectors
2nd	24 Industry Groups	19 Super Sectors	28 Business Sectors	33 Sub-Sectors
3rd	68 Industries	41 Sectors	54 Industry Groups	157 Industries
4th	157 Sub-Industries	114 Sub-Sectors	136 Industries	Not Applicable

Source: Thomson Reuters, S&P/MSCI, FTSE/Dow Jones.

Production-oriented vs. market-oriented

Advantages

- Diversification
- Performance benchmarks

Disadvantage

- Company may span multiple industries

Sector	Consumer Discretionary	Consumer Staples	Information Technology
Industry Group Example	Automobiles & Components	Food, Beverage & Tobacco	Technology Hardware & Equipment
Industry Example	Automobiles	Beverages	Electronic Equipment, Instruments & Components
Sub-Industry Example	Motorcycle Manufacturers	Soft Drinks	Electronic Manufacturing Services

Source: MSCI.

EXAMPLE 2

Segmenting the Equity Investment Universe

A portfolio manager is initiating a new fund that seeks to invest in the Chinese robotics industry, which is experiencing rapidly accelerating earnings. To help identify appropriate company stocks, the portfolio manager wants to select an approach to segment the equity universe.

Recommend which segmentation approach would be most appropriate for the portfolio manager.

Segmentation of Equity Indexes and Benchmarks

Equity indexes and benchmarks are segmented based on:

- Size and style
- Geography
- Economic Activity

Examples:

- MSCI Europe Large Cap Growth Index
- MSCI Emerging Markets Large Cap Growth Index
- MSCI Latin America Mid Cap Index
- S&P Global Natural Resources Index
- MSCI World Energy Index
- Thomson Reuters Global Financial Index

4. Income and Costs in an Equity Portfolio

1. Dividend Income
2. Securities Lending Income
3. Ancillary Investment Strategies
4. Management Fees
5. Performance Fees
6. Administration Fees
7. Marketing and Distribution Costs
8. Trading Costs
9. Investment Approaches and Effects on Costs

Dividend Income

Types of dividends

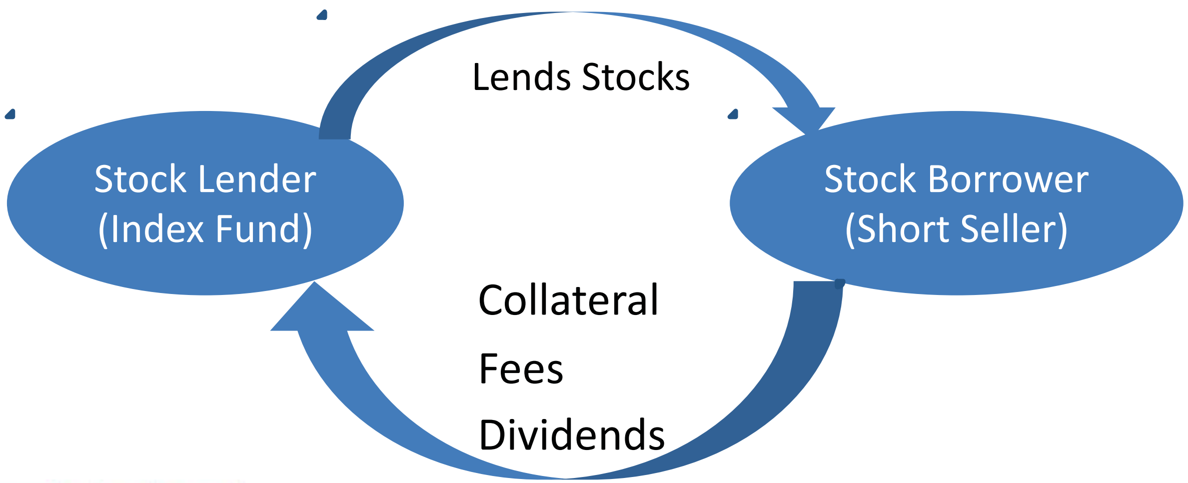
- Regular dividends
- Special dividends
- Optional stock dividends

Taxes on dividends

Ancillary Investment Strategies

- Dividend Capture
- Covered Call
- Cash-covered Put

Securities Lending Income



EXAMPLE 3

Equity Portfolio Income

Isabel Cordova is an equity portfolio manager for a large multinational investment firm. Her portfolio consists of several dividend-paying stocks, and she is interested in generating additional income to enhance the portfolio's total return. Describe potential sources of additional income for Cordova's equity portfolio.

Solution:

Cordova's primary source of income for her portfolio would likely be "regular" and, in some cases, special dividends from those companies that pay them. Another potential source of income for Cordova is securities (stock) lending, whereby eligible equities in her portfolio can be loaned to other market participants, including those seeking to sell short securities. In this case, income would be generated from fees received from the stock borrower as well as from reinvesting the cash collateral received. Another potential income-generating strategy available to Cordova is dividend capture, which entails purchasing stocks just before their ex-dividend dates, holding the stocks through the ex-dividend date to earn the right to receive the dividend, and subsequently selling the shares. Selling (writing) options, including covered call and cash-covered put (cash-secured put) strategies, is another way Cordova can generate additional income for her equity portfolio.

Management Fees

- Also called ad-valorem fees
- Percentage of funds under management
- Covers costs related to:
  - Research/investment analysts
  - Portfolio managers
  - Direct portfolio management costs

Performance Fees

- Also called incentive fees
- Generally associated with hedge funds
- Features might include
  - Upward only
  - High water mark
  - Threshold

Administration Fees

- Processing of corporate actions
- Performance and risk measurement
- Voting at company meetings
- Fees for third party services
  - Custody fees
  - Depository fees
  - Registration fees

Marketing and Distribution Costs

- People costs
- Advertising costs
- Sponsorship costs
- Brochures and related material costs
- Platform fees
- Sales commissions

Trading Costs

- Explicit costs: brokerage commissions, taxes, stamp duties, stock exchange fees
- Implicit costs: bid-offer spread, market impact, delay costs
- Total trading cost is generally not revealed to the investor
- Trading costs depend on:
  - Size and frequency of trades
  - Degree to which trades demand liquidity from the market

Investment Approaches and Effects on Costs

Strategies that “demand liquidity” have relatively high transaction costs

	Passive Strategies	Active Strategies
Management fees	Low	High
Transaction fees	Low	High

5. Shareholder Engagement

- Shareholder engagement: shareholders actively engage with companies
- Methods include: voting on corporate matters, participating in investor calls, in-person meetings
- Generally focused on issues which impact company value
- Issues that might be discussed:
  - Strategy
  - Allocation of capital
  - Corporate governance
  - Remuneration
  - Composition of the board of directors

Benefits of Shareholder Engagement

- Company perspective
  - More effective corporate governance
- Investor perspective
  - Better company performance
  - More information
- Shareholder engagement is more relevant for active managers
- Other investors can get a free ride

Disadvantages of Shareholder Engagement

- Time consuming and costly
- Short-term versus long-term focus
- Selective disclosure to subset of shareholders
- Potential conflicts of interest

The Role of an Equity Manager in Shareholder Engagement

- Written policies on shareholder engagement
- Meetings with company management
- ESG considerations
- Activist investing
- Voting

EXAMPLE 4

Shareholder Engagement

An investor manages a fund with a sizable concentration in the transportation sector and is interested in meeting with senior management of a small aircraft manufacturer. Discuss how the investor may benefit from his/her shareholder engagement activities, as well as from the shareholder engagement of other investors, with this manufacturer.

Solution:

The investor may benefit from information obtained about the aircraft manufacturer, such as its strategy, allocation of capital, corporate governance, remuneration of directors and senior management, culture, and competitive environment within the aerospace industry. The investor may also benefit as a "free rider," whereby other investors may improve the manufacturer's operating performance through shareholder engagement—to the benefit of all shareholders. Finally, if the investor has non-financial interests, such as ESG, he or she may address these considerations as part of shareholder engagement.

6. Equity Investment Across the Passive-Active Spectrum

Equity portfolios exist across a passive-active spectrum

Position on spectrum depends on:

- Confidence to outperform
- Client preference
- Suitable benchmark
- Client-specific mandates
- Risk/costs of active management
- Taxes

Portfolios may represent a "closet index"

EXAMPLE 5

Passive–Active Spectrum

James Drummond, an equity portfolio manager, is meeting with Marie Goudreaux, a wealthy client of his investment firm. Goudreaux is very cost conscious and believes that equity markets are highly efficient. Goudreaux also has a narrow investment focus, seeking stocks in specific country and industry sectors.

Discuss where Goudreaux's portfolio is likely to be positioned across the passive–active spectrum.

Solution:

Goudreaux's portfolio is likely to be managed passively. Because she believes in market efficiency, Goudreaux likely believes that Drummond's ability to generate alpha is limited. Goudreaux's cost consciousness also supports passive management, which is typically less expensive to implement than active management. Finally, Goudreaux's stated desire to invest in specific countries and sectors would likely be better managed passively.

Summary

- Roles of equities
- Segmentation
- Income and costs
- Shareholder engagement
- Passive-active spectrum