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Idiosyncratic returns – consistent alpha across different style cycles

Peter Rutter – Head of Equities

Peter Rutter, Head of Equities at Royal London Asset Management, explains the investment ethos behind the RL Global Equity Select Fund, which differentiates stocks across their respective lifecycles to build a style neutral diversified portfolio across different market style cycles.

Since the Pfizer vaccine was announced in November, there has been an extreme rotation in stock and sector leadership within equity markets. Value stocks have significantly outperformed, as investors rushed to participate in both a 're-opening' trade, i.e. buying companies who stand to benefit from a lifting of Covid-19 related restrictions, such as high street retailers and travel operators, and a 'reflation' trade, buying companies whose profits are likely to be supported by inflation and higher interest rates, such as commodity producers and banks. The consumer services sector, such as high street retailers, pubs & restaurants, and travel operators, have significantly outperformed during the last few months, as did the oil & gas sector.

The recent reversal in trend has shown the dangers of a harsh market correction to reduce the divergence between value and growth, highlighting that investors might experience less performance volatility if they avoid betting too heavily on either outcome. Fortunately, we have formulated an approach that has proved successful in both scenarios.

Using a differentiated stock selection approach which has been run by the team since inception, the Global Equity Select strategy has delivered a consistent track record of performance across economic cycles and differing periods of style leadership.

Our unique approach

The RL Global Equity Select Fund classifies stocks through the lens of an 'Economic Return Framework' and our proprietary 'Corporate Life Cycle'.

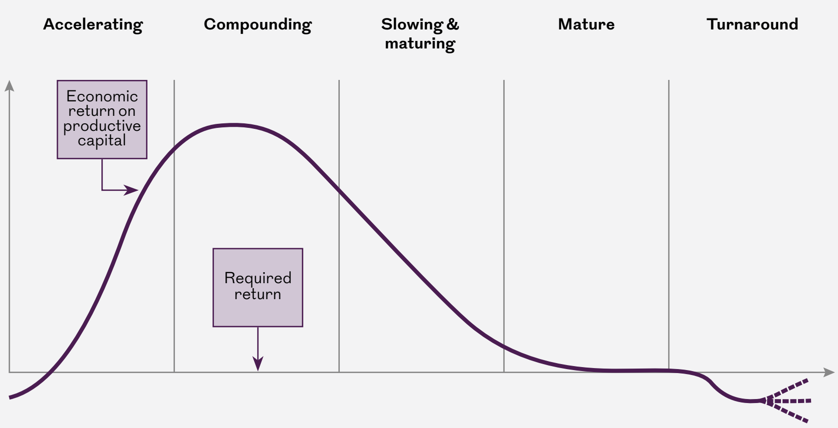
This provides a proven, superior and differentiated dataset within which to further evaluate 'shareholder wealth creating' companies for inclusion in our portfolios, which are then constructed to maximise stock specific risk rather than being dominated by exposure to style and other factors.

Proprietary information and analytical advantages

The proprietary Economic Return Framework covers more than 5000 stocks across the globe and has been built to standardise both balance sheet and cashflow data across regions, sectors, timelines and accounting practices.

Figure 1: Corporate Life Cycle

Insightful	Best wealth creation informed by Life Cycle
Efficient	Drives key elements of process
Enduring	Universal financial principles



Source: RLAM for illustrative purposes only.

Our Life Cycle classification (figure 1) uses this standardised real economic return data to categorise companies into five distinct phases, each representing a different stage of a corporate's life cycle. This allows us to better compare and evaluate companies within each stage, knowing that the key drivers of success in each are different.

Our Shareholder Wealth Creation test seeks to identify companies that are creating shareholder wealth with superior business models, management skill and capital allocation opportunities, recognising that the drivers of this wealth creation are Life Cycle specific. For example, a Compounding business creates wealth via maintaining high returns on productive capital and growing; however, a Turnaround business should look to shrink weak assets, as a route to improve its returns on capital. We capture shareholder wealth creation in a rating from 'A' to 'D' for each company that we analyse.

Stock selection to portfolio construction

We perform deep-dive fundamental and valuation analysis on companies with the strongest evidence of long-term wealth creation and typically spend most of our time and energy in this phase. Importantly, the path of analysis is again informed by our proprietary Life Cycle stage considerations and with reference to industry structure and company specific sources of competitive advantage. There is also an explicit focus on Life Cycle specific ESG analysis, further differentiating our work.

The output from this process is approximately 300 companies which have good or strong evidence of wealth creation together with attractive valuations. It is this pool of stocks that provides the source of potential investments for inclusion in our Global Equity Strategy.

The Global Equity Select Fund is invested across a portfolio of 25-40 stocks which our process has identified as having the best combination of shareholder wealth creation and attractive valuation. Given our Life Cycle approach, the combination of these stocks within a portfolio leads us naturally to high stock specific drivers of risk and return rather than reliance on thematic or other factor positioning. We target a tracking error in line with a 2.5-3% outperformance objective, the approach has delivered consistently high information ratios, and has provided investors with a differentiated return stream that has delivered across and within different style cycles.

Ultimately this process leads to portfolios that are balanced across regions, sectors, styles and life cycle segments. It also leads to portfolios with a high active share – typically 85% or more, which is consistent with our view that stock selection will normally account for 70% or more of our total risk budget.

Consistent alpha – seeing through the market cycles

Despite the portfolio tending to be relatively balanced in terms of growth and value, performance has not been negatively impacted by the strong performance of the former. We believe that this approach creates portfolios with better quality and value characteristics than the broader market. After a period of long-term strong performance for growth-oriented strategies, this may be an attractive proposition for investors looking to diversify their global equity exposure.

We look to the future with optimism. The world is certainly a much-changed place from this time 12 months ago, but there is light at the end of the tunnel. We are hopeful that with the successful rollout of the vaccines, life will return to normality soon. This means people once again going to their places of work, pubs and restaurants being open for business, and airlines welcoming people on board again.

Across multiple scenarios for what might happen next as we enter a new phase in the global economy, the Global Select strategy using its proprietary Life Cycle framework is designed to have high levels of stock specific risk and limited aggregate macro/style exposures. This means that should our idiosyncratic stock picking alpha be as successful as it has been over the past 19 years, the portfolio has the potential to perform on a relative basis across multiple market and in post-Covid-19 socio-economic scenarios. At a time like this, a core part of our proposition is to take the need for investors to get the growth-value, inflation-deflation and/or boom-bust calls 'right' off the table.

Contact us

For more information about our range of products and services, please contact us.

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