Solving the Return Challenge

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It’s safe to predict that the terrific market returns of the past decade, particularly for U.S. stocks, likely will revert to normal in the years ahead. Yet any mean reversion after a protracted bull run suggests that investors may have to deal with below-average returns for a while, leading to difficult conversations with clients who have overly optimistic return expectations. The longer below-average market returns persist, the more creative and precise investors will have to be to achieve desired outcomes. There will be slimmer margins for error and inefficiency.

We believe there are four attributes that portfolios will need to demonstrate in order to be successful in the next decade: (1) reduced drag on returns, (2) more intentional use of rewarded risk factors, (3) reduced U.S. overweights, and (4) more deliberate use of active management. We explore each of these below.

BACKGROUND
BlackRock Investment Institute’s capital market assumptions for U.S. stocks and core bonds suggest that a 60/40 mix of the two will deliver a return of only 5.1 percent over the next decade. That’s a lower return for that portfolio than in 87 percent of the rolling 10-year time periods going back to 1926. What’s worse—it’s before fees and taxes. Clearly investors usually own more than just U.S. stocks and bonds, but these two assets often represent the core of most portfolios, and thus represent an important part of the equation. The good news is that this forecast doesn’t consider extra returns that are attainable through other asset classes or through successful portfolio tilts. Higher returns will be available, but investors will need to be methodical about how they pursue—and achieve—them.

The BlackRock Portfolio Solutions team helps advisors diagnose unintended risks and design portfolios that can achieve better outcomes for their clients. The team utilizes BlackRock’s Aladdin® risk management platform to analyze portfolios, spot trends, and provide insights into the common portfolio construction practices of advisors.

The question is: If our capital market assumptions prove correct, will advisors really be able to accept the market’s returns and still help clients achieve their investment goals?

We generally ask advisors about their preference as a portfolio manager: “Would you rather beat the market with the same risk or accept the market’s return with less risk?” Both would represent an improvement in Sharpe ratio over the market itself, but the two outcomes speak to different goals. Anecdotally, about 75 percent of advisors would prefer the same return but with less risk. The question is: If our capital market assumptions prove correct, will advisors really be able to accept the market’s returns and still help clients achieve their investment goals?

OVERCOMING LOW RETURNS
Here we identify four ways to overcome this hurdle of low returns and put portfolios on the best pathway to deliver the returns that clients may need to meet their goals. These methods involve efficiently capturing what the market provides and effectively creating excess returns with active portfolio decisions. Our analysis of the 11,000+ models we’ve collected in the past 12 months provides an interesting picture of how advisors are currently positioned—and how successful they may be in delivering the returns their clients may require.

REDUCE THE DRAG ON RETURNS
If U.S. equities and fixed income deliver only 5.1 percent, then we need to collect as much of that 5.1 percent as we can. Two critical sources of drag are fees and taxes (see figure 1). These can vary quite a bit across advisors, but our data suggests that the average blended expense ratio is 0.53 percent and the average tax drag is 1.23 percent. We don’t collect data on the fees advisors charge their clients, but if we assume the industry standard is roughly 1.00 percent, then these three sources of drag cut the expected return by half. For clients that need a 6%-percent return to meet their goals, having the core of the portfolio potentially deliver less than 3 percent will be challenging.

Certainly, exchange-traded fund (ETF) usage plays an important role in reducing both expenses and tax loss—and we see evidence of these efficiencies in the data (see figure 2). There is a direct correlation between the percentage of ETF ownership in the portfolio and the
The amount of drag on portfolio returns. Portfolios with high ETF allocations enjoy a one-third lower tax drag and cost two-thirds less than portfolios with no ETF allocations.

**GAIN EFFICIENT EXPOSURE TO THE REAL DRIVERS OF (EXCESS) RETURNS**

Investors must identify and access the exposures that most persistently create excess returns in the most tax- and fee-efficient way possible. In a word, this is about factors—the broad and persistent sources of returns that summarize seemingly disparate observations on the return potential of different stocks. Plenty of academic research demonstrates the benefits of certain rewarded equity style factors including: value (stocks trading cheaply tend to outperform those that are more expensive), momentum (recent winners tend to outperform recent losers), quality (companies with more stable earnings tend to outperform lower-quality earnings), small size (small companies tend to outperform large ones), and minimum volatility (low-risk stocks tend to have superior risk-adjusted returns than high-risk stocks).

These factors may provide either excess returns over the broader market or risk-adjusted return enhancement over the long run to compensate investors for bearing risk.

Although factor product usage within portfolios managed by advisors is on the rise, the current sizing of positions remains insufficient to enhance returns in a meaningful way. Figure 3 illustrates advisor allocations to dedicated factor products, both at a total portfolio level in the equity sleeve alone, for conservative (fixed income heavy) through aggressive (equity heavy) portfolios. Because factor research and dedicated factor products began in equities, it’s unsurprising to see factor product usage rise as equity allocations increase.

Yet the allocations depicted above are not enough to create meaningful tilts at the portfolio level in most rewarded.
factors (see figure 4). The lone exception is the size factor where smaller-cap exposure does seem to be a consistent tilt represented in advisor models. One of three reasons could cause this neutral weighting in most rewarded factors: (1) advisors intend to be factor neutral; (2) allocations to factor products are not large enough; or (3) the non-factor-oriented holdings in the portfolio are diluting or diversifying the factor exposures being sought.

The persistent excess returns from rewarded risk factors suggest that we should target positive portfolio loads on all of them. Beyond the size factor, exposures to value, momentum, quality (profitability as one measure), and even minimum volatility should be persistently positive wherever possible unless we are intentionally trying to factor rotate and have a significant tactical bias against a specific factor at a given moment. Factor rotation is complex, and those who attempt it should normally do so by shading between different sizes of positive loads in all rewarded factors. There should be a high bar against making any of them negative.

Solving this requires you to know what you own. If what we really want is a basket of high-quality companies that pass certain screens, then rules-based factor ETFs can help us gain that exposure with greater purity, lower cost, and more tax efficiency than we could have traditionally accessed through an active mutual fund manager. The ETF can prioritize the rewarded factor exposure above all else, while the active manager’s factor exposure may ebb and flow based on security selection or other idiosyncratic risk exposures the manager creates.

Too many line items in the portfolio can compound the issue. Consider two hypothetical equity managers: one is overweight the technology sector, the other is underweight. If both are in the same portfolio, the investor ends up neutral in technology with no portfolio tilt at all. This example uses two managers tilting in the sector factor, but this also can happen in any factor—including persistently rewarded factors such as value, size, quality, or momentum. We would advocate that all portfolios try to maintain positive tilts in these exposures, yet these tilts can be diluted if investors do not consider the number of funds and ETFs they own. (More on this below.) Reducing drag isn’t just about taking what the market offers. It’s also about accessing our intended tilts in the most efficient way possible.

So why is the size factor a prevalent tilt we can observe among advisor portfolios? The answer seems to lie in the indirect exposure to mid-cap stocks coming from products that are not necessarily included in portfolio weightings to provide this exposure.

We analyzed three specific equity categories where there are typically smaller companies compared to the broad market—small-cap, mid-cap, and emerging market equities (see figure 5). The “small size” factor tilt is not created through direct allocations to products dedicated to small- and mid-cap stocks but rather through a large indirect exposure in mid-cap stocks, likely coming from large-cap product holdings. These large-cap holdings tend to have larger portfolio allocations—and though “large cap” by name—tend to benchmark against indexes that have a lot of mid-cap exposure in them (for example, S&P 500 or Russell 1000). Most active decisions by any portfolio manager to move away from the cap-weighted benchmark seeking excess returns likely would result in an overweight to smaller companies.
If non-dedicated factor positions can give us this kind of indirect overweight, then the opposite is also true: Indirect exposures also can mitigate the intended factor tilts we may try to make in a portfolio—particularly those in rewarded factors.

**ALLOCTE MORE TO ASSETS WITH HIGHER EXPECTED RETURNS**

This may sound easy and obvious, but it’s not. Sometimes we avoid owning certain assets because we don’t have a high conviction in their return potential. Other times, there are exogenous factors that keep us from owning them in abundance. As an example, investors were not harmed by a persistent and sizable underweight to international stocks over the past decade. Which leads us to ask the question: Does this home-country bias exist because U.S. stocks have fared considerably better during this period or because clients are less comfortable owning things they are less familiar with?

A common question we ask advisors is: “If you were wildly bullish on non-U.S. stocks, what’s the maximum you’d put in the equity sleeve of the portfolio?” A common answer is 30–35 percent. This is a full 10 percentage points below the non-U.S. stock weighting in the MSCI All Country World Index—and suggests a legitimate home-country bias rather than a preference for what’s performed well lately.

Our firm’s capital market assumptions for the next five years suggest that higher levels of expected returns are available for non-U.S. stocks versus those from the United States. We expect European and emerging market stocks to outperform U.S. large caps by at least 1 percent per year during that span. If these assumptions are at least directionally accurate, the underweights to these higher-return markets will hamper clients’ efforts to reach their investment goals (see figure 6).

Investors tend to want to own the things they’re familiar with. They are much more comfortable owning the stocks of companies whose products they buy every day. It becomes considerably harder to own the stocks of companies that are operating in a country we know very little about, selling products we know little about to customers we know nothing about. Once an advisor has provided us the max-bullish non-U.S. position size in the portfolio, we ask why. The most common answer? My client won’t be comfortable owning more than that. It’s easy to suggest that we should allocate more to assets with higher expected returns, but overcoming this challenge won’t be easy. It’s not as simple as a math problem, and solving it likely will involve advisors helping their clients become better acquainted with geographies and trends they are less familiar with. In other words, they will have to make the uncomfortable comfortable.

**BE MORE DELIBERATE WHEN USING ACTIVE MANAGERS**

This is not to suggest that there aren’t terrific active managers that can produce positive excess returns. We do, however, suggest that when using active managers in our portfolio that we assess a few attributes beyond the typical Ps: performance, people, and process.

First, are they deriving enough of their excess returns from something that is unique to their process? We shouldn’t hire a manager who, for example, derives most of its outperformance through a momentum orientation when we can simply buy a momentum ETF for a fraction of the overall cost.

Second, we should ensure the managers we hire are working well together in the portfolio. Each manager has a combination of both factor and idiosyncratic exposures. The more managers we put in the portfolio, the more we must assess how much their factor exposures amplify or dilute one another. A likely reason for the neutral factor weightings we demonstrate above is due to one manager being positively oriented toward quality while another manager is negatively oriented toward it. The result? A neutral loading to quality at the portfolio level.
A complicating factor to this second point is the number of holdings we choose to own in our portfolio. Based on our 2018 study of advisor models, we found that the typical advisor model held roughly 19 line items: about 12 equity items and between four and five fixed income items (see figure 7). Our team believes that you can build a strong global multi-asset portfolio of mutual funds and ETFs with only 10–12 holdings.

We then measured the number of discrete underlying stocks within the equity sleeve in order to better understand the real drivers of equity risk and return in the portfolio. The average advisor model in our data contains 3,463 discrete underlying stock positions. A number that high suggests that the specific return of any one stock is likely going to be fairly de minimis at the portfolio level, and the more likely drivers of both risk and returns are the factor exposures that thread across the holdings.

If an investor wants stock-picking to drive alpha, that means owning just a few equity funds or ETFs. Otherwise the portfolio resembles a collection of explainable risk factors. This is why using a factor-based risk model is so important. From our work, the vast majority of advisor portfolios have so many underlying holdings that factors explain both performance and excess returns.

Further, if we were to combine the S&P 1500 and MSCI ACWI ex-U.S. indexes—a reasonable benchmark for an equity sleeve—the total combined number of holdings in our benchmark would be 3,577. So although the weights of each security are obviously different, the average advisor model holds roughly the same number of total securities as can be found in a reasonable benchmark (see figure 8).

Thankfully, our portfolio data highlights a trend toward fewer holdings. The most recent update of our standard report now shows an average of only 17 line items. We also see fewer instances of the practice of manager diversification, where several managers are selected within the same category to attempt to balance out underperformers with outperformers.

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**Figure 7**

![AVERAGE NUMBER OF ADVISOR MODEL HOLDINGS](image)

**Figure 8**

![DISTRIBUTION OF ADVISOR MODELS BASED ON UNDERLYING EQUITY HOLDINGS](image)
This practice is, of course, closer to owning the market by its very nature—and is emblematic of the challenge we see in neutral factor weights. If I expect that two managers in the same category may provide opposite relative performance (one underperforms, one outperforms), then I’m expecting their factor orientations to likely offset each other by definition. In other words, one manager’s will be right, the other’s will be wrong—and my portfolio holding both ends up closer to neutral. By owning them both, I’m losing the very thing that made me willing to pay a higher price for each manager in the first place.

Finally, although we advocate for not diluting your tilts at the portfolio level, the opposite—unintentionally amplifying tilts—also can be a problem. This generally occurs when advisors become overly reliant on a fund’s performance rankings within standard categories. Let’s use momentum as an example. When momentum works, it tends to work over an elongated period of time—and such outperformance can influence the category rankings of any fund manager whose process is influenced by it, regardless of the fund’s category. All mutual fund managers whose processes are biased toward momentum may gravitate toward the top of their categories as the momentum factor continues to lead markets, in this case. Their collective presence at the top of their categories will lead to their joint selection for a portfolio, causing an unintentional portfolio tilt toward momentum in a levered way—even if the fund categories vary. As soon as momentum rolls over in the markets, the returns of all managers benefiting from momentum-generated returns roll over with it. We suddenly have multiple underperforming funds in our portfolio at the same time. This doesn’t happen by accident. We don’t discourage advisors from using quartile rankings when selecting funds. Rather, we suggest that it’s critical to gather further insight on how those top-quartile returns were created by each manager. This ensures that the same factor tilt doesn’t unintentionally drive too many of the holdings in our model.

A PLAN FOR IMPLEMENTING

Executing against these four dimensions involves a consistent framework designed to invest cheaply and efficiently in your strategic asset allocation, and a plan to create tilts and measure their aggregate size in the portfolio. Our team uses a four-step approach we call B-B-I-M (Benchmark, Budget, Invest, and Monitor) to help navigate.

The portfolio needs a benchmark, which provides a North Star for the amount of return and risk the market is likely to provide over time. Beating the returns of that benchmark comes from only a few places—asset allocation tilts made by the advisor, successful factor tilts, and the true alpha (idiosyncratic, beyond factor tilts) of any active managers in the portfolio.

The Budget and Invest steps work together. Here we budget for both risk and cost. We don’t want to overpay for what we can otherwise get at a lower cost; but we also need to budget for the amount of risk and active risk we will require in order to generate the returns that meet the client’s goal. During the Invest step, security selection is the focus, but we must recognize that each security we select has an impact on our risk budget, which is why these two steps work together.

We’d first decide on which asset allocation bets we’d make in pursuit of excess returns, and measure the size of our bets in that area before doing anything else. We can make asset allocation bets using the same low-cost core ETFs, which keeps portfolio drag down. These tilts may satisfy the pursuit of our excess return target. If so, we can stop here if we’d like, with a very low-cost portfolio.

If we need more, we can introduce rewarded factor products into the portfolio, hire active managers, or both. Rewarded factor products allow us to generate tilts at a low cost and can help us further pursue excess returns. Again, we can stop here with a reasonably low-cost portfolio if this satisfies the amount of active risk we need to target the client’s return goal.

We also can choose to add only active managers, but given that their excess returns usually come from a combination of factor exposure and an idiosyncratic component unique to their process, we want to measure how the managers we’re using will work when placed alongside each other in our portfolio. Their factor exposure can compound or be diluted, as explained above, so we may have to leave certain managers out of the mix if they’re not helping the overall portfolio reach its goals.

If choosing to add both factor products and active managers, we’d start by selecting the active managers. We’d measure their combined factor weightings, and then blend in factor products at the end to compensate for any unintentionally large or small factor bets, ensuring we have a blend of rewarded risk factors and an idiosyncratic component to help drive the portfolio’s returns.

Finally, the Monitor step is an exercise in measuring where we’ve been, how we’re doing against the client’s long-term goals, and adjusting the portfolio to change the source and size of our tilts and total risk to keep the client’s plan on track.

CONCLUSION

If the markets are going to deliver lower than historically average returns, then we will need to be much more deliberate in how we build portfolios to better connect the client return requirements with such expected returns.

Making portfolios more efficient across a number of dimensions is going to be critical for managing investments in the

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next decade. Reducing drag on returns will play a bigger role as the heady results of the past decade fade further into the rearview mirror. Accessing excess return streams in an efficient, effective, and uncorrelated manner often will be the key for delivering on client return goals.

We likely will need to pull all levers: owning market beta as cheaply as possible, accessing meaningful amounts of rewarded risk factors through efficient sources to create more predictable alpha, tilting toward higher reward geographies—and topping it off with incremental excess returns through idiosyncratic true alpha via active managers. These will be the keys to success in a lower-return environment.

Generating returns over the next decade likely will be tougher than over the past decade. But we have a blueprint, the technology, and the know-how. All that is left is execution. ●

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ENDNOTES
1. See Ang (2014) for a literature summary on factor investing.
2. For academic references, see Basu (1977) for value; Jegadeesh and Titman (1993) for momentum; Sloan (1996) for quality; Banz (1981) for small size; and Ang et al. (2006) for low volatility. The famous Fama and French (1993) model incorporates value and size factors.

REFERENCES
