Rocaton

INSIGHTS

Rocaton's Public Equity Investment Philosophy

February 2018

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EXECUTIVE SUMMARY

- Rocaton's public equity investment philosophy, discussed herein, is focused on equity programs that are a component of a total return multi-asset class investment structure. The philosophy may not directly apply to some client types, such as Defined Contribution Plans, for which Rocaton recommends structures that typically include passive and active equity options.
- Our broader philosophy also relies on a mix of active and passive management, but is predicated on effective use of active management, primarily allocating active risk in the areas of greatest market inefficiency.
- Key tenets of our philosophy are:
    - Investment across the full global market capitalization opportunity set (reflected by the MSCI ACWI IMI)
    - Active investment in a global large capitalization equity mandate -or-
        - Passive investment in U.S. large capitalization equity
        - Active investment in non-U.S. large capitalization equity
    - Active investment in U.S. and non-U.S. regional small capitalization, versus global small capitalization equity
    - Active, direct, strategic investment in emerging markets equity
- The framework described herein can be modified to 1) suit a variety of needs, preferences, or objectives across all programs and 2) optimize the use of active and passive management in less efficient areas of the market, with the goal of capturing a higher net of fee return over a full market cycle than a fully passive portfolio.
- Above all, Rocaton remains focused on creating customized solutions across our client base.

Introduction

In an environment characterized by richer valuations and lower yields, investors may feel the propensity to shift to riskier investments to generate higher returns. We continue to believe that in the current market environment, a well-structured public equity program will play an important role in investors' ability to meet long-term objectives. In this paper we outline our long-standing equity investment philosophy. This equity investment philosophy is predicated on the prudent use of active risk, and is envisioned to be a baseline for discussions on specific objectives and preferences for clients' equity programs.

What is an appropriate benchmark?

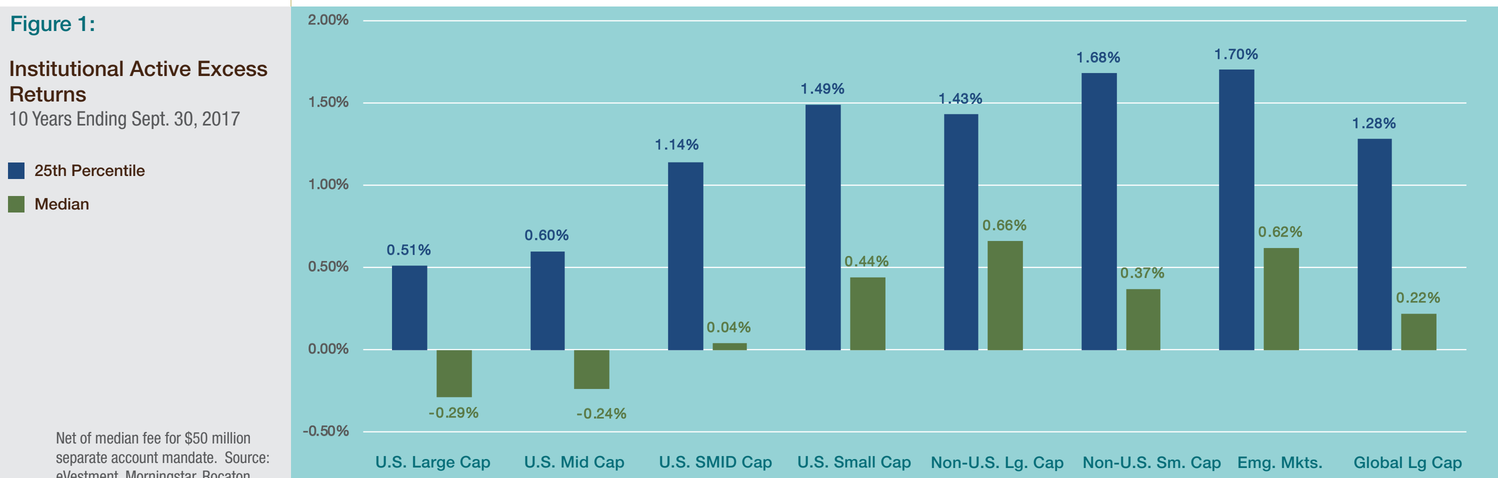
Consistent with the desire to capture an unconstrained opportunity set at the manager and equity program level, we suggest the optimal benchmark for a public equity allocation in client investment programs is the MSCI ACWI IMI Index. The IMI ("Investable Market Capitalization Index") version of the MSCI ACWI Index covers all investable large-, mid-, and small capitalization securities across developed and emerging markets. Per MSCI, the Index targets approximately 99% of each market's free-float adjusted market capitalization and has a structural (not tactical) allocation to smaller capitalization companies. For portfolios structured to access the full market, usage of the all-capitalization IMI Index may also reduce the potential for misfit risk between the portfolio and benchmark.

The importance of diversification

While we emphasize the importance of an all-capitalization opportunity set, we also recognize that the cycle of market performance across classifications of size, region, and style varies greatly in length, frequency, and amplitude. Academia has proven exhaustively that timing exposure to certain factors is in fact very difficult given the inconsistency of factor leadership over time. By balancing style instead of tilting the portfolio, Rocaton feels that investors can potentially minimize systematic risks versus an index. Moreover, in addition to the difficulties associated with timing factors, managing active portfolio tilts may be challenging for investors from a staffing or governance perspective. Generally, awareness of portfolio factor imbalances in any given portfolio is always advisable. We encourage investors to be aware of explicit or implicit (i.e. manager-level) exposures in their overall allocation to equities.

Figure 1:

Institutional Active Excess Returns
10 Years Ending Sept. 30, 2017



Net of median fee for $50 million separate account mandate. Source: eVestment, Morningstar, Rocaton.

Prudent use of active risk[1]

Core to the foundation of Rocaton's equity investment philosophy is prudent use of active risk within an equity program. In prior work[2], Rocaton has underscored that active management, especially in public equities, remains a zero-sum game. That is, for every dollar-weighted positive excess return, there must be a corresponding dollar-weighted negative excess return[3]. Given the difficulty of identifying skilled managers, which requires a thorough and patient process, we want to focus efforts on those categories within active equity management that seem to provide better opportunities for skilled institutional active managers to generate alpha over time.

Our study of the public equity marketplace suggests that over the longer term, skilled institutional managers (as measured by the top quartile of active institutional equity managers in the eVestment database) have historically added value relative to a benchmark in several key areas, namely global large capitalization equity, non-US large capitalization equity, regional small capitalization equity (U.S. and non-U.S.), and emerging markets equity. Each of these regions has historically shown larger spreads between the top quartile and median quartile of managers (a measure of the potential for

[1] Tolerance of active risk, or tracking error, may differ across investors. Clients should consider how much active risk to take and where to take it, "active risk budgeting", across their equity structure, and perhaps across their aggregate portfolio.

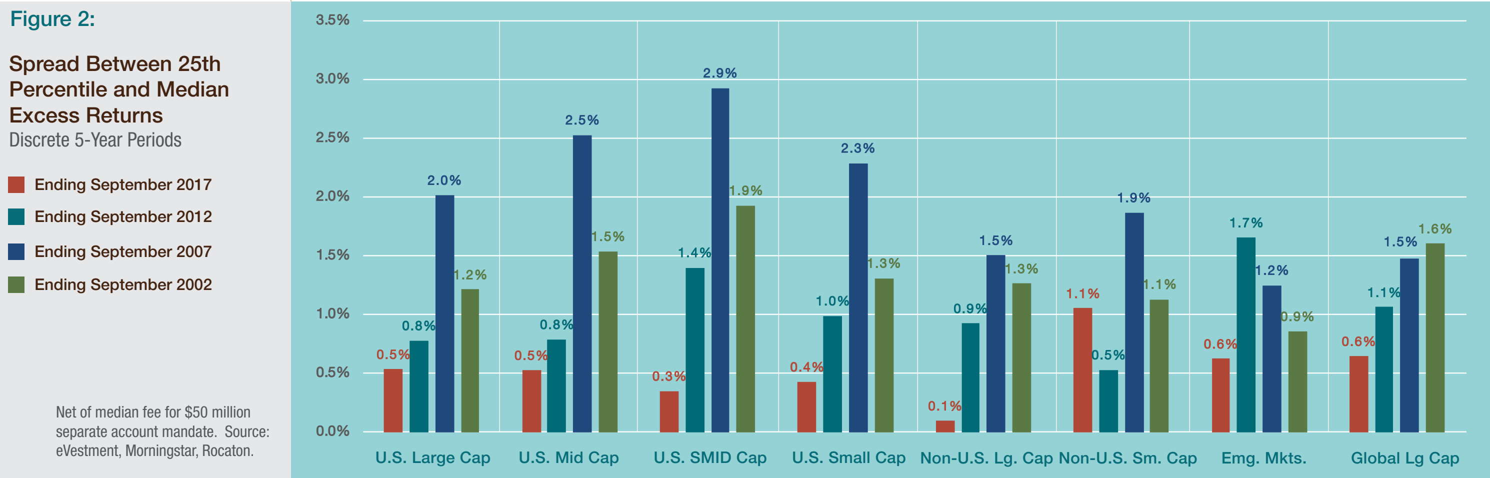
[2] See *Rocaton Insights - Active Management Philosophy & Implementation*, May 2017.

[3] Sharpe, William F. (1991), "The arithmetic of active management." Financial Analysts Journal.

skilled managers to add value). Inefficient flows of information, structural considerations, and poorly constructed benchmarks may be some of the factors that contribute to a region's level of inefficiency, and we explore this in further detail in subsequent sections of this paper.

Figure 2:

Spread Between 25th Percentile and Median Excess Returns
Discrete 5-Year Periods



Net of median fee for $50 million separate account mandate. Source: eVestment, Morningstar, Rocaton.

Passive investment in U.S. large capitalization equity

Rocaton recognizes that for many investors, active management in the U.S. large capitalization equity arena may be a critical component of an investment program. However, over longer term rolling periods, while there is potential for skilled managers to add value, alpha generation has been more challenging and inconsistent in U.S. large capitalization markets than in other categories. Figures 1 and 2 highlight how difficult it has been for U.S. large capitalization equity managers, even in the top quartile, to add value net of fees relative to their respective benchmarks[4]. Additionally, the spread between the top and bottom quartile is also much smaller relative to other parts of the global market, suggesting greater efficiency of the market. In many cases, we therefore suggest a passive allocation in U.S. large capitalization public equities as the default option. Given the episodic nature of performance in the space, investors with an allocation to active U.S. large capitalization equities should employ a level of patience, skill in manager selection, and adherence to a rebalancing policy (characteristics that we would argue are germane to the maintenance of any active equity program).

Why active global large capitalization equity?

Rocaton continues to encourage the use of active global large capitalization equities in client portfolios. Regular studies of the financial landscape show that global markets continue to converge from a revenue standpoint. With continued integration of world markets, companies across different size segments are increasingly exposed to economic activity beyond their domestic borders. Therefore, we suggest not only that the distinction between U.S. and non-U.S. large capitalization regional portfolios is becoming increasingly arbitrary, but that maintenance of separate U.S. and non-U.S. strategies may achieve a suboptimal global result.

[4] Rocaton's philosophy reflects active management in key targeted areas, but we also recognize that there may be some investors who wish to increase passive exposure in their portfolio beyond what we have proposed herein. The spectrum of efficiency across different areas of the market does provide a roadmap for passive implementation beyond U.S. large capitalization equity. If investors seek to implement additional exposure to passive strategies, we would recommend a targeted reduction in certain areas, as opposed to a broad-brush approach. For example, the developed international large capitalization equity space is the next most efficient market on the spectrum after U.S. large capitalization equity.

The opportunity set for an active global large capitalization equity manager is intuitively appealing. By virtue of no regional restriction, global managers have greater degrees of freedom with which to deploy capital and can search for winners in any region. For example, an active non-U.S. manager seeking the most attractive automotive company is likely beholden to buy names domiciled in the non-U.S. universe, whereas an active global large capitalization manager has the flexibility to choose the most attractive automotive company in any market. Though we admittedly espouse passive investment in U.S. large capitalization equity as a standalone structural allocation, a global large capitalization equity manager's ability to opportunistically invest in U.S. names has intuitive appeal.

From a relative performance standpoint, excess returns from active global large capitalization equity managers have exceeded those of a proxy 50% active U.S. large capitalization/50% active non-U.S. large capitalization equity allocation over longer time periods. Studies conducted by Rocaton's Asset Allocation team further demonstrate that from a beta perspective, there is little difference between U.S. and non-U.S. portfolios and global portfolios (from a risk and expected return standpoint), which supports the global view. Finally, in addition to achieving a broader opportunity set, active investment in global large capitalization equities may also result in reduced administrative overhead and less complexity as separate U.S. or non-U.S. line items are eliminated.

An alternative to global large capitalization equity

We recognize that implementation of an active global equity mandate may not be suitable for some investors. For those who cannot or choose not to implement a global manager, or who are concerned with unintended regional bets, an allocation to active non-U.S. large capitalization equity combined with a passive allocation to U.S. large capitalization equity is consistent with prudent use of active risk and simultaneously allows investors flexibility to express tactical regional views (i.e., control regional misfit risk introduced through active management)[5]. Depending on whether a portfolio contains residual regional bets (due to manager exposures), tactical investors might re-weight their allocation to non-U.S. large capitalization equities or their allocation to a passive U.S. large capitalization index, to neutralize the regional disparity. As a best practice, we recommend that investors annually review their broader equity portfolios for style, size, and regional misfit on both a strategy and equity program level.

Why active regional (U.S. and Non-U.S.) small capitalization equity?

Unlike the recommended approach in large capitalization equity, the employment of a "global" view further down the capitalization spectrum may lead to missed opportunities in smaller companies; as such, we prefer a regional construct across smaller capitalization categories. Smaller capitalization companies often compete regionally, and revenues tend to be more locally driven, perhaps providing some insulation from macroeconomic influences that are more pervasive in large capitalization markets. There is greater breadth of and less analyst coverage of the investable universe in smaller

[5] Many of Rocaton's highest conviction active global large cap equity managers evaluate securities from a bottom-up perspective. Country or region allocation, especially relative to a global benchmark, are often a residual of the investment process. For example, more recently, as rallying U.S. equity markets have continued to stretch domestic valuations, active global large cap equity managers have rotated out of U.S. securities to more attractive names in non-U.S. regions. The resultant underweight to U.S. large cap equities in global portfolios is therefore not a function of top-down view on the U.S. market, but its presence has overshadowed stock selection and ultimately may have detracted from active global large cap equity performance results.

capitalization firms, which contributes to the overall inefficiency of the space[6]. Stock selection, therefore, can be especially valuable within these markets.

Notably, the performance of regional U.S. and non-U.S. small capitalization managers has been quite good. In both cases, the top quartile of active equity managers has not only added positive excess returns relative to their indexes over medium and longer-term rolling time periods, but have also demonstrated consistency of outperformance relative to global small capitalization strategies and global large capitalization equity strategies. Fama and French proved that investors were compensated for taking on additional risk unique to smaller companies (such as elevated company-specific risk, or financing risk due to fewer funding options) and we continue to believe in the higher risk premium associated with smaller capitalization companies[7]. Additionally, the structural inefficiencies within smaller capitalization markets suggest that not only can security selection be rewarded, but that active equity allocations in U.S. and non-U.S. small capitalization mandates may aid in overall portfolio diversification and enhancement of risk-adjusted returns within a broader portfolio.

Why direct, strategic, active emerging markets equity?

Before considering an investment in emerging market equities, Rocaton feels that investors must maintain an appropriately long time horizon and tolerance for volatility. To the extent that investors have such a mindset, we then believe that investment in a direct manner in emerging market equities is optimal. We recognize that most investors already have indirect exposure to emerging markets through investment in global multinational companies. However, a direct emerging markets equity allocation offers several distinct advantages. Active emerging markets equity managers can be selective within the full opportunity set of thousands of emerging markets firms, whereas global or non-U.S. managers with emerging markets equity exposure typically invest primarily in "blue-chip" emerging markets companies that are often subject to global drivers (a much more limited opportunity set - of the many thousands of publicly-traded emerging markets companies, the ACWI IMI Index includes fewer than one thousand). We appreciate that for varying reasons, it may not be optimal or appropriate for some investors to invest directly in emerging markets. For these investors, Rocaton would recommend remaining active in emerging markets equity by achieving exposure through indirect global (ACWI) or non-U.S. (ACWI ex US) equity mandates.

For investors invested directly in emerging markets, we recommend a strategic, not tactical, implementation because timing emerging markets cycles (or further, the "bottom" in emerging markets) is difficult. Recent work by Morgan Stanley, for example, tracks the performance of $10,000 invested between 1988 and December 2017. If the investor did not participate in the ten best performance months in emerging markets, returns would have been a quarter of what they were if the investor was fully invested over the entire period. For some investors, valuation discrepancies in the asset class can provide interim opportunities to add to or trim strategic allocations.

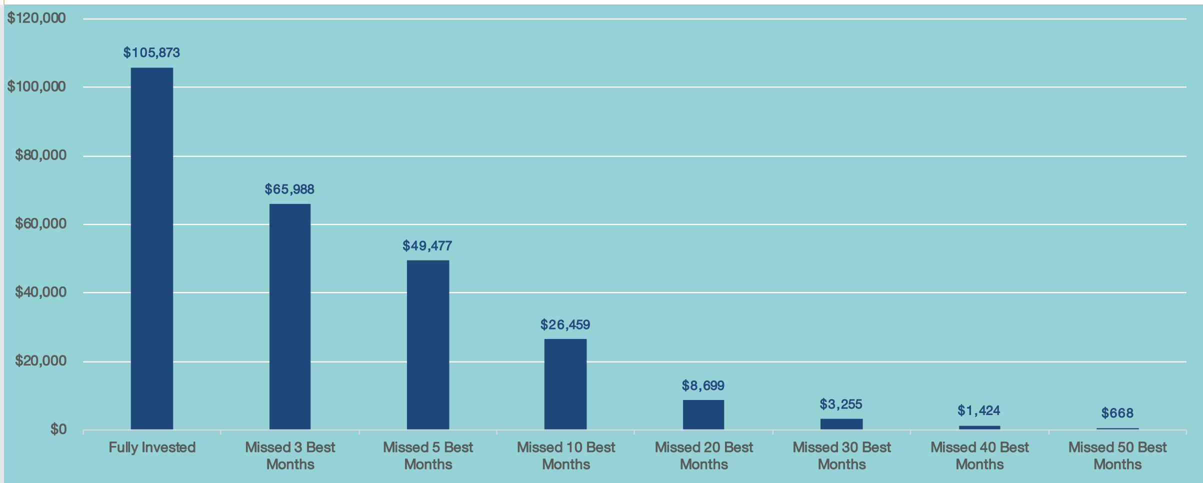
[6] Based on over 5000 companies with a minimum market capitalization of $100 million. Companies larger than $10 billion in market capitalization have between 20-25 analysts issuing estimates, versus 10-15 analysts for companies in the $1-10 billion range, and less than five analysts for companies less that $500 million in capitalization. Source: Bloomberg.

[7] Fama, E., and K. French, "The Cross-Section of Expected Stock Returns," Journal of Finance, 1992.

Figure 3:

Returns of MSCI Emerging Markets

Performance of $10,000 investment between January 1998 and December 2017



Source: FactSet, MSIM EM Research. As of December 2017. For illustrative purposes only.

Lastly, regardless of direct or indirect implementation, there are several key advantages to an active allocation to emerging markets. Flawed benchmark construction and inefficient information flow, capital controls, and dispersion across sectors create a robust opportunity set for skilled active managers to add value. Selectivity within emerging markets is, in fact, a pivotal component of an active manager's potential to generate value versus a benchmark; active managers may be able to reduce risk by avoiding unattractive countries and companies held by the Index. State-owned enterprises comprise over 35% of the MSCI Emerging Markets Equity Index, and the top four countries (of the 23 included) in the Index comprise over 60% of the total Index weight. The dispersion of country returns can be a meaningful source of potential alpha for active managers in emerging markets – the spread between the best and worst performing emerging markets countries has been significantly higher than the comparable dispersion in developed markets. Further, active emerging market equity managers can re-position the portfolio for future growth before changes (driven by market performance) are reflected in the Index.

Active emerging market equity manager performance relative to a benchmark has been very strong, with most managers performing above the Index in trailing three-year periods. Despite the recent market strength, our asset allocation framework continues to demonstrate that emerging markets equities have the potential to provide a broader public equity allocation with 1) long-term returns above developed markets and 2) diversification by geography across the capitalization spectrum. For investors with the appropriate governance structure and size of plan, consideration of the broadest opportunity set (all-capitalization or smaller capitalization mandates) in emerging markets equities may be warranted.

Conclusion

In summary, Rocaton believes that a well-structured public equity program will continue to play an important role in investors' abilities to meet long-term objectives. Prudent use of active management is the cornerstone of our philosophy, applied optimally across the most inefficient areas of the public equity market landscape. We fully acknowledge that for some investors, practical considerations or the ability to implement some or all of our views will vary based on specific client type, program structure, program objective,

[8] Source: Factset. MSCI, Rocaton.

and preferences. Above all, Rocaton remains focused on creating customized solutions across our client base. As investors continue to review their broader allocation to public equities, Rocaton would welcome more targeted discussions on how to best adapt our equity investment philosophy to your specific program.

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