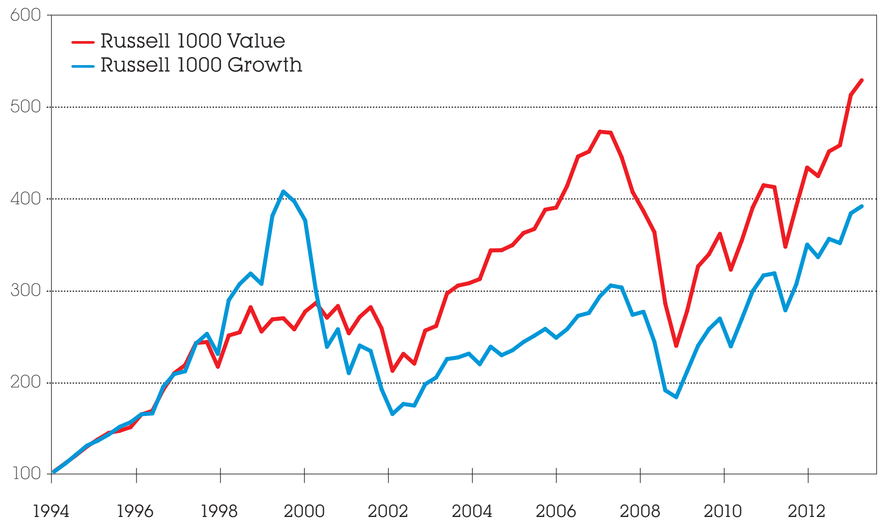
Powers of Concentration

Three managers are applying focused portfolios with high active shares to beat the notoriously difficult Russell 1000

The work of running multi-million-dollar portfolios in high-speed markets is always challenging, and especially so for managers who follow the style of large-cap U.S. growth equity. Part of the difficulty is in the system of measurement: The Russell 1000 Growth Index, the primary standard against which large-cap growth results are evaluated, is not based on the growth in revenues or profits of the constituent companies but, rather, the valuation of their shares. As the companies with the highest market values are granted the greatest weights, accordingly, the return of the index will reflect whatever fads, fashions and curious valuations drive the prices of the largest stocks. And those, at times, may not represent the broad growth-stock universe.

For reasons of index construction, among others, delivering performance that beats the Russell 1000 Growth Index has eluded many managers. For instance, for the periods ended in June, the return of the benchmark, which might reasonably be expected to fall somewhere in the middle of the distribution of managers' returns, ranked far higher—in the 29th percentile for three years and the 36th for five years (the returns of the Russell 1000 Growth and Value Indexes are illustrated in Figure 1). "Four years ago, the Russell 1000 Growth Index was in the 10th percentile, something I had never seen in 20 years in the industry," recalls Peter Bourbeau, portfolio manager at ClearBridge Investments in New York: "It has been a tougher benchmark to beat."

Figure 1. Returns of the Russell 1000 Growth and Russell 1000 Value Indexes, December 1994 – June 2013 (Rebased to 100 at December 1994)



Source: eVestment

This article profiles three managers of large-cap U.S. growth equity that have stayed true to their discipline of growth, building concentrated portfolios with high "active shares"—the proportion of holdings that differs from the benchmark, according to a paper by Cremers and Petajisto, "How Active Is Your Fund Manager?"—and earning some of the best returns in the business. All returns and rankings are drawn from the manager database of eVestment, of Marietta, Georgia.

1) Peter Bourbeau, ClearBridge Investments

For ClearBridge Investments, a unit of Legg Mason Inc., the key to stock selection for the ClearBridge Large Cap Growth strategy is revenues, says portfolio manager Peter Bourbeau. "Earnings growth by definition is flawed—a company can skew its underlying profitability with cost takeouts and share buybacks, but they can't fudge the top line. Revenue growth gives companies a lot of operating flexibility, and growth in revenues and rising incremental profit margins are the two hallmarks we stress for companies in the portfolio."

Decisions for the $6.2 billion portfolio are made by Bourbeau and Margaret Vitrano, who was promoted to portfolio manager in October 2012 after a long tenure with ClearBridge as an analyst of consumer and technology stocks. They draw many of their ideas from the firm's 20 research analysts: "I'm a generalist and could not do half as much without that team," says Bourbeau. For the three and five years ended in June, the strategy posted annualized returns of 20.58% and 10.38%, respectively, earning 1.90% and 2.91% above the Russell 1000 Growth Index and ranking in the 7th and 15th percentiles among large-cap growth managers.

The strategy is limited to just 50 positions, with a goal of concentrating 30% of assets in the top 10, to provide clients with what Bourbeau calls "an active experience." He says the portfolio's active share is about 70%: "The more a portfolio looks like the benchmark, the less likely it is to outperform, so we buy stocks outside the benchmark and consider carefully the weightings of the benchmark names." Annual turnover averages below 20%.

"We also take pride in our ability to avoid 'thesis creep,'" Bourbeau adds. "Situations where the underlying story—the original reasons for buying the stock—is quietly changing can be deadly to growth investors."

2) Peter Kwiatkowski, Fifth Third Asset Management

For Peter Kwiatkowski, director of growth and income strategies at Fifth Third Asset Management Inc. in Cincinnati, the hallmark of superior growth stocks is their dividends. The firm's $863 million Dividend Growth Above Market Yield strategy delivered annualized returns of 20.81% and 8.44%, respectively, for the three and five years ended in June, outperforming the Russell 1000 Growth Index by 2.36% and 1.43%, and ranking in the 5th and 18th percentiles for those periods.

While yields make an important contribution to returns, Kwiatkowski contends that dividends are an essential indicator of quality: "We look for companies that can support growing their dividends quickly, as that's a signal of a strong balance sheet and management's confidence in a company's prospects." The portfolio also holds up to 20% of assets in stocks that fall outside the dividend limits, given that they show revenue growth better than twice that of their sector. Portfolio holdings number from 45 to 65, but Kwiatkowsi prefers to keep to the lower bound. The recent active share of the portfolio has been 67%.

The firm's tenets of stock selection are fundamental research and valuation, plus attention to stocks' technical pictures. "We've put an emphasis on relative strength to be sure we don't stick with companies that we like but are chronic underperformers," he says. In looking for new candidates, Fifth Third turns up names through quantitative screens, as well as through what Kwiatkowski calls the "circle of life." "There are stocks that you like and own for a while and sell when they peak out. We stay close to those companies, looking for those times that the dynamics are shifting enough to make them a good buy [again] but when the market isn't yet giving them enough credit in the share price."

> "Four years ago, the Russell 1000 Growth Index was in the 10th percentile, something I had never seen in 20 years in the industry."

3) Aziz Hamzaogullari, Loomis, Sayles & Co.

"Growth in profits by itself is not sufficient for our investing style," declares Aziz Hamzaogullari, portfolio manager of the $6.5 billion Large Cap Growth strategy of Boston-based Loomis, Sayles & Co. Instead, the analytical starting point is companies' quality, defined as the difficulty competitors or new entrants would face in creating the business for themselves. "Only a very few companies really are able to defend their turf," he observes. The portfolio returned 19.99% and 11.90% annualized for the three and five years, respectively, ended this June, and generated 1.31% and 4.43% above the Russell 1000 Growth benchmark. Those returns earned 11th and 2nd percentile rankings among growth manager peers. The strategy's active share over the past three years has run at 82%.

"Once we find high-quality companies, we focus on their growth and whether it is profitable," says Hamzaogullari. "Several years ago we looked at solar energy companies, and while we thought the sector would grow, it seemed the product could be replicated by anyone, so we didn't invest in them." The third hurdle is sustainability of growth, which requires that companies address very large markets but have very low rates of penetration. He cites Visa, which, in spite of recent rapid growth, has just a small share of the trillions of dollars in global consumer and business purchases.

The Loomis, Sayles Large Cap Growth portfolio is concentrated, holding 30 to 40 positions, and the long-term view results in low turnover. "In 2008, our turnover was the highest ever, at about 40%. But two years ago, we invested in only two new companies and last year, five. Our goal is to be boring," Hamzaogullari explains. "About half of the portfolio is in the same stocks as it was at the inception of the strategy seven years ago." —*John Keefe*

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