An Asset Allocator's Guide to Multi-Strategy Equity Portfolios

Cameron Stoddard, CFA,
Vice President, Portfolio Manager, Institutional Asset Allocation

Nicole Lomax, CFA,
Vice President, Portfolio Manager, Institutional Asset Allocation

Jafer Naqvi, CFA,
Vice President and Director, Portfolio Manager, Institutional Asset Allocation

Equity strategy selection for institutional investors is an important process that can be time-consuming, both from an implementation and an on-going management perspective. A significant challenge that arises from this process is that it can steer investors towards focusing on each equity mandate in isolation when assessing its strengths. As an asset allocator, it is critical to recognize that all equity strategies have style biases and to focus on ensuring that the overall portfolio structure has the right set of style ingredients to weather any market environment. This gestalt approach recognizes that the whole is greater than the sum of its parts, provided those parts fit together. Finding and maintaining an optimal mix of styles within and across asset classes can be complex and time-consuming, but investors could potentially reap the benefits in reduced volatility and improved risk-adjusted returns.

To appreciate the importance of properly diversifying equity styles, consider the performance of Value and Growth investing over the long term. As **Figure 1** shows, these strategies have performed very differently in different market environments. Some market regimes can persist for decades, and being on the wrong side of a style trade can result in structural underperformance. Even during a secular regime, multi-quarter or multi-year periods of outperformance by other styles creates risk, as well as opportunities to add value by tactically pulling on different style levers.

Figure 1: A Historical Perspective on Value and Growth Investing

Source: Fama/French Data, accessed through the Kenneth R. French Data Library. As of April 30, 2022.

Every asset class, including fixed income and alternatives, has style biases, but the diversity and liquidity of the equity market mean that equities offer a particularly powerful set of tools for shifting a portfolio's underlying factor exposures.

Over the next several pages, we explore the merits of equity style diversification and provide a framework for implementing it on a strategic and tactical basis.

Styles and Factors: How Are They Related?

What is an equity "style"? Each style is shorthand for the constellation of factor biases common to that investing approach. Value and Growth are two of the best-known equity styles.

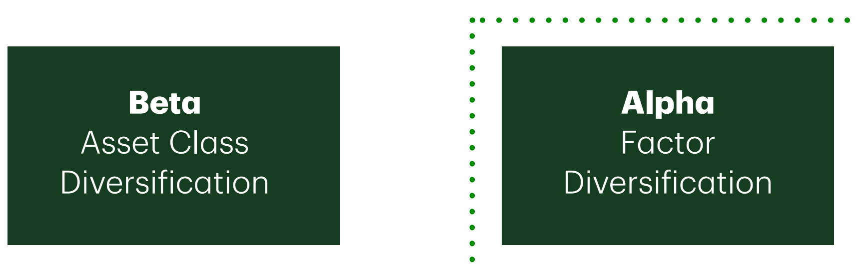
Figure 2: Integrating Equity Style Diversification to Maximize Portfolio Potential

- **Strategic Mix** informs the role that equities play in the portfolio
- **Fund Structure** aligns equity factors with portfolio objectives
- **Tactical Targets** position equity factors through different market environments
- **Rebalancing** optimizes buys and sells of equity factors

Strategic Asset Mix: Identifying the Role of Equities in a Portfolio

To realize the full benefits of equity style diversification, it must be integrated into every aspect of the portfolio management process. The first step is strategic design: establishing a portfolio's overall asset mix and the benchmark weights for each component asset class or equity style. The traditional approach to setting the strategic asset mix focuses on beta, or market exposure, which is a function of asset class diversification. Alpha, the value added (or lost) relative to the market, is driven by the second-order effects of equity strategy selection: what factor biases, intentional or not, exist in the portfolio? Choosing a strategy with a philosophy and process oriented towards Value investing, for instance, will add alpha when Value factors are in favour, but trail the market when Growth is in vogue, and vice versa.

Figure 3: Sources of Portfolio Returns



By diversifying styles within an equity allocation, investors can generate alpha across a wider range of market conditions. The correlation matrix shown in **Figure 4** plots three different equity styles and the correlation of their value-add (alpha) vs. the broad market. Negative correlation between styles means that in periods when one style is lagging the market, the other is likely outperforming. Having a mix of diverse styles reduces the risk of prolonged underperformance, should a given style be out of favour.

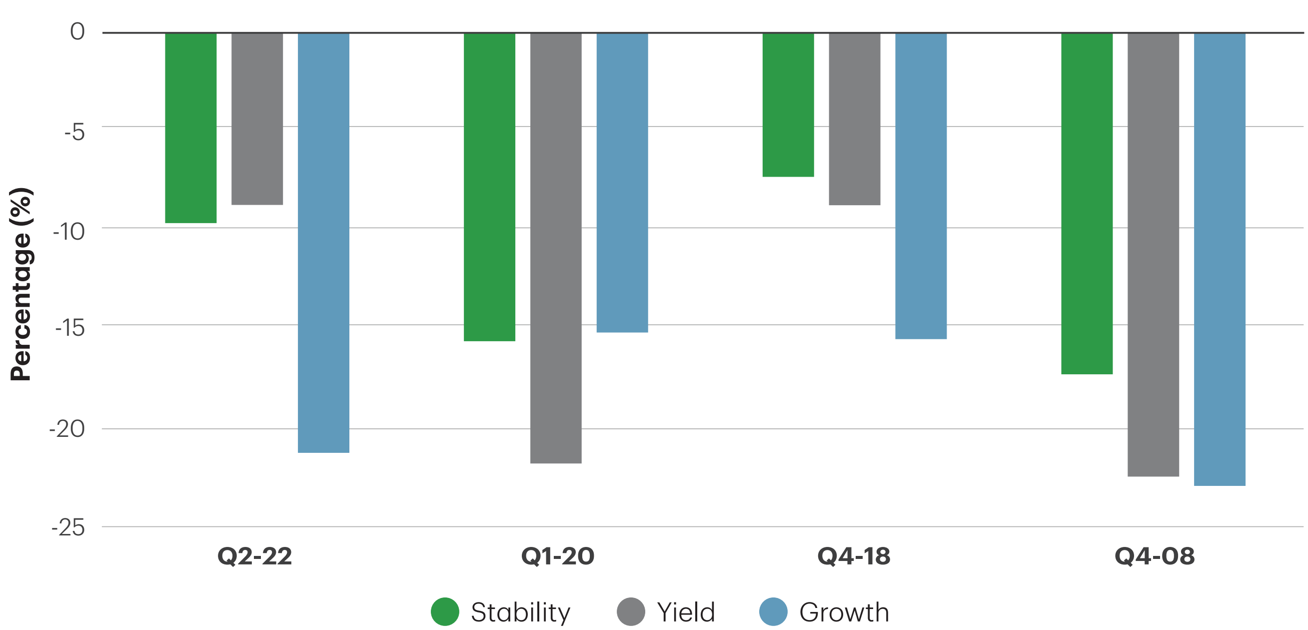
Figure 4: Correlation of Value-Add by Styles

	Stability	Yield	Growth
Stability	1.0	0.59	-0.22
Yield	–	1.0	-0.70
Growth	–	–	1.0

Correlation of monthly value add from Jul 1, 1999 to Jul 31, 2022 of MSCI World Minimum Volatility, MSCI World High Dividend, and MSCI World Growth vs. MSCI World. Source: Bloomberg Finance L.P. As of Jun 30, 2022.

The benefits of equity style diversification are especially evident in market downturns. While some equity styles are inherently more stable than others, every market sell-off is distinguished by a unique set of factors. As **Figure 5** shows, no one equity style consistently protected against negative returns in the last four major market drawdowns. Clearly, having more than one horse in the race is an advantage, especially for investors with cash flow needs or for whom capital preservation is an important objective.

Figure 5: Style Performance During Equity Market Downturns

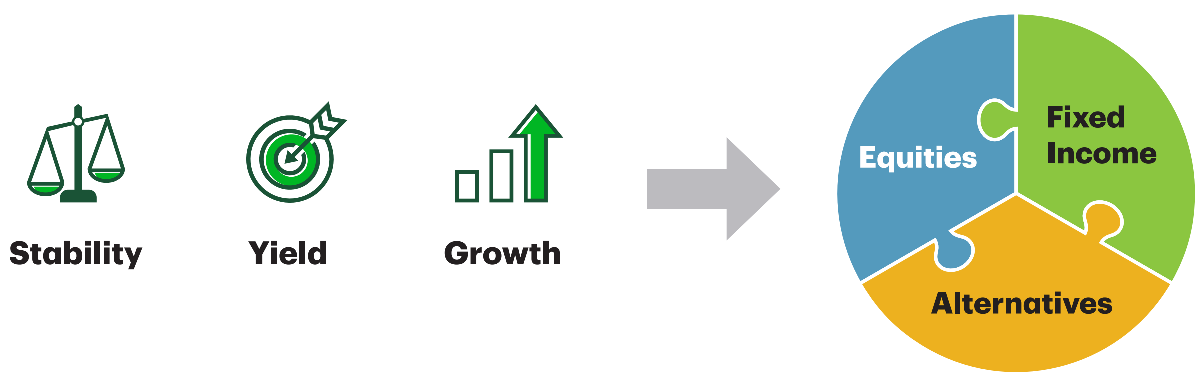


Footnote text: 3-month return of MSCI World Minimum Volatility, MSCI World High Dividend, and MSCI World Growth.
Source: Bloomberg Finance L.P. As of Jun 30, 2022.

Fund Structure:
Aligning Equity Factors with Portfolio Objectives

While the benefits of equity style diversification may be obvious, achieving the right mix of styles requires a nuanced approach and a deep understanding of a portfolio's overall factor exposures. For example, a portfolio with a high weighting in infrastructure and government bonds will already be tilted toward the factors that underlie stability-style equities strategies. In this instance, using equity strategies that focus on stability could unintentionally magnify that factor bias. Rather than producing the intended effect of reducing risk, diversification could be lost, leading to more risk at the portfolio level.

Figure 6: Which Factor Exposure Does Each Piece of Your Portfolio Contribute?



Investors often ask what the optimal mix of styles or factors is for their portfolio. There is no one answer. It is a function of each investor's objectives, understood in relation to factor exposures across the breadth of their portfolio. Typically, clients have multiple objectives, which are generally best addressed by having multiple strategies. The table below illustrates how a strategic approach to equity style mix, complemented by factor-based analysis, can help investors determine whether an allocation to a given set of factors is warranted in the context of their equity allocation, as well as their overall portfolio.

Figure 7: Style Biases Should Support Portfolio Objectives

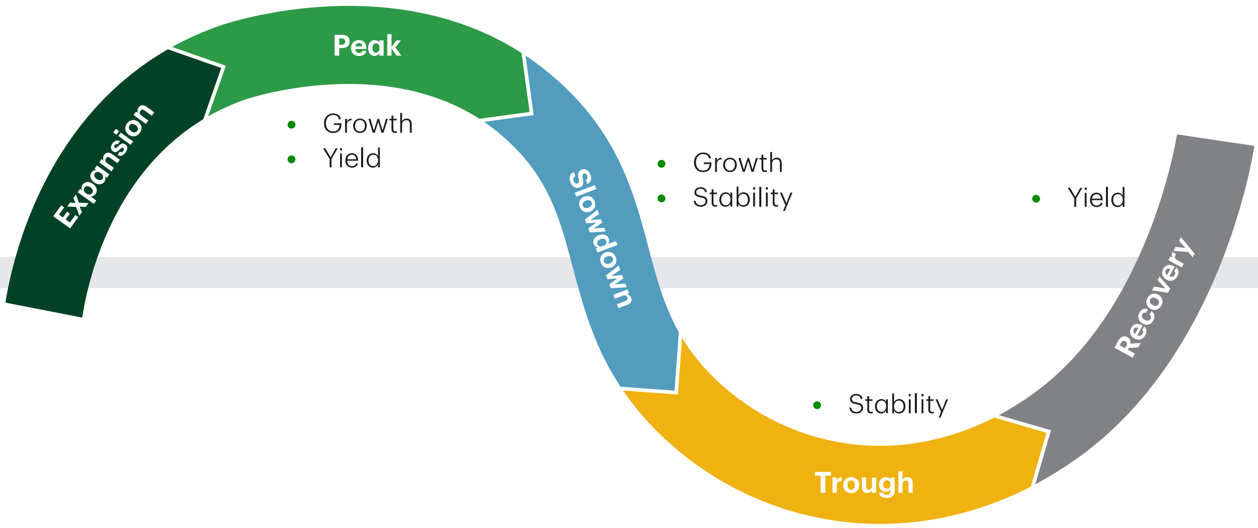
	Equity Factors		
Portfolio Objectives	**Growth**	**Yield**	**Stability**
I have a high equity weight		✔	✔
My income needs are high		✔	
I have material exposure to alternative assets	✔		
I am benchmark conscious	✔		
I am concerned about volatility		✔	✔
I seek higher returns	✔		

✔ = Asset Allocation Team Recommendation. Note: For illustrative purposes only. Source: TD Asset Management.

Tactical Targets: Positioning Equity Factors Through Different Market Environments

The preceding discussion has demonstrated how a strategic approach to equity style diversification can minimize unintended factor biases and deliver more consistent alpha. But investors can realize even more value-add by tactically managing equity styles – dynamically adjusting exposures to better position their portfolios as market conditions change.

Figure 8: Adding Value Through the Economic Cycle

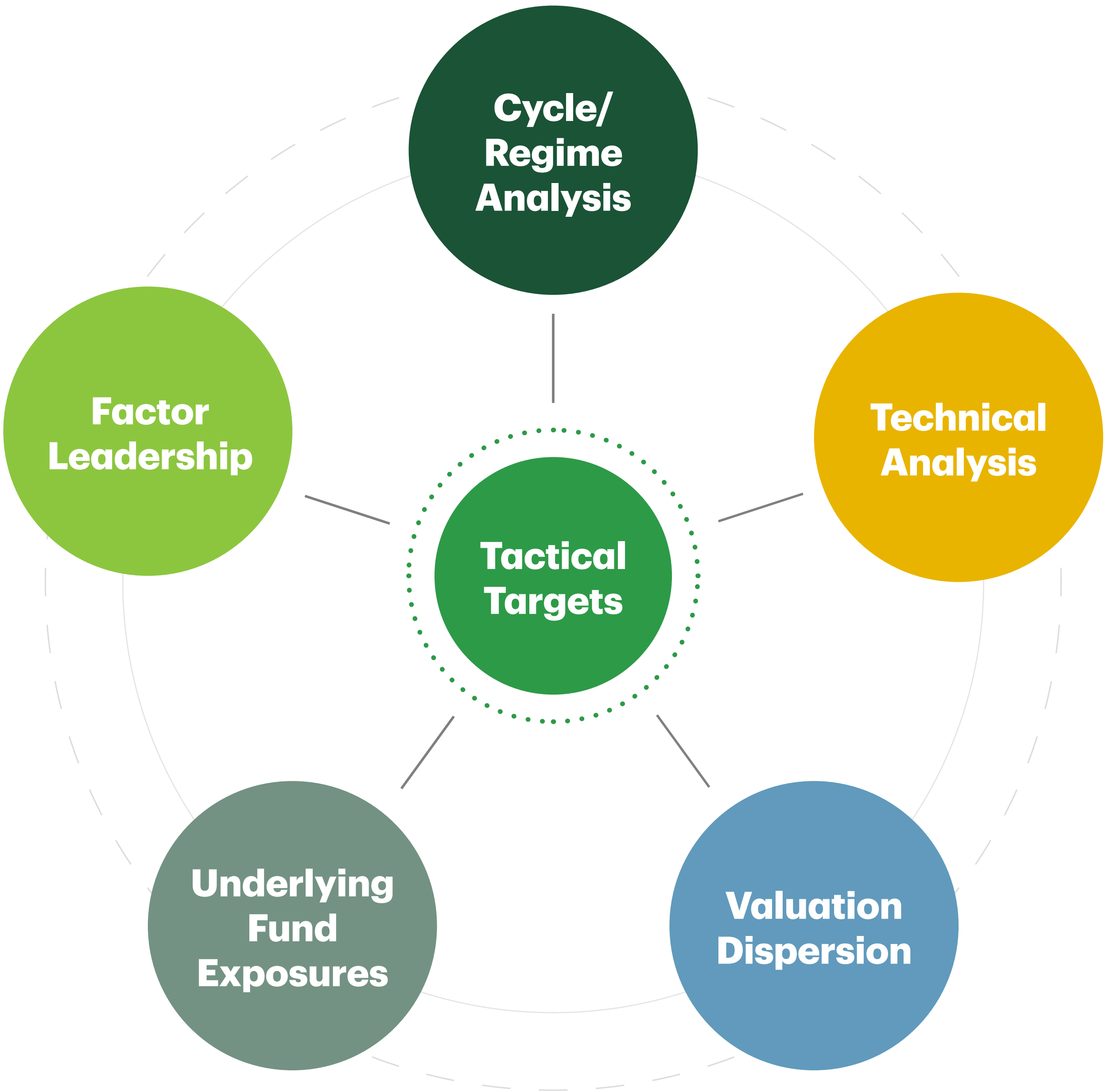


	Expansion	Peak	Slowdown	Trough	Recovery
Equities	++	+		-	++
Bonds	--	-		++	--

Note: For illustrative purposes only. Source: TD Asset Management.

Figure 8 provides a simplified view of a highly complex process. Tactical equity style allocation requires being able to identify the current point in the economic cycle, understand the attributes that make each cycle different from prior cycles, and recognize the factor exposures that are most favoured in the present environment.

Figure 9: How to Set Tactical Targets: A ‘Balance of Evidence’ Approach

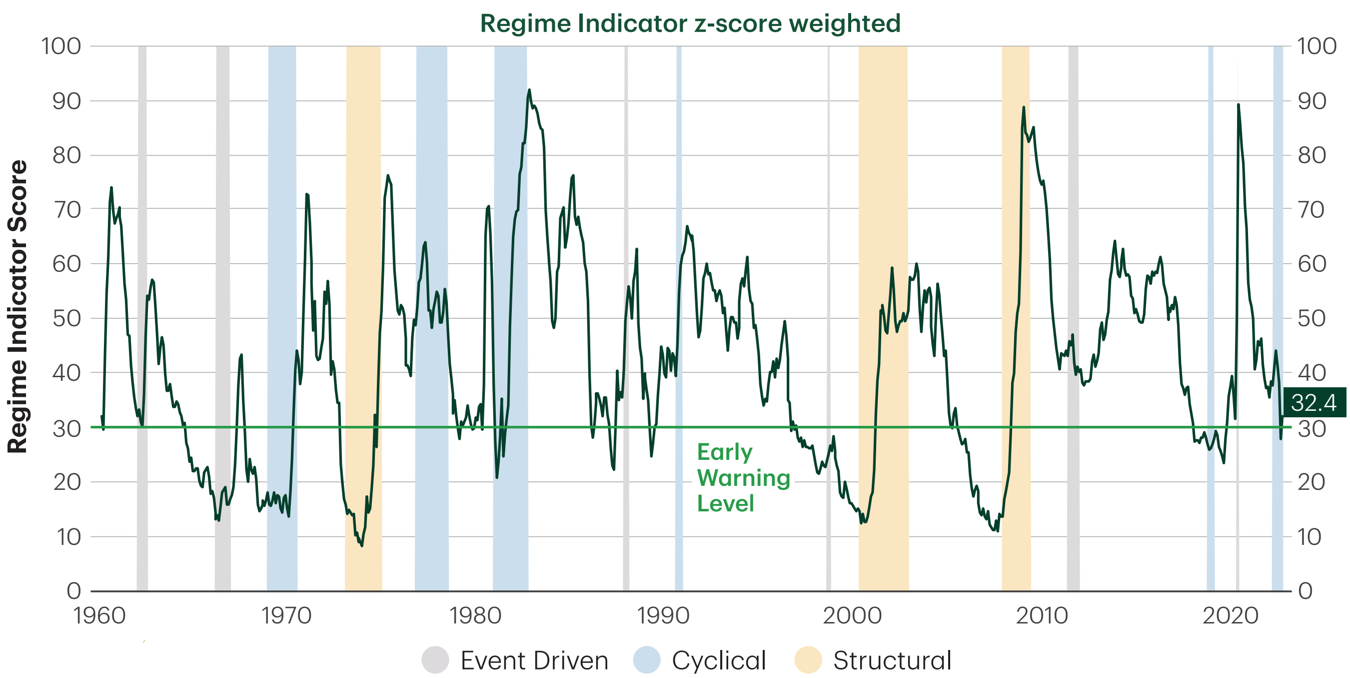


Setting Tactical Weights

Determining appropriate tactical weights for equity styles at different points in the cycle requires a ‘Balance of Evidence’ approach, supported by a wide range of inputs.

Identifying where the market is in the investment cycle is a critical first step. Is the market near a peak, meaning it may be time to reduce exposure to riskier growth stocks and rotate into more stable non-cyclicals? Or does the expansion have room to run? One way to make this determination is through regime analysis. The chart in **Figure 10** shows the output of TD Asset Management's proprietary regime indicator, which aggregates a cross-section of economic, market, and statistical measures to generate a regime score. A high score, nearer to 100, indicates that the underlying environment is more conducive to risk-taking. A low score, nearer to 0, indicates that the environment is less supportive for risk assets.

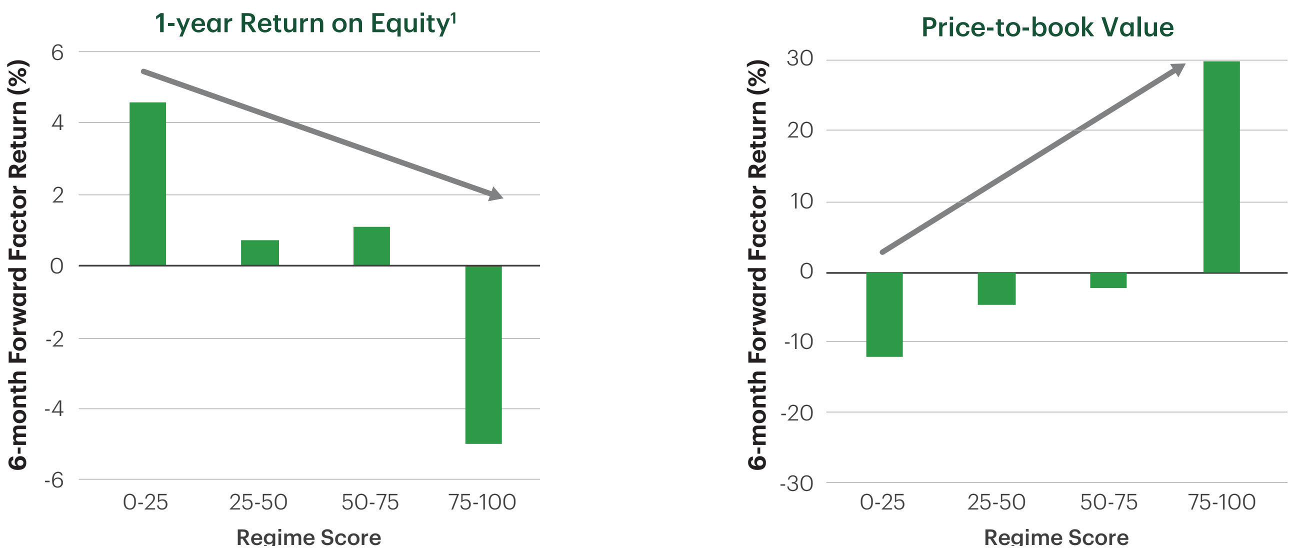
Figure 10: TDAM's Proprietary Market Regime Indicator



Note: The indicator is scaled from 0 to 100. The higher the more bullish, the lower the more bearish. Most of the previous bear markets are captured when this indicator is falling below 30. Source: Refinitiv Datastream, TD Asset Management. As of Aug 31, 2022.

Having identified the market regime, the next step is to determine which factors have performed best during similar regimes in the past. In **Figure 11**, we show how two factor exposures – 1-Year Return on Equity (aligns to a Growth style) and Price-to-Book Value (aligns to a Value style) – lead to diametrically opposite outcomes across different investment regimes.

Figure 11: Different Factors Outperform During Different Market Regimes



[1] The Return on Equity factor calculations make an adjustment to incorporate the level of debt in a company.
Source: TD Asset Management. As of Jul 22, 2022.

As part of TDAM's asset allocation process, we conduct this analysis for a wide range of factors to identify the leaders and laggards in various market regimes. **Figure 12** presents a subset of these results for a market regime with a score of 25-50, which is generally one where the cycle is showing signs of peaking and heading for a slowdown. Armed with this knowledge, skilled asset allocators can tactically adjust positions to add exposure to those equity factors most favoured in the current environment.

Figure 12: Factor Leaders and Laggards for a Regime Indicator of 25-50

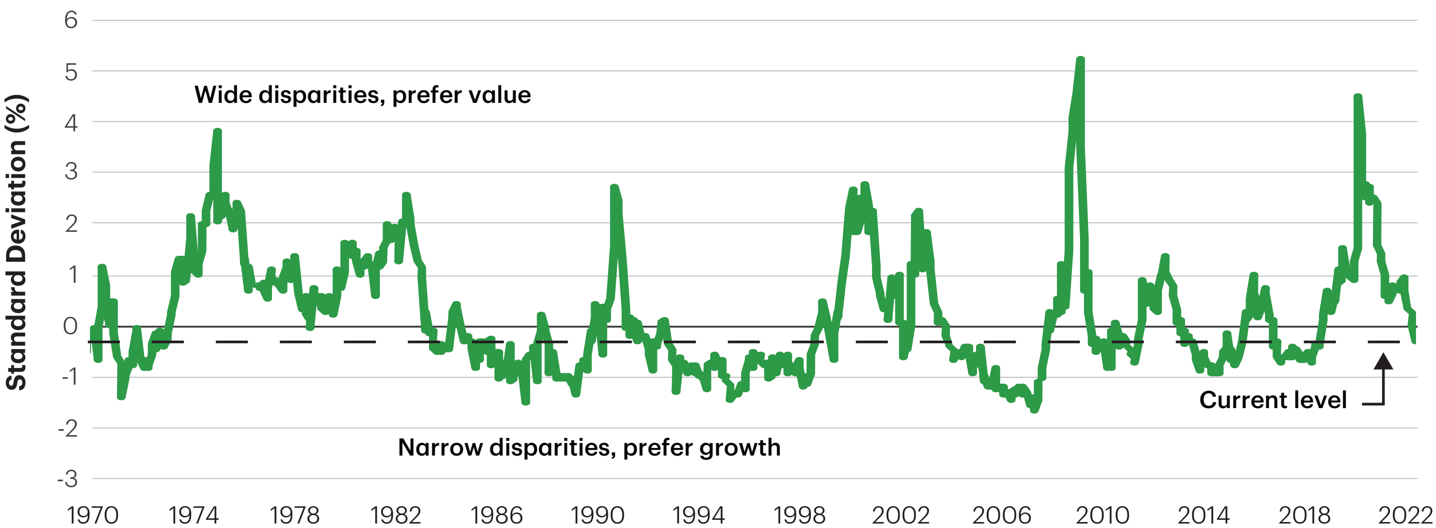
Leaders
Price return
Relative strength index
Free cash flow / EV
Return on assets
EPS estimate revisions
1-year return on equity
Projected 5-year EPS growth
Return on capital
Dividend growth
Share repurchase

Laggards
Price to book value
Price / cash flow
Price (high or low)
Estimate dispersion
EV / EBITDA
Dividend yield
Most active
Size
Beta
Price / sales

Note: Leaders and Laggards based on expected 6-month forward relative performance. EPS = Earnings Per Share, EV = Enterprise Value, EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization. Source: TD Asset Management.

Another useful input in a 'balance of evidence' approach is valuation dispersion. **Figure 13** provides an example for U.S. large cap stocks. The chart shows that when there is a large gap between the valuation of the top quintile of stocks (measured by their price/earnings ratio) and the market average, Value investing may be more in favour; conversely, a narrow gap augurs better for Growth. This makes intuitive sense if we think of valuation dispersion as the premium for earnings growth. When the premium paid for Growth is low, there is more opportunity for Growth to outperform.

Figure 13: Valuation Spreads for U.S. Large Cap Stocks



Note: Top quintile compared to the average. Source: National Bureau of Economic Research, Empirical Research Partners Analysis.
As of May 31, 2022.

Rebalancing: Optimizing Buys and Sells of Equity Factors

The final step in extracting value from equity style diversification is rebalancing back to targets or benchmarks. In TDAM's framework, this stage in the process offers its own opportunities to add value. Our research has revealed that the optimal cadence for rebalancing is different within a single asset class (i.e., rebalancing across equity styles) than between asset classes (i.e., rebalancing between bonds and equities). Our analysis shows that the outperformance (or underperformance) between equity styles and factors tends to persist for longer periods of time than do trends between asset classes. As a result, less frequent rebalancing has historically added value within an equity portfolio. This differs from rebalancing between asset classes, where more frequent rebalances tend to deliver better results. Active and thoughtful rebalancing can allow a portfolio to benefit from this persistence of outperformance between equity styles, while also optimizing rebalancing at the asset class level.

Bringing It All Together

Equity style diversification is a complex process, requiring a range of different solutions to choose from, detailed and timely insights into their factor profiles, and a disciplined asset allocation framework that can nimbly adjust portfolios to respond to shifts in the macro environment. The prerequisites are rigorous, but the payoff is meaningful. Properly implemented, equity style diversification has the potential to help investors build cohesive portfolios that are well-aligned with their objectives and that add value consistently over time.

TD Asset Management has been implementing total portfolio solutions for institutional investors for many years. Our investment professionals, including a 25+ strong Asset Allocation team, can draw on a broad suite of equity, fixed income, and alternative investments in constructing well-diversified portfolios that meet clients' risk and return objectives.

Connect with TD Asset Management