Vontobel

The Not So "Secret Sauce" of Portfolio Construction

Quality Growth Boutique

September 2020

Asset Management

David Souccar
Executive Director
Portfolio Manager
24 years in industry
13 years with Vontobel

Matthew Benkendorf
CIO Quality Growth
Portfolio Manager
23 years in industry
21 years with Vontobel

Igor Krutov
Executive Director
Director of Research
26 years in industry
18 years with Vontobel

Defining Our Principles of Portfolio Construction

A famous Michelin-star French chef once said that the perfect meal consists of just a few simple components: The main course, two independent sides and a sauce. Each ingredient must be the highest quality.

Portfolio construction is a little like gourmet cooking where quality ingredients stand on their own without the need for a lot of embellishments. Our view is that the perfect portfolio is concentrated in the highest conviction quality names, each sized to deliver relative outperformance with lower volatility than the market.

While we have published white papers on our stock selection process before, in this discussion we explain the fundamentals of our approach to portfolio construction. Before we delve into the details, let us first define what portfolio construction means to us:

Our starting point is the value proposition. To outperform the market over an economic cycle means to participate to a large extent in the upside and to limit the downside. Therefore, if we were to imagine a portfolio of a single name, it would consist of a stock with a predictable business model that both grows earnings at a faster rate than the market and has greater resilience to economic recessions.

The largest risk resides at the business level. We limit risk by seeking to invest in the right businesses; the investment process is at the core of portfolio construction. We believe we can add most of our value in stock selection by aiming to get the business model right, and the earnings growth trajectory reasonably accurate. By definition, forecasting is uncertain and we acknowledge that we are no smarter than the market. Yet a portfolio of quality companies helps put the odds of investment success in our favor.

We are aware of our limitations and understand that even with a quality approach and a careful due diligence process, sometimes the prince turns out to be a frog. We aim to build portfolios to minimize the risk of capital loss from lapses in human judgment. We do not build our portfolios with the purpose of hedging our mistakes; if we are not sure about an investment opportunity, we simply stay away.

On the other hand, a portfolio with too many names dilutes the return to our clients. We view a portfolio with too many names as a sign of sloppy thinking rather than informed focus. Our global portfolio typically holds between 30 and 60 names, and we constantly strive to be on the lower side of that range depending on the opportunity set and valuations. In our view, quality companies are rare; thus, a portfolio of fewer stocks can help deliver above average performance and help serve our clients better.

Portfolio construction is a tool to minimize idiosyncratic risk. The recent Covid-19 pandemic is a case in point. A concentrated portfolio of the very best companies in only the travel and leisure sectors, for instance, certainly would not have provided the downside protection that our clients should expect from us. We construct portfolios to allow for diversity among drivers of the underlying businesses we own. That way we can diversify within the quality space, rather than diversifying away from quality.

The error is in the tracking error. Tracking error is useful to measure how different a portfolio performs relative to its benchmark. This term, however, is misleading because the words tracking and error give the false impression that risk increases when portfolio allocations deviate from the benchmark. Remember though that the benchmark is merely a reference point and that the weight of its components are simply a reflection of market capitalization, i.e. a measure of size. It is not a weight or a measure reflecting any prediction of future return; in fact, tracking error is at best a backward-looking tool. Thus, so-called hugging or performance that looks similar to or tracks the benchmark does nothing, in our opinion, to enhance an investor's return prospects relative to that benchmark.

We build portfolios with our clients in mind, not to maximize assets under management. We measure success based on delivering outsized returns while simultaneously taking less risk, commensurate with our clients' expectations. We never aim to take unnecessary risks to reach for unrealistic returns to try to make us look smarter or to promote our business. We fully realize that, behind every dollar we have under management there is a hard-working individual who is relying on us to reach their financial goals. We take this responsibility quite seriously. And that means the true measure of our success is to deliver our clients to their investment destination, safely.

“The true measure of our success is to deliver our clients to their investment destination, safely.”

Embracing Simplicity in Building Portfolios

The heart of our portfolio construction approach is fairly simple: to maximize return and minimize risk. Leonardo da Vinci said that "simplicity is the ultimate sophistication," which applies to money management as well as to art. The graveyards of investment firms are full of managers who had all kinds of complex theories about how to invest money. Think Long-Term Capital Management. Our philosophy is not underpinned by fancy algorithms or celebrity managers. We use a team-oriented approach, and we operate within a common framework for how a stock fits in the portfolio. Portfolio construction is one of the more important pillars of our success.

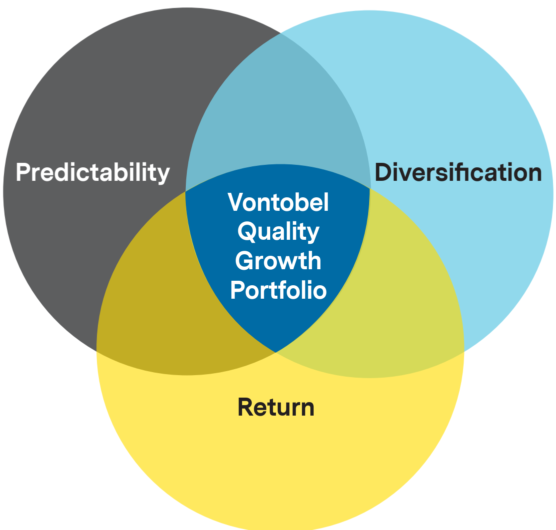
We strive to build portfolios that look favorable on the three characteristics that we think matter most. The first two variables relate to risk management, and the third to alpha generation:

1) Predictability of earnings;
2) Diversity of quality drivers; and
3) Rate of Return (Figure 2).

1. Predictability: We understand that quality and predictability are separate. We define predictability as our level of confidence in a company's long-term earnings trajectory. For instance, while it may be easier to forecast Nestlé's long-term earnings growth than the equipment-rental company Ashtead, both are currently quality businesses in our view. They both have well-defined sustainable competitive advantages and high returns on capital—critical elements of a quality business. However, these are two distinctly different business models and quality is defined accordingly: Nestlé owns dominant brands in consumer staples; Ashtead manages one of the largest networks of branches for equipment rentals in the US, and thus offers the best availability of equipment at competitive prices.

We measure predictability in different ways. We rank qualitatively each stock in the portfolio on a predictability rating from zero to ten. We avoid investing in stocks with predictability ratings below five and we aim to maintain an average predictability rating of seven or higher for the portfolio. We also look at historical standard deviation of earnings growth and stock prices, and maximum earnings downfall during the last decade.

Figure 1: Vontobel Quality Growth Portfolio



2. Diversity of Drivers: People are always surprised to be surprised. In just the last 20 years, we experienced the demise of the Internet bubble, a large-scale terrorism attack on US soil, two wars, a global financial collapse and a global health pandemic. Therefore, we need to incorporate the risk of unknowns in portfolio construction. While sometimes our research points to a sector with an overly rich pool of quality ideas (e.g., travel and leisure), it would be a mistake not to consider the excessive risk we would be potentially taking by putting too much capital into only these businesses with overlapping earnings growth drivers. When faced with a choice between two similar incremental investment opportunities, we will lean toward the one with a lower correlation to the rest of the portfolio. In addition to our fundamental assessment of the diversity of drivers, we also reference a quantitative risk model from Northfield, which we describe on page 8.

3. Rate of Return: The investment rate of return is an outcome of our profit forecast. For every stock in the portfolio, we forecast earnings growth and estimate future returns on equity. We then compare all of our holdings on a total return basis (earnings growth and free cash flow yield). While this may sound mechanical, the reality is that our assessment of the longevity of growth has a meaningful impact on the price we are willing to pay. While we are only forecasting out five years into the future, the growth sustainability beyond five years has a direct bearing on the terminal multiple we use. (Please refer to our paper *On Valuations* for more details on our valuation methodology).

Estimating the longevity of growth for a business is always a challenging exercise. There is no magic formula on which to rely. It's an effort that requires deep business and industry knowledge, as well as confidence, to translate how the future will (or will not) look like the past, and to what degree fortunes or fundamentals will change. In the end, looking into the future requires a combination of boldness and imagination. This is where the collective experience and collaboration of our team of analysts drives our consistency and success.

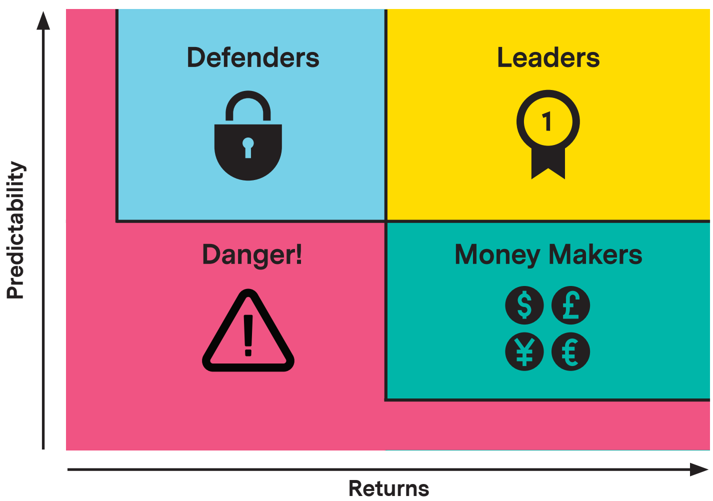
Sizing the position: With the three aforementioned inputs in hand, we have enough information to size our portfolio positions. As with many comparisons, we start with a baseline point of reference. For example, in a portfolio of 50 names, the average position will be close to 2%. Names that sit close to the theoretical average characteristic of the portfolio (predictability and return) are sized closer to the baseline.

In situations where our assessment of risk and return is materially different from what we believe the market is discounting, we will size stocks at a higher/lower position compared to the baseline. While we are comfortable having a view that differs from consensus, we protect ourselves against hubris with a rule that typically limits our maximum position sizing to 7%. Moreover, we would only allow the stock to grow to a 10% maximum position, and only in rare instances.

If we were to visualize the ideal portfolio, it is helpful to imagine it along two axis (Predictability vs. Return) as shown in Figure 2. We aim to maximize the weight of the portfolio in the top right segment, high predictability/high return, and to avoid the bottom left segment, low predictability/low return. The market is quite effective in valuing the high predictability stocks; which makes it difficult to construct an entire portfolio of names in the “Leaders” box. Therefore, to add stability, we look for names in the top left (“Defenders”). And, to add upside, we look for names in the bottom right (“Money Makers”). A picture of our portfolios today would show that most of the weight is in the “Leaders” category, followed by the “Defenders” and the “Money Makers.”

Portfolio management is a dynamic exercise. We are always active in buying and selling stocks because of valuations, a change in the investment thesis, or simply when we find a better alternative for our client’s capital. Over time, a stock could become more fairly valued and shift from the "Leaders" to the "Defenders" category, or even move out of the portfolio entirely if the valuation becomes too rich. Sometimes, a “Money Maker” proves to be more predictable than we assumed and it will shift to the “Leaders” category.

Figure 2: Optimizing Predictability and Returns



We are constantly searching the world for new ideas. This is a healthy exercise that not only expands our intellectual book value, but also prevents the portfolio from becoming stale. We are careful about introducing new names and we only invest after a thorough process of research and team debate. We increase the sizing of new names gradually until we have followed the company for a while, and along the way gain more conviction and proof in management’s consistent performance and strategy.

Quality Control – The Northfield Model: As we mentioned briefly above in the section on diversity of drivers, we use a quantitative, multi-factor risk model from Northfield to gauge the degree to which related risks accumulate at the portfolio level and identify potential unintended factor bets.

The quantitative model most often estimates lower risk for our portfolios than the respective benchmarks, a result one would expect since we tend to invest in companies with more predictable earnings streams and diversified earnings drivers. In rare cases, when the changes in the model’s risk predictions are not intuitive to us, we have further deliberations to make sure we catch the emergence of any unintended bets.

While a mechanical system that bases its forecasts on past volatility and correlation matrices has its limitations, we believe it is prudent to utilize any tool that has the ability to alert us to possible shifts in risk accumulation at the portfolio level. While Northfield as a quantitative model is not core to our portfolio construction decisions, it is a contributory tool in the process, and a valuable safety line against human fallibility.

In summary, our portfolio sizing framework helps us make better decisions not unlike a master chef who uses recipes as a guideline for melding flavors to create a tasty dish. We do not rely on the framework to spit out perfect answers. This would be a terrible mistake because ultimately, as we said above, investment risk always lies primarily and predominantly at the individual and aggregated business level of a portfolio. As long as computers cannot do our job as consistently well as we do (not yet at least), we will use our collective best judgment and invaluable experience to size individual positions and build portfolios. Good decisions will always depend on the quality of our people and the enduring culture of our firm.

So What is Our Secret Sauce?

The long lasting values that define our firm:

1. Clients First – Our clients' financial goals provide the motivation behind all our decisions. We do not take unnecessary risks to make headline news or to grow our assets under management.

2. Team Approach – Stock selection is at the heart of our process. Stock specific knowledge lies at the analyst level. We believe our success will come mostly from the quality of our security analysis and thorough research.

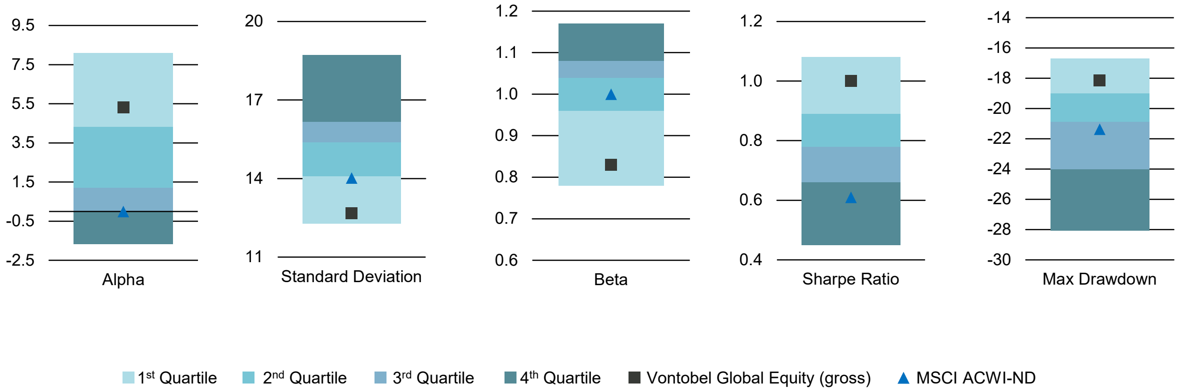
3. Disciplined Process – We have no illusions that our style will outperform the market every year. Outperforming over time does not mean outperforming all the time. Despite that, we will not deviate from the process to conform to consensus. This goes back to rule #1.

4. Humility – We are not smart enough to understand every business model in the world. If we cannot clearly define the competitive advantages, estimate the long-term earnings growth with some degree of confidence, have doubts about management's integrity or the business accounting, we will simply take a pass. We will never put our client's money at risk, even if only for a token position size.

Quality Growth Portfolio Construction at Work

Vontobel Global Equity Strategy – Higher returns with lower risk vs. peers and benchmark.

Vontobel Global Markets Equity (gross) vs eVestment peers (Global All Cap Growth Equity) 01.07.2010 to 30.06.2020



Source: eVestment, Vontobel as of 30.06.2020.
Past performance is no guide to future performance. Based on the Vontobel Global Markets Equity Composite. The composite's gross rates of return are presented before the deduction of investment management fees, other investment-related fees, and after the deduction of foreign withholding taxes, brokerage commissions and transaction costs. An investor's actual return will be reduced by investment advisory fees. Please refer to the end of this presentation for a table of the gross and net returns for this composite. Peer Group: eVestment Global All Cap Growth Equity. Benchmark: MSCI All Country World Index (net).

Global Markets Equity Composite Performance as of December 31, 2019

	TOTAL RETURN[1]			COMPOSITE CHARACTERISTICS AT END OF PERIOD				EXTERNAL STANDARD DEVIATION[3]		
PERIOD	GROSS OF FEE COMPOSITE	NET OF FEE COMPOSITE	BENCH-MARK[4]	# ACCTS	INTERNAL DISPERSION[2]	MARKET VALUE (US$ MILLION)	% FIRM ASSETS	GROSS OF FEE COMPOSITE	NET OF FEE COMPOSITE	BENCH-MARK[4]
2019	28.82%	28.33%	26.60%	20	0.37%	9,053	26%	10.33%	10.32%	11.22%
2018	-4.09%	-4.46%	-9.41%	22	0.31%	7,262	24%	10.22%	10.21%	10.48%
2017	30.18%	29.62%	23.97%	24	0.51%	8,630	22%	9.31%	9.30%	10.36%
2016	5.50%	5.00%	7.86%	27	0.25%	7,106	22%	10.31%	10.29%	11.06%
2015	5.50%	4.78%	-2.36%	29	0.38%	8,211	17%	10.97%	10.95%	10.79%
2014	8.16%	7.42%	4.16%	24	0.12%	7,006	15%	11.06%	11.06%	10.50%
2013	17.49%	16.51%	22.80%	11	0.67%	4,159	9%	12.29%	12.30%	13.94%
2012	20.67%	19.81%	16.13%	8	0.30%	2,019	6%	14.12%	14.13%	17.11%
2011	6.27%	5.00%	-7.35%	4	N/A	584	3%	14.95%	14.93%	20.35%
2010	17.85%	15.94%	11.76%	2	N/A	143	1%	19.02%	18.99%	23.72%

The composite's gross rates of return are presented before the deduction of investment management fees, other investment-related fees, and after the deduction of foreign withholding taxes, brokerage commissions and transaction costs. An investor's actual return will be reduced by investment advisory fees. The composite's net rates of return are presented after the deduction of investment management fees, brokerage commissions, transaction costs, other investment related fees and foreign withholding taxes. Results portrayed reflect the reinvestment of dividends and other earnings.

Performance Disclosure
Vontobel Asset Management, Inc. ("Vontobel") is an investment advisory firm registered with the Securities and Exchange Commission, under the Investment Advisers Act of 1940, as amended, and a subsidiary of Vontobel Holding AG, Zurich, Switzerland. For GIPS purposes, the firm is defined as all institutional accounts at Vontobel, excluding wrap accounts and private client assets managed in previous years. Vontobel claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Vontobel has been independently verified for the periods from January 1, 2001 through December 31, 2018. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The Global Markets Equity composite has been examined for the periods from January 1, 2001 through December 31, 2018. The verification and performance examination reports are available upon request.

The Global Markets Equity Composite includes all discretionary accounts that invest mainly in equity or equity-linked securities of issuers located in the developed and emerging markets in the United States, Europe, Asia and Latin America. This composite consists of accounts that are not required to be at least 75% hedged at all times, and these accounts can hold as many as 70 stocks at any given time. The minimum account size for this composite is $1 million.
The composite was created on May 3, 2004. The firm maintains a complete list and description of composites, which is available upon request.

The U.S. Dollar is the currency used to express performance. Policies for valuing portfolios, calculating performance and preparing compliant presentations are available upon request.

Since January 2011, results of the composite are shown compared to the MSCI All Country World Index (the "MSCI ACWI"), an unmanaged index of stocks traded in major world markets. The benchmark was changed to provide a closer representative comparison versus the composite. The benchmark is used for comparative purposes only and generally reflects the risk or investment style of the investments in the composite. The index is a free float-adjusted market capitalization index that is designed to measure global developed and emerging markets equity performance. It is a market-weighted aggregate of 49 individual country indexes that collectively represent major markets of the world. The index is calculated on a total return basis with net dividends reinvested. It reflects withholding taxes, but not fees and other investment expenses, and is expressed in U.S. Dollars. Investments made by Vontobel for the portfolios it manages according to respective strategies may differ significantly in terms of security holdings, industry weightings, and asset allocation from those of the MSCI ACWI. The index has not been examined by an independent verifier. Prior to January 2011, results of the composite were shown compared to the MSCI World Index, an unmanaged index of stocks traded in major developed markets.

Net composite performance is presented after the deduction of foreign withholding taxes. Capital gains, dividends and interest income received may be subject to withholding taxes imposed by the country of origin and such taxes may not be recoverable. Returns include the effect of foreign currency exchange rates. Returns are presented gross and net of management fees and include the reinvestment of all income. The gross rates of return are presented before the deduction of investment management fees and other investment-related fees, and after the deduction of foreign withholding taxes, brokerage commissions and transaction costs. The net rates of return are presented after the deduction of investment management fees, brokerage commissions, transaction costs, other investment-related fees, foreign withholding taxes and bundled fees. Such investment management fees are actual fees. Withholding tax rates for the indices are applicable to Luxembourg withholding companies. Our withholding taxes, as captured in the composites, may vary from those captured in the index. Effective January 2016, the net returns reflect daily accruing of fees based on each account's fee schedule. Prior to 2016, the net returns were calculated using actual fees recorded on a cash basis. Starting in 2014, the net rates of return are also reflective of performance fees. Prior to 2014, the net rates of return did not contain any performance-based fee components. Derivatives in the form of forward foreign currency contracts were used in managing client portfolios for opportunistic currency hedging until October 2011.

---

[1] Total returns are expressed in USD.
[2] The measure of internal dispersion presented is an asset-weighted standard deviation based on gross of fee returns, and is calculated if the composite contains greater than five portfolios for the full year.
[3] 3-year annualized standard deviation based on monthly returns.
[4] Since January 2011, results of the composite are compared to the MSCI All Country Word Index (Total Return Net Dividends). Prior to January 2011, results of the composite were compared to the MSCI World Index (Total Return Net Dividends).
Source: Vontobel

The standard annual management fees charged by Vontobel for the Composite are: 0.75% on the first $100 million, 0.65% over $100 million. Certain accounts may have higher management fees than the standard fee schedule. Investment advisory fees are further described in Part 2 of its Form ADV.

As of March 7, 2016, Mr. Matthew Benkendorf took over the management of the Vontobel Global Equity Strategy. There are no changes to the composite strategy as a result of the management change.

Past performance is not indicative of future results.

Disclaimer

The index comparisons in this commentary are provided for informational purposes only and should not be used as the basis for making an investment decision. Further, the performance of the composite and the Index may not be comparable. There are significant differences between the composite and the indices referenced, including, but not limited to, risk profile, liquidity, volatility and asset composition. Please note that an investor cannot invest directly in an index.
Investments discussed in the commentary are based on a representative portfolio and there is no assurance that Vontobel will make any investments with the same or similar characteristics as the representative portfolio presented. The representative portfolio is presented for discussion purposes only and is not a reliable indicator of the performance or investment profile of the composite. Further, the reader should not assume that any investments identified were or will be profitable or that any investment recommendations or that investment decisions we make in the future will be profitable.

Any projections contained in this commentary are based on a variety of estimates and assumptions. There can be no assurance that the assumptions made in connection with the projections will prove accurate, and actual results may differ materially. The inclusion of projections should not be regarded as an indication that Vontobel considers the projections to be a reliable prediction of future events and projections should not be relied upon as such.
This disclaimer applies to this commentary and the oral or written comments of any person presenting it.

There can be no assurance that investment objectives will be achieved. Clients must be prepared to bear risk of a total loss of their investment.

Due to a varying frequency of the fees being paid and associated compounding effects, the actual difference between gross and net returns may differ from the stated annual fee. For example, on an account with a 0.50% fee, continuous monthly gross performance of 1.50% and the fees being deducted monthly, the compounding effect will result in an annual gross return of 19.56% and a net return of 18.97%. Thus, a $10,000 initial investment would grow to approximately $14,295 gross of fees, versus $14,155 net of fees, over a two-year period. Effective January 2016, the net-of-fees rates of return are calculated based on the fee schedule. All net returns that were previously calculated on a cash basis are linked to the returns being calculated under the new methodology, reflecting daily accrual of fees. Vontobel's investment advisory fees are further described in Form ADV Part 2A.

Vontobel Asset Management, Inc. (Vontobel) is registered with the U.S. Securities and Exchange Commission as an investment adviser under the Investment Advisers Act of 1940, as amended, in the USA. Registration as an Investment Advisor with the U.S. Securities and Exchange Commission does not imply a certain level of skill or expertise. Vontobel is exempt from the requirements to hold an Australian Financial Services License under the Corporations Act in respect of the financial services it provides to Australian wholesale clients under ASIC Class Order CO 03/1100. Vontobel is regulated by the US Securities and Exchange Commission under US laws, which differ from Australian laws.

Vontobel Asset Management, Inc.
1540 Broadway, 38th Floor
New York, NY 10036

T +1 212 804 9300

vontobel.com/am