Q2 2018

The Power of Focus:

Looking for Alpha in a Sea of Beta

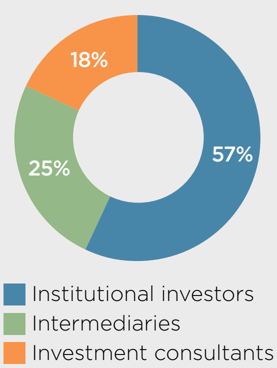
GREENWICH ASSOCIATES

CONTENTS

METHODOLOGY

Between September and November 2017, Greenwich Associates conducted a study examining the use of focused equity strategies in the U.S. institutional market. Interviews were conducted with 91 key decision-makers including institutional investors, intermediary platforms and investment consultants. Questions explored the rationale for seeking out focused strategies, the ways in which they are being incorporated into portfolios and the outlook for these strategies in the future.

RESPONDENT TYPE



Institutional investors include public and corporate pensions as well as endowments and foundations.

Intermediaries include analysts, model teams and key decision-makers in the home offices of wirehouses, broker-dealers, registered investment advisors, and retirement platforms.

Investment consultants provide investment advice, including but not limited to asset allocation, manager research and selection, risk management, and performance analysis, to institutional investors.

INVESTORS OF ALL TYPES NEED TO BALANCE THEIR EXPANDING ALLOCATIONS TO COST-MINIMIZING BETA WITH RELIABLE SOURCES OF ALPHA

76% OF INTERMEDIARIES IN THE STUDY BELIEVE FOCUSED STRATEGIES HAVE A BETTER CHANCE THAN DIVERSIFIED STRATEGIES OF DELIVERING ALPHA

Executive Summary

Investors are increasing allocations to focused strategies, or investment strategies consisting of approximately 50 or fewer securities.

Focused strategies make up 20%–30% of total active equity assets among the 75 institutional investors and intermediary fund platforms participating in a recent Greenwich Associates study. Fifty-six percent of these institutional investors have increased allocations to focused strategies over the past 12–18 months, and 30% of intermediaries have increased their recommendations of focused equity strategies over the past 18 months.

Driving this growth is the pressing need for alpha among investors who are: 1) relying on market outperformance to meet their long-term goals and funding needs, and 2) allocating growing shares of their investment portfolios to passive strategies designed to deliver low-cost beta.

These investors believe that the best way to create alpha is by allocating assets to managers that diverge from their benchmarks and invest only in their highest conviction ideas to drive outperformance. As a result, they are allocating more assets to managers and strategies with 50 or fewer securities and higher active share.

The study results show that institutional investors and intermediaries are employing focused strategies across the spectrum of U.S. equity product categories, in both the "satellite" and "core" components of their portfolios. While investors view focused strategies as most relevant in large-cap value and growth, they are also applying them in mid cap and small cap, in both value and growth.

Many investors reject the notion that investing in focused strategies materially adds risk to their portfolios. Eighty-four percent of study participants believe that a portfolio of just 50 stocks can achieve the majority of the risk-reduction benefits generated by a diversified portfolio. Investors say any incremental risk can be managed through smart and diligent portfolio construction that takes into account correlations with other portfolio assets—without sacrificing the strategy's potential to deliver critically needed alpha.

Introduction

Investors relying on investment returns to meet long-term pension liabilities and other funding needs are turning to focused strategies in which active managers concentrate portfolio assets in their highest conviction investments.

With passive strategies making up a growing portion of their portfolios, investors are under more pressure than ever to find complementary sources of market outperformance. As they search for this critical alpha, institutional investors and intermediary platforms are increasing their allocations to strategies typically consisting of 50 or fewer securities.

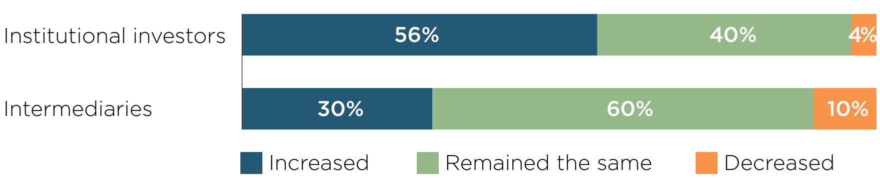
Focused strategies currently comprise between 20% and 30% of total active equity assets among the 75 institutional investors and intermediary fund platforms participating in a recent Greenwich Associates study. Those allocations have been growing. Fifty-six percent of institutional investors have increased allocations to focused strategies over the past 12–18 months, and 30% of intermediaries have increased their recommendations of focused equity strategies.

Greenwich Associates Managing Director Davis Walmsley advises on the investment management market in North America.

Sara Sikes is a Principal with the Firm's investment management team and advises leading asset managers and investment consulting firms in the U.S.

MAJORITY OF INSTITUTIONAL INVESTORS HAVE INCREASED ALLOCATIONS TO FOCUSED STRATEGIES

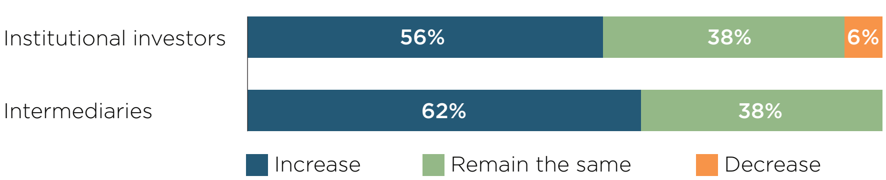
Changes to Focused Strategy Allocations in Last 12–18 Months



Note: Based on 75 institutional investors and intermediaries.
Source: Greenwich Associates 2017 Focused Strategies Study

INTEREST IN FOCUSED EQUITY PRODUCTS IS EXPECTED TO INCREASE

Expected Change in Interest in Focused Strategies Over the Next 24 Months



Note: Based on 75 institutional investors and intermediaries.
Source: Greenwich Associates 2017 Focused Strategies Study

Driving this growth is investors' belief that the best way to create alpha is to choose managers that diverge from their benchmarks and allocate assets to their highest conviction investments to drive outperformance. As one fund intermediary from the study explains, "We are really looking for managers with a lot of confidence; a lot of conviction. You're getting more manager skill ultimately, and you're going to have more divergence."

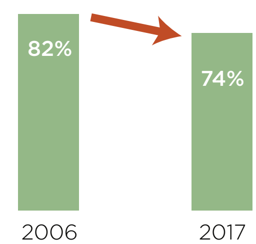
Acute Need for Alpha

U.S. institutional investors allocate about a quarter of portfolio assets to domestic equities. Within U.S. equity portfolios, investors are shifting growing shares of assets to passive strategies—especially in large cap. Many investors think large cap has become so efficient that there is little opportunity for active managers to achieve outperformance.

However, many advocates of indexing will admit that pre-emptively ceding alpha potential from that sizable chunk of a portfolio is a daunting prospect—particularly for underfunded pension plans. The pension-funding crisis in the United States has not improved noticeably since the financial crisis, at least when it comes to some of the largest public pension plans. U.S. public pension plans with at least $5 billion in assets report average funding levels of just 74%. That's down from 82% in the pre-crisis year of 2006. With little hope of taxpayer-funded cash contributions, many underfunded public pension plans are banking on investment performance to fund future liabilities.

The dire need for alpha is hardly limited to underfunded pensions. Investors of all types need to balance their expanding allocations to cost-minimizing beta with reliable sources of alpha. Even investors with fully funded plans are focused on generating alpha in order to keep pace with growing liabilities.

DESPITE A MULTI-YEAR BULL MARKET, FUNDING LEVELS FOR THE LARGEST U.S. PUBLIC PENSIONS HAVE FALLEN



Source: Greenwich Associates 2017 U.S. Institutional Investors Study

Focus: The Path to Alpha

Seventy-six percent of intermediaries in the Greenwich Associates study believe focused strategies have a better chance than diversified strategies of delivering alpha. These intermediary platforms put their trust in focused strategies in large part because they believe that in any active portfolio, excess returns are driven disproportionately by the portfolio manager's highest conviction holdings. Ninety percent of respondents believe these holdings contribute disproportionally to a strategy's overall outperformance.

"If you have a portfolio that's full of diversified managers, you end up being overly diversified. You're paying a lot of active management fees to essentially have index-like exposure," says one study participant. "So our preference is to have more focused managers in place in certain asset classes."

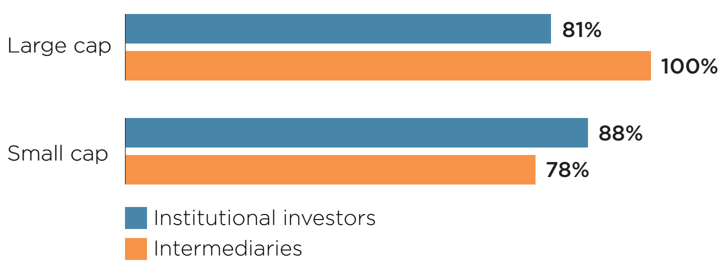
Data from eVestment, which provides a database of institutional asset managers and other analytical products, shows that institutional investors are acting on similar beliefs. "Number of holdings" now ranks among the top criteria used by investors in manager searches for large-cap growth, value and core strategies in the database. Number of holdings is used more often than popular metrics like annualized alpha and even fees.

Among searches that include "number of holdings" across all U.S. equity categories, the most common are for managers with 50 or fewer holdings. In large-cap and small-cap equities, searches for managers with 50 or fewer holdings represent approximately 55% of searches; in mid cap it is about 45%.

Results from the Greenwich Associates study echo these behaviors. The vast majority of institutional investors and intermediary platforms believe that the optimal number of securities in focused large- and small-cap equity strategies is 50 or fewer.

RESPONDENTS BELIEVE FEWER SECURITIES ARE OPTIMAL

Percentage Citing Optimal Number of Securities for Focused Strategies at 50 or Fewer



Note: Based on 75 institutional investors and intermediaries.
Source: Greenwich Associates 2017 Focused Strategies Study

Investors choose focused strategies for one main reason: alpha.

Implementing Focused Strategies

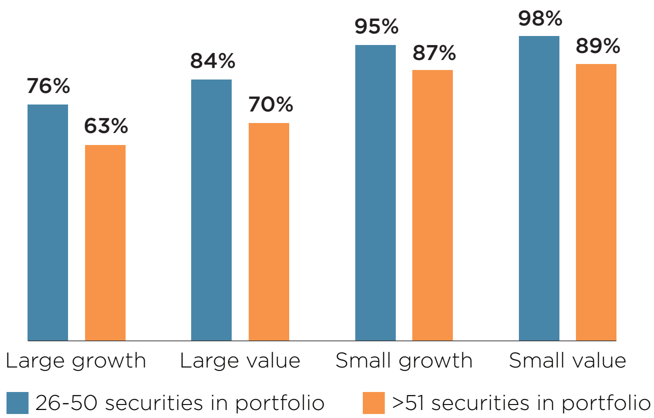
Investors choose focused strategies for one main reason: alpha. Although the investors in the study look closely at how a given focused strategy will complement existing passive investments in the portfolio, a manager's potential to generate alpha is the most important factor considered when selecting a focused strategy.

Most investors see a close connection between alpha potential and active share. In the ongoing debate about the benefits of active versus passive investment strategies, active managers are all too often lumped together as a single group.

In reality, the universe of so-called active managers includes “benchmark huggers” whose active share is far too low to allow much deviation from benchmark performance in either direction. As the graphic below illustrates, institutions on the hunt for high active share and alpha potential are gravitating toward focused portfolios.

FOCUSED STRATEGIES DELIVER ACTIVE SHARE

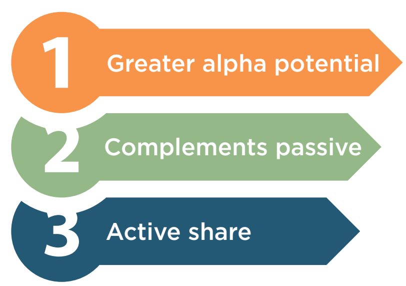
Average Active Share by U.S. Equity Category



Source: eVestment as of 12/31/17

ALPHA IS THE PRIMARY DRIVER FOR SELECTING A FOCUSED STRATEGY

Factors Considered When Selecting a Focused Strategy

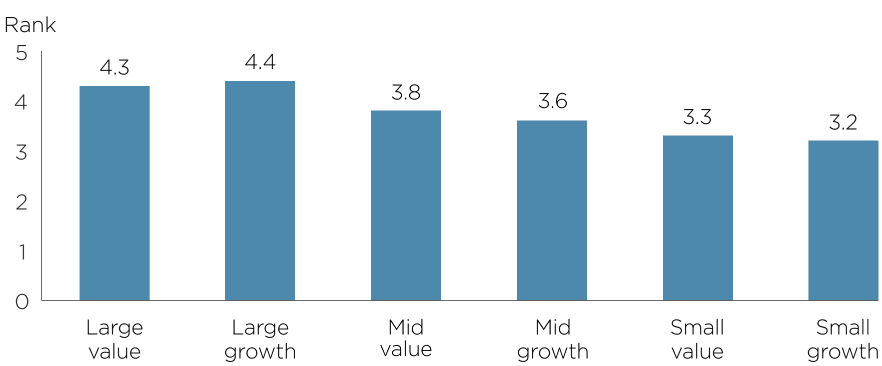


Note: Based on 75 institutional investors and intermediaries.
Source: Greenwich Associates 2017 Focused Strategies Study

The study results show that institutional investors and intermediaries are employing focused strategies across the spectrum of U.S. equity product categories. While investors view focused strategies as most relevant in large-cap value and growth, they are also applying them in mid cap and small cap, in both value and growth.

FOCUSED PRODUCTS ARE APPLICABLE ACROSS U.S. EQUITY CATEGORIES

Suitability for Use of Focused Products



Note: 5 = highly relevant, 3 = moderately relevant, 1 = low relevance. Based on 75 institutional investors and intermediaries.
Source: Greenwich Associates 2017 Focused Strategies Study

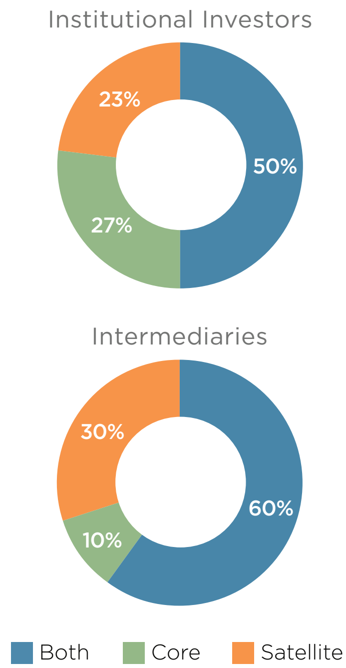
Investors in the study are clearly using focused strategies in both the "satellite" and "core" components of their portfolios.

When used as satellite holdings, focused strategies are expected to deliver alpha and complement the investor's passive holdings. As one study participant says, "We've been utilizing focused strategies [alongside passive investments] to lower our fees, while still being able to provide some alpha to end users."

An almost equal share of investors are using focused strategies as core holdings. One investment consultant explained how his firm employs focused strategies in this manner:

> "Even if we're not using a core-satellite approach, say in the large growth universe, we might take a concentrated aggressive-growth strategy and pair it with a global absolute-return strategy to create our own diversified product. That gives our portfolio management team leverage if they're leaning toward one way in a market environment in which we think that aggressive growth might do better or we might want to be a little more conservative with our market outlook. We can shift our allocations, our discretionary assets in that sense. We like to give our portfolio managers different levers to pull."

FOCUSED STRATEGIES SERVE AS CORE AND SATELLITE HOLDINGS



Note: Based on 75 institutional investors and intermediaries.
Source: Greenwich Associates 2017 Focused Strategies Study

PORTFOLIO CONSTRUCTION FROM INVESTMENT CONSULTANTS

The consultants participating in the study have one clear piece of advice for investors considering an investment in a focused strategy: Understand the bets the manager is making and how these bets might affect the portfolio as a whole.

For any focused strategy, the due diligence process should start with an analysis to identify and monitor precisely what bets the manager is taking to create alpha. As one study participant puts it, "It is OK to take risks, but not OK to be unaware of the risks taken."

This understanding is the first element in the essential process of determining how those risks and positions will correlate and interact with the positions that make up the rest of the portfolio. Through this portfolio-wide risk-management function, investors can achieve the risk-reduction benefits of diversification across strategies, while preserving the benefits of the manager's alpha-generating ability.

One investment consultant says his firm attempts to pair complementary focused managers and strategies. "For example, when the growth portfolio is doing well, maybe the value portfolio is lagging a little bit. But combined it should still give you positive alpha." The consultant concludes, "Aspirationally, we would prefer that the entirety of our clients' equity exposure be implemented through this focused structure, because we can customize the passive and smart beta portion to meet their needs on a risk-adjusted basis. In a perfect world, 100% of our clients' [active] equity portfolios would be invested in [focused strategies]."

Debunking the Risk Myth

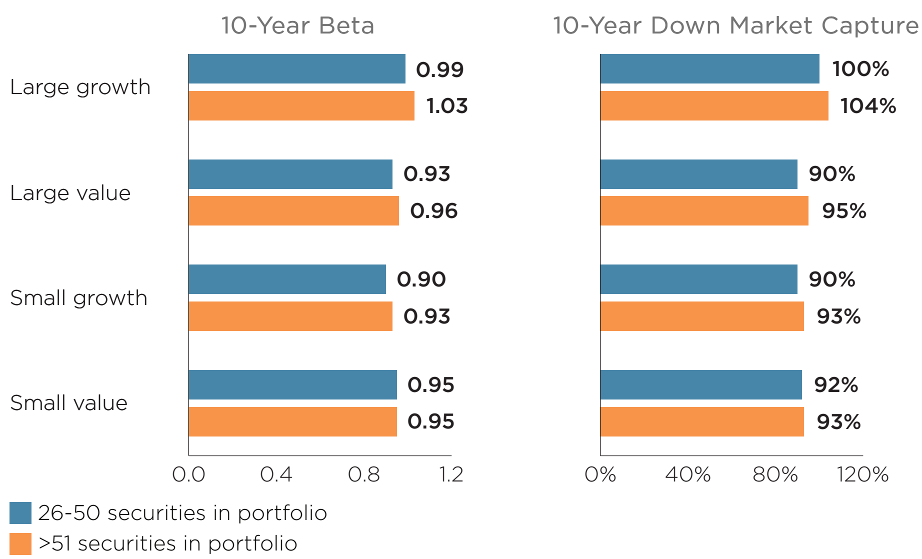
The institutional investors and intermediaries participating in the study expect focused strategies to exceed diversified strategies when it comes to active share, alpha and overall returns. Although they also expect focused strategies to come with more risk on average than diversified strategies, many investors reject the notion that investing in focused strategies materially adds risk to their portfolios. Furthermore, another potential benefit is that high-quality focus names might offer protection when the market goes down.

"There are numerous focused managers who have exhibited much lower risk than a benchmark and other peer group strategies," says a U.S. institutional investment consultant. "So it comes down to the manager's skill and how they're implementing their process."

For instance, beta and down market capture as proxies for risk are typically lower in focused strategies compared to larger portfolios across many domestic equity asset classes. (For a 3-, 5- and 10-year view of the graphic below, please see the Appendix.)

84% of investors in the study believe that a portfolio of just 50 stocks can achieve the majority of the risk-reduction benefits generated by a diversified portfolio.

FOCUSED STRATEGIES HAVE TYPICALLY DELIVERED LOWER RISK

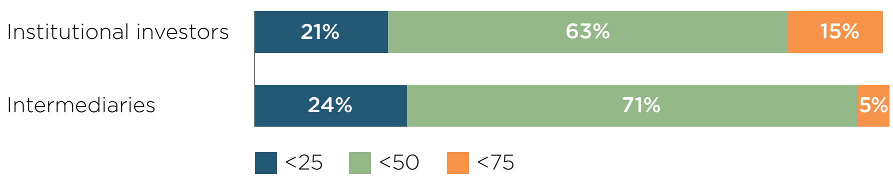


Source: eVestment as of 12/31/17

Eighty-four percent of the institutional investors in the study believe that a portfolio of just 50 stocks can achieve the majority of the risk-reduction benefits generated by a diversified portfolio. Among intermediaries, that share reaches 95%. "There is a certain point where the additional risk from adding or removing another stock in a portfolio starts to be so little, that it's not worth it," says one intermediary gatekeeper.

DIVERSIFICATION CAN BE ACHIEVED WITH FEWER THAN 50 SECURITIES

Number of Securities Needed to Achieve Diversification Benefits



Note: May not total 100% due to rounding. Based on 75 institutional investors and intermediaries.
Source: Greenwich Associates 2017 Focused Strategies Study

Of course, some investors believe that the increased alpha potential of certain concentrated portfolios comes with a trade-off of increased risk and volatility. However, many believe that attempting to reduce the idiosyncratic risk within a focused portfolio defeats the purpose of adding these strategies in the first place. These risks can be better managed through smart and diligent portfolio construction that takes into account correlations with other portfolio assets—without sacrificing the strategy's alpha potential.

"We've actually found by sometimes bucketing two focused portfolios together that you create a better, more risk-controlled product than you do with a diversified strategy that even has more holdings at the end of the day," says one investment consultant. Another fund intermediary sums up that belief, stating that through the combination of multiple focused strategies and other portfolio assets, investors can "build diversification with the portfolio structure."

Conclusion

Institutional investors, decision-makers at intermediary platforms and investment consultants believe strongly that active managers can generate alpha by concentrating assets in their highest conviction investments. Investors also believe that active managers can achieve the risk-reduction benefits of diversification in a portfolio consisting of 50 or fewer stocks and that total portfolio risk can be managed through effective portfolio construction. Furthermore, focused strategies exhibited lower risk, as measured by beta and down market capture, compared to strategies with a larger number of stocks.

Based on those beliefs and the stated plans of the investors participating in its study on focused strategies, Greenwich Associates expects to see continued demand for focused strategies run by skilled and experienced managers with proven track records who can demonstrate that their highest conviction ideas lead to a strong pattern of outperformance.

Greenwich Associates expects to see continued demand for focused strategies run by managers who can prove that their highest conviction ideas lead to a strong pattern of outperformance.

Appendix

BETA BY CATEGORY OVER 3, 5 AND 10 YEARS

	Large Growth		Large Value		Small Growth		Small Value	
	Focused	Diversified	Focused	Diversified	Focused	Diversified	Focused	Diversified
3 years	1.00	1.00	1.00	1.00	0.87	0.90	0.88	0.93
5 years	1.01	1.02	0.98	0.99	0.87	0.91	0.89	0.93
10 years	0.99	1.03	0.93	0.96	0.90	0.93	0.95	0.95

Note: Focused portfolios have between 26–50 securities. Diversified portfolios have 51 or more securities.
Source: eVestment as of 12/31/17

DOWN MARKET CAPTURE BY CATEGORY OVER 3, 5 AND 10 YEARS

	Large Growth		Large Value		Small Growth		Small Value	
	Focused	Diversified	Focused	Diversified	Focused	Diversified	Focused	Diversified
3 years	102%	103%	93%	94%	83%	90%	87%	90%
5 years	102%	103%	93%	95%	82%	89%	86%	90%
10 years	100%	104%	90%	95%	90%	93%	92%	93%

Note: Focused portfolios have between 26–50 securities. Diversified portfolios have 51 or more securities.
Source: eVestment as of 12/31/17

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