Overview of Equity Portfolio Management

The Roles of Equities in a Portfolio

The benefits of adding equities to a portfolio include:

- Capital appreciation
- Dividend income
- Diversification
- Inflation hedge

The following investment objectives and constraints should be considered when determining the amount of equity to include in a client's portfolio:

- Risk objective, including the client's willingness and ability to take on risk
- Return objective, measured in absolute or relative terms
- Liquidity requirement for anticipated and unanticipated needs
- Time horizon
- Tax concerns
- Legal and regulatory factors
- Unique circumstances, including environmental, social, and governance (ESG) issues

ESG consideration involves screening sectors and individual company stocks. ESG approaches include negative screening, positive screening, thematic investing, and impact investing.

Equity Investment Universe

The equity investment universe can be segmented by:

1. **Size**: Large cap, mid cap, and small cap
   Style: Value, growth, and blend/core
2. **Geography**: Developed, emerging, and frontier
3. **Economic activity**: Using either a production-oriented approach or a market-oriented approach

Income and Costs in an Equity Portfolio

Sources of equity portfolio income include:

- **Dividend income**: Regular dividends, special dividends, and optional stock dividends
- **Securities lending income**: Fees earned and reinvestment of cash collateral received
- **Ancillary investment strategies**: Dividend capture trading strategy and selling options (covered calls and cash-covered puts)

Sources of equity portfolio cost include:

- Management fees
- Performance fees
- Administration fees
- Marketing and distribution costs
- Trading costs

Shareholder Engagement

Shareholder engagement is the process of investors interacting with companies. This includes voting at general meetings and other communications, such as quarterly investor calls.

Various parties benefit from shareholder engagement:

- The company gets better corporate governance
- Shareholders benefit from better financial performance
- Active portfolio managers benefit from having more information about the company
- Passive portfolio managers benefit when active managers monitor company behavior and enhance performance

Disadvantages of shareholder engagement include:

- Time consuming and costly
- Management focuses on short-term rather than long-term goals
- Selective disclosure of important information, which could violate insider trading rules
- Conflict of interest

The Role of an Equity Manager in Shareholder Engagement

Active managers typically engage with the companies in which they are invested through regular meetings. Some investment firms may have a team that focuses on non-financial issues, such as ESG.

Activist investors seek to change a company to create gains in their investment. Hedge funds are common activists.

Voting by shareholders in general meetings is a critical function in shareholder engagement. Proxy voting allows shareholders that cannot attend the meeting to vote. Empty voting is the process of borrowing shares for the purpose of voting.

Equity Investment Across the Passive-Active Spectrum

The following factors should be considered when determining where to reside in the passive-active spectrum:

- Confidence to outperform
- Client preference
- Suitable benchmark
- Client-specific mandates
- Risks/costs of active management
- Taxes

Benchmark Selection

For an equity index to be considered appropriate as an investment benchmark, it must have the following characteristics.

- **Rules-based:** Index rules must be objective, consistent, and predictable
- **Transparent:** Inclusion criteria must be clear
- **Investable:** Performance can be replicated in the market

Buffering and packeting are examples of policies used to limit required trading. Buffering allows stock to stay in an index provided they are within a range. Packeting involves splitting stock positions into multiple parts.

Considerations when choosing a benchmark index include the desired market exposure and risk-factor exposure. The market exposure is driven by the IPS and includes the market segment, capitalization, style, and exposure. The risk-factor exposure comes from sources including market capitalization, investment style, price momentum, and liquidity.

Index Construction Methodologies

Exhaustive stock inclusion strategies try to select every constituent of a universe. Selective approaches only choose the ones with certain characteristics.

Four types of weighting schemes can be used to construct an equity index. The choice of weighting scheme influences the indexes performance.

1. **Market-cap-weighted**
    - Results in a mean-variance efficient portfolio
    - A liquidity-efficient approach
    - Uses the free-float approach, which adjusts the shares outstanding for each company to exclude the shares that are closely held and generally not available to the public
    - Based on the efficient market hypothesis
2. **Price-weighted**
    - Can be replicated by owning one share of each constituent company
    - Calculation is complicated by stock splits
3. **Equally-weighted**
    - Reduces the concentration in any particular stock, but results in high volatility because more weight is given to small-cap stocks
    - Requires regular rebalancing
    - Faces the issue of limited investment capacity as the smallest-cap constituent may not have many shares available to trade
4. **Fundamentally-weighted**
    - Based on fundamental concepts such as sales or income
    - Low-cost, rules-based, transparent, and investable

- Seek to exploit market inefficiencies in the market

The Herfindahl-Hirschman Index (HHI) can be used to measure stock concentration risk in a portfolio.

$$HHI = \sum_{i=1}^{n} w_i^2$$

A lower HHI means the portfolio is more diversified.

The effective number of stocks is the reciprocal of the HHI. It represents the number of stocks required in an equally weighted portfolio that would have the same HHI.

$$\text{Effective number of stocks} = \frac{1}{HHI}$$

Cap-weighted indexes have a low effective number of stocks.

Indexes have varying rebalancing and reconstitution schedules. Rebalancing involves reweighting the constituents. Reconstitution entails adding and deleting constituents. Both of these create turnover.