There was a time when the ASX employed 'chalkies' to write bids and offers on a board. It was a relatively slow and manual process but they got the job done.

More than three decades on, the ASX has evolved and new trading systems allowed for faster and more cost-effective ways to trade shares.

The same can be said about Australian equities portfolios. There are new ways to build portfolios that would have been far too sophisticated to implement back in 1987, when the ASX was formed and chalkies walked up and down the trading floors.

In this issue, leading fund manager BlackRock explains how financial advisers can use a mix of index, factor and alpha together in the one portfolio to deliver the right dose of risk and return – at a cost that works for their clients. Find out more in this article.

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A new way to build better Aussie equity portfolios

Investors are no longer constraining themselves to just an active or index strategy when it comes to domestic equities.

Australian investors typically focus on picking the right stocks, funds or managers to access domestic equities, depending on their expertise. As the investment landscape rapidly evolves, however, with a plethora of new products and strategies, there's an increasing need for advisers to take more control over their portfolios; to seek order within the chaos. "Knowledge of what they are holding has become of paramount importance," says BlackRock head of portfolio analysis and solutions APAC James Kingston[01]. "They need to actively manage their portfolio risk and understand the drivers of return."

Blending strategies

Ultimately, portfolio construction comes down to balancing risk, return and cost in line with an individual investor's needs, Kingston says. This often calls for both active and index strategies within the one portfolio, whether that's "index" through market indices such as the S&P/ASX 200, "factor" through smart beta exchange traded funds (ETFs), for instance, or "alpha" by way of actively managed funds.

"There's a growing appreciation that the investment decision-making process is no longer a binary one," Kingston says. "'Active in X, and index in Y' is too simplistic."

He and his team work with clients on the role index and alpha can play in portfolio construction. With more products and exposures available to advisers, they can blend the two strategies to obtain a cost and risk investors are comfortable with, while at the same time pursuing higher returns.

"If you look at an adviser's repertoire of securities and investment vehicles available to them, it's quite broad and deep," Kingston says. "More choice means a better understanding of how to combine these strategies is needed. It's where we spend a lot of time with our clients."

The power of index

Understanding exactly what's on offer is a good start.

Clearly, ETFs are a big – and growing – part of the investment landscape. Their low cost and convenience are key factors, but they also help deliver confidence after the Royal Commission.

As head of iShares, Australia, Christian Obrist notes: "Values like transparency, liquidity and the client's best interests have all come to the forefront, and ETFs really fit the bill there."

While index-tracking ETFs are commonly referred to as passive products, they can be used as part of an active strategy. For instance, model portfolios, which are seeing widespread take-up, are typically built with ETFs but form part of an active portfolio.

"So you're essentially still buying an active product, but the building blocks used are ETFs," Obrist says. Again, that's possible today because of the greater choice of product.

Getting smart

Within the ETF space, meanwhile, there's a growing interest in smart beta strategies. These exposures use investment techniques that have long been used by asset managers. However, they're now readily accessible through ETFs.

"The focus is on delivering outperformance, through factors such as quality, momentum, size and value, or optimising for a lower volatility" Kingston explains. "Typically used in addition to traditional index exposures, they can also provide a better benchmark to compare active funds against. If a long-only fund can't outperform a smart beta strategy, then why pay the higher fees?"

Adding alpha

Another way to access Aussie equities is through a high-conviction strategy, which holds a limited number of stocks.

BlackRock's Concentrated Industrial Share Fund, for instance, holds just 20 to 40 stocks and eschews the ASX's largest players, such as the big four banks and BHP.

"We're not looking to buy those very large cap stocks," explains BlackRock head of fundamental active equities, Australia, Charlie Lanchester. "In fact, we're looking to scour the rest of the market, which, I guess, is something that retail investors don't have the time to do. We're looking to find companies with strong growth prospects, and [which] are re-investing capital wisely."

Of course, this approach has its risks, but it does play an important part in a well-balanced portfolio. "It's definitely at the higher-risk end of the portfolio," Lanchester agrees, "But with the goal that it's higher return as well. It will move up and down and be quite different to the index."

For those investors who are loath to take on that much risk, but still need some differentiated alpha, there are other options. For instance, the BlackRock Advantage Equity range utilises the latest innovation in big data and technology in a systematic approach to get risk controlled returns as well as broad market exposure.

The quote

Investors need to appreciate that a portfolio is much more than a collection of funds, and really consider how each investment interacts with each other.

Sometimes less is more

Adding more managers into your alpha mix might be one way to balance out the risk here, but it's overrated, Kingston says. As he notes, the more long-only managers you buy in a single asset class, the higher the chance you could end up getting benchmark performance – for a very high fee.

"Having a better handle on the managers that you're using and the risk you've actually got in your portfolio is becoming far more important. Investors need to appreciate that a portfolio is much more than a collection of funds, and really consider how each investment interacts with each other."

Kingston suggests taking a narrower bet on fewer but uncorrelated managers, and combining that with index. "That means you, number one, manage your costs in the portfolio far more effectively, but, number two, you're actually taking some alpha bet from uncorrelated return sources."

Balancing risk and cost

Ultimately it's about bringing a mix of index, factor and alpha together in the one portfolio to provide the all-important balance of risk and return – at a cost the investor can afford.

"With ETFs, for example, you can mix cost-effective core exposures to Australian equities with factor exposures such as minimum volatility, value, growth, size and momentum," Kingston says. "You then blend those two with higher-octane, actively managed strategies that deliver sustainable alpha over a long time period." FS

Watch the video on www.fsitv.com