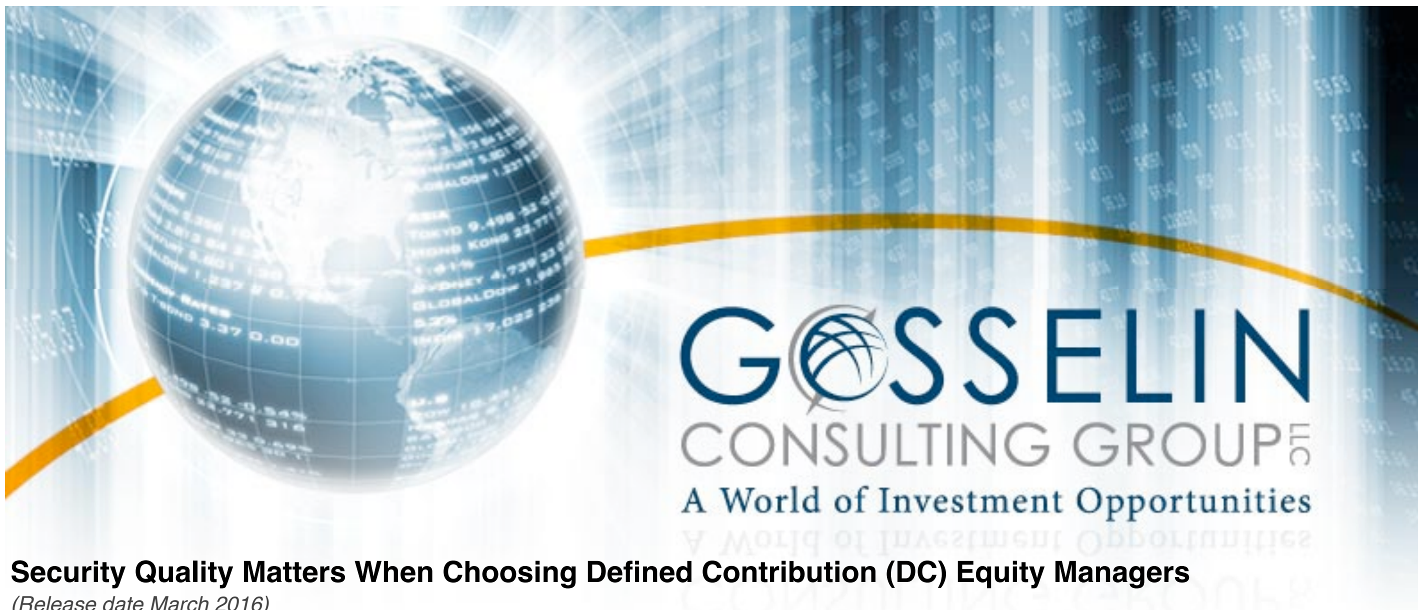


Security Quality Matters When Choosing Defined Contribution (DC) Equity Managers

(Release date March 2016)

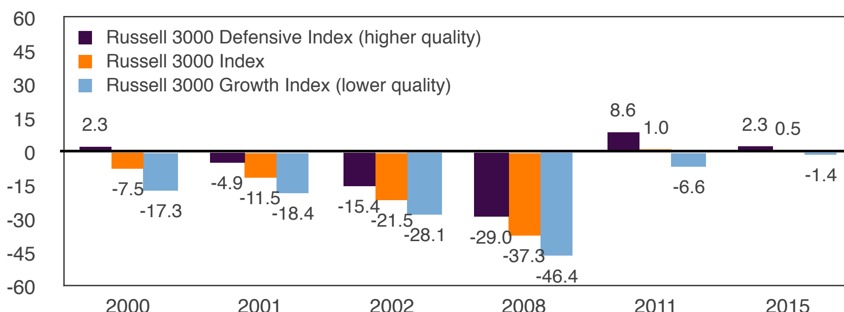
Summary

Downside performance protection, better long-term returns, and lower long-term risk – three objectives all investors seek for their investment managers relative to their appropriate benchmarks. What if an investor could significantly increase the chances of achieving these objectives? For defined contribution (DC) plan sponsors, this could help to mitigate fiduciary liability exposure; For DC participants, this could improve overall retirement readiness and achieve better long-term retirement outcomes.

With respect to equity managers, history shows that focusing on security quality, when selecting and monitoring DC managers, can actually increase the odds of achieving these objectives. This brief paper explores the concept of security quality and its impact on both the plan sponsor and participant.

The definition of holdings quality varies widely. For the purpose of this discussion, we define it as the financial strength of the underlying companies in an equity portfolio. For example, a portfolio holding stocks that consistently exhibit stronger-than-market (relative to style-appropriate benchmark) profit margins, earnings growth, and cash-flow growth with lower-than-market leverage could be defined as higher quality. To the contrary, companies with the opposite relative characteristics could be defined as lower quality (weaker margins, earnings growth, cash-flow growth; higher leverage).

EXHIBIT 1: US EQUITIES – Calendar Year Performance (worst 6 years since 1997)



Russell Stability Indexes™ - Morningstar Direct

The indexes measure a portion of the market based on the sensitivity to economic cycles, credit cycles, and market volatility, referred to as stability.

Stability, as defined by Russell, is measured at the company level in terms of volatility (earnings, total return), leverage (debt/equity), and return on assets. The more stable half of the index is called the Defensive Index® and the less stable half is called the Dynamic Index®.

Gosselin Consulting Group utilizes these indexes as one example of security quality differentiation. We define the defensive companies as higher quality and dynamic companies as lower quality.

Periods of Market Stress vs. Exuberance

Higher quality companies tend to out-perform lower quality companies in times of market stress (sizable market losses) while lower quality companies tend to out-perform higher quality companies in times of market exuberance (sizable market gains). As one example, Exhibit 1 (above right) illustrates US equity performance by quality for the six worst calendar year periods since 1997 (as defined by the Russell 3000® Index). Here we utilize Russell's Stability® Indices to define quality – Defensive® represents the companies in the broad Index that exhibit lower leverage (debt/equity) and volatility (earnings, total return) with higher profitability (ROA) - thus are higher quality; Dynamic® represents the companies that exhibit higher leverage and volatility with lower profitability - and are of lower quality. In all of these periods of market stress, Russell's Defensive® Index (higher quality) significantly out-performed Russell's Dynamic® Index (lower quality).

In similar fashion, one could expect that an investment manager consistently holding higher quality stocks would tend to out-perform their respective style-appropriate benchmark when market losses are significant, yet under-perform when market gains are strong.

For participants—whose investment knowledge can vary widely—the risk lies with the potential "absolute" loss during a time of market stress. A significant loss in any given time period can severely impair one's account balance, in some cases on a permanent basis. This is especially true for participants who (1) re-allocate their assets close to a market bottom or after a sell-off, thus negating any potential recovery, (2) choose to stop contributing and sacrifice the advantage of dollar-cost averaging, and (3) are near, at, or in retirement. As participants are responsible for their own asset allocation in a DC plan, it would make sense to avoid lower quality managers as they tend to suffer greater absolute losses (vs. higher-quality) in times of market stress.

For plan sponsors, the risk lies with the potential "relative" loss during a period of market stress and flows through to the suitability of the investment offered in their plan. We believe plan sponsors face greater fiduciary risk when an investment significantly under-performs its benchmark in times of market stress vs. significantly under-performing its benchmark in times of market exuberance. In other words, most participants would be quite satisfied with a manager who rises 25% in a particular calendar year, even if the benchmark was up 35%. Yet the story would be vastly different if the investment manager fell 35% in a particular calendar year when the benchmark dropped 25%. Not only are participants more apt to take notice of relative returns, but one might be able to question the suitability of the option for a DC plan (in contrast to a DB plan) as the participant may re-allocate out of the option at an unfavorable time (i.e. buy high / sell low).

Quality Investing Over the Long-Term

In addition to mitigating downside relative performance risk, higher quality stocks have out-performed lower quality stocks and, in turn, the market, over the long-term. This may be surprising as higher quality stocks exhibit significantly less risk than lower quality stocks. Historically, investing in higher quality stocks has placed one in the enviable northwest quadrant of a risk-return chart – that being higher return / lower risk.

Exhibit 2 illustrates this phenomenon, as we again use Russell's Stability Indices whose return streams are backdated to mid-1996. This provides us with a nearly 20 year period in which to analyze the long-term impact of quality investing across both risk and return.

Though conventional wisdom has taught us that the greater one's risk, the greater one's potential for return over long periods of time, the analysis of historical returns by quality begs to differ. As mentioned earlier, higher quality stocks (Russell Defensive® Index) do out-perform lower quality stocks (Russell Dynamic® Index) over full market cycles, and with significantly less risk, as shown in Exhibit 2 (above right). This phenomenon not only exists across the full US market but also within each capitalization range: Large-, Mid-, and Small-cap.

Historically, the most dramatic benefit exists within US small-cap where high quality stocks more than doubled the return of low quality stocks (+118%) while doing so with 40% less risk (illustrated in Table 1 at right). The return premium in US large- and mid-cap was still a respectable 29% and 18% respectively while the reduction in risk was 36% in each case.

EXHIBIT 2: US EQUITIES - Risk-Return
7/1/1996 - 12/31/2015

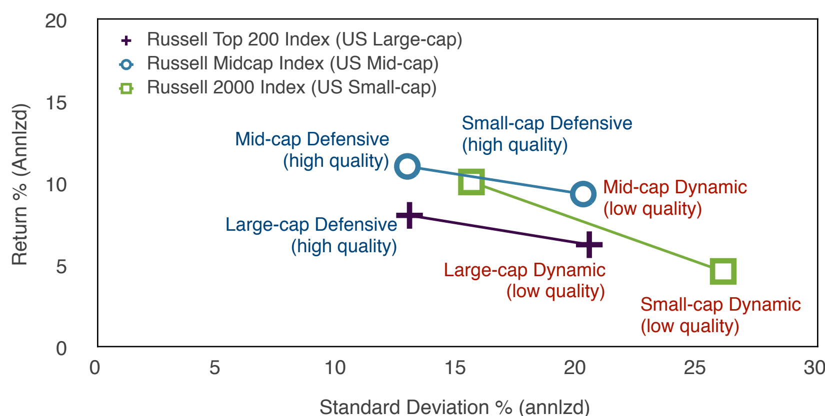


TABLE 1 Capitalization	Quality	Annlzd Return (%)	Annlzd Std Deviation (%)	High Quality Return Benefit (%)	High Quality Risk Benefit (%)
US Large-cap	Defensive (High)	8.0	13.1	29%	-36%
	Dynamic (Low)	6.2	20.5		
US Mid-cap	Defensive (High)	11.0	13.0	18%	-36%
	Dynamic (Low)	9.3	20.3		
US Small-cap	Defensive (High)	10.1	15.6	118%	-40%
	Dynamic (Low)	4.6	26.1		

Russell Stability Indexes™ - Morningstar Direct

Summary

DC participants and plan sponsors face unique risks when it comes to performance, especially in times of market stress; Participants face the threat of not achieving their retirement financial goals over the long term and face potential account impairment risk in times of market stress; Meanwhile plan sponsors are responsible for designing a suitable investment menu for their participants so they can meet their long-term retirement goals. However, plan sponsors may face increased fiduciary liability when selecting potentially unsuitable investment options, especially in times of market stress.

In summary, this study illustrates how investing in higher quality equity managers can not only mitigate downside performance risk (vs. benchmark) in times of market stress but can also deliver stronger returns with less risk over the long-term.

At Gosselin Consulting Group, we are strong proponents of using high-quality equity managers who consistently exhibit at-market or greater-than-market financial strength. As an acknowledged fiduciary to our clients, it serves to better our collective fiduciary position and, most importantly, can improve outcomes for participants.

IMPORTANT DISCLOSURE

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