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The myth of concentration

AIE is benefitting from diversification and higher potential alpha generation...

Update
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When Peter Lynch took over the Fidelity Magellan fund in 1977, it was recommended he make the 40-stock portfolio he had inherited even more concentrated and reduce the number of holdings to just 25 companies. Instead, Lynch raised the number of stocks soon after to as many as 150.

A study by professors Lawrence Fisher and James H. Lorie had been published seven years earlier that had found that a randomly created portfolio of 32 stocks reduced investors' volatility by 95%. Many of today's most successful stockpickers have shot to fame by sticking to this formula.

One popular argument posits that the more stocks you own, the more you end up becoming an expensive closet tracker fund. Indeed, if one has a small team of analysts, one might find it much easier to keep track of and get to know a smaller universe of companies.

Portfolios filled with hundreds of holdings generally get derided for lacking in conviction or taking a scattergun approach to investing. That's not always the case, though, as Lynch's subsequent record shows.

In the five years before Lynch took over Magellan, the average number of stocks was 40 and the compound annual growth rate (CAGR) was -1% versus 0% for the S&P 500. During Lynch's tenure, the fund's average number of stocks was c. 200, and the CAGR was 27% versus 15% for the S&P 500.

"The point is not to rely on any fixed number of stocks but rather to investigate how good they are, on a case-by-case basis," Lynch said.

Safety in numbers

Grinold and Kahn's Fundamental Law of Active Management states that information ratio (a risk-adjusted measure of active fund performance versus a benchmark) grows in proportion to skill and the breadth of strategy. Skill is a function of the experience of the team while breadth is a function of the team's ability to evaluate a large number of names. Essentially, it's a benefit having a large team of highly experienced and knowledgeable analysts.

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Let's take the example of Indian equity investment trusts. India is home to more than 4,000 stocks, giving these fund managers a large universe from which to choose. That number is increasing each year, too.

There were a record 76 initial public offerings (IPOs) in India in the first 11 and a half months of 2024, raising a record total of 1.3 trillion Indian rupees (INR), or $15.8 billion. That meant that India was the world's second largest equity fundraiser, behind only the US, and eclipsing China as Asia's top market for company listings – the first time it's had that honour.

It's certainly not been a one-off, though – this is a continuing trend. There have been 236 IPOs between 2021 and 2024 that raised INR3.6 trillion, compared to just 170 IPOs that raised INR1.8 trillion between 2013 and 2020.

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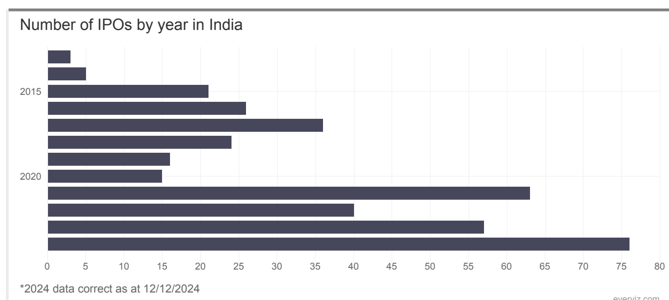
Fig.1: India's Stock Market Is Thriving



Source: Nuvama Alternative & Quantitative Research, Prime Database

This trend has served to increase the number of small and mid (SMID)-cap companies in the Indian market. Conveniently, this SMID-cap area is the part of the market that provides the highest alpha opportunity: active fund managers with a properly resourced investment team can deliver a lot more added value to shareholders within SMID caps than they can in the large-cap segment.

The Indian SMID-cap market is a vast, heterogenous market providing investment opportunities in every segment of every sector. Take the largest sector of the Indian market, financials, as an example. The large-cap part of the sector is dominated by a few large banking groups such as HDFC and ICICI, but within the SMID-cap market, you can find insurers, asset managers, credit card providers, stock market exchanges and many more sub-sectors, too.

Another inefficiency within India's SMID caps is that it remains highly under-researched, making it fertile ground for bottom-up stock selectors. HDFC is a $120 billion company that has lots of sellside analysts reporting on it and there's a wealth of easily searchable information on its financials going back more than a decade. By contrast, a small-cap financial company typically won't have any sellside analysts and very little if any financial information widely available to find, meaning much more work has to be done to assess the investment case.

There are a number of observations to be made from this. First, it shows how sub-optimal it is for any fund management group to handcuff themselves to investing in a small pool of companies when they could fish in a much larger pond. Second, we'll make the point that not everyone is equipped to analyse and assess every one of the 4,000-plus companies in the Indian market.

Indeed, for those with small teams, it makes more sense to restrict your universe so that can keep track of them sufficiently, but that simultaneously hampers the alpha you can deliver for your clients.

Therefore, one can surmise that investing with a fund group that has a large group of experienced analysts working alongside the fund or portfolio managers provides a huge competitive advantage.

That's the case with **Ashoka India Equity (AIE)**, which can call upon a 31-strong team of analysts focused exclusively on Indian equities, 27 of whom are based on the ground in India. We believe that this gives AIE an advantage in generating alpha compared to teams typically employed by UK-based asset managers.

Playing to win

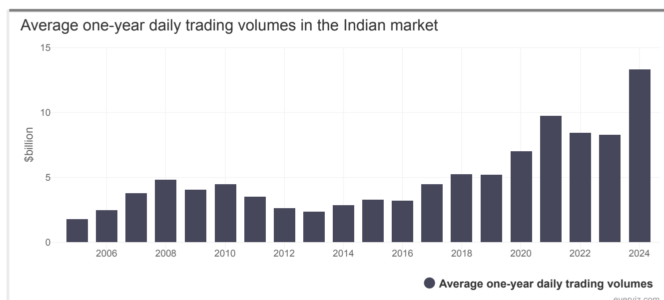
In addition, the team structure, culture and compensation policy were all designed to align the interests of the management team with shareholders. The structure is flat and meritocratic, with analysts given sectors of responsibility and rewarded based on their performance: effectively, attribution analysis is done on the portfolio and analysts are rewarded for the trust's successful stock picking in their sectors.

This allows AIE to run a highly diversified portfolio, which has already risen from 125 as at 31/07/2024 to 146 as at 31/10/2024.

That number could rise further after shareholders approved a proposal to allow the managers to invest in a larger number of companies. The change reflects the growing number of alpha opportunities the managers are identifying in the SMID space which they wish to capitalise on, whilst maintaining portfolio diversification for risk purposes.

We've already noted that the SMID universe has been growing, with the number of companies with a market capitalisation of over $500 million rising from 406 when AIE was launched in December 2018 to 826 today. We've also seen a clear rise in the average daily trading volume, which has almost trebled from c. $5.2 billion in December 2018 to c. $13.3 billion today.

Fig.2: Record Levels Of Liquidity



Source: Nuvama Alternative & Quantitative Research, Prime Database

In that time, AIE's team has expanded, too. Taking this altogether, it seems logical to us that there are more names within the portfolio, especially because every stock within the portfolio is there to generate as much alpha in absolute terms as possible.

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AIE's diversification certainly hasn't held back returns; quite the opposite, in fact. AIE's five-year net asset value (NAV) total return is 169.3%, making it the sector-leading Indian equity fund. MSCI India's gain in that timeframe has been 92.9%, while the weighted average gain from AIE's AIC sector peers is 99.1%.

Much of this has come down to stock selection, with the managers achieving a 'hit rate' of c. 65%, well above the 55% that is considered a high standard in the industry. It has also helped AIE outperform peers in both rising and falling markets.

In all, the end goal for any equity-focused investment company must surely be to generate the highest alpha for its shareholders over reasonable time frames and with competitive fees. Judging any investment on simple metrics such as 'number of holdings' or 'turnover' seems a fool's errand, since they should be by-products of the investment approach.

AIE has shown itself to be one of the stand-out trusts across all emerging markets in our opinion. The sensible increase in the maximum number of holdings allows the managers to effectively harness the growing size of India's small-cap market and continue delivering for shareholders.

We think that AIE is a risk-managed way of accessing this popular asset class with significant alpha potential.

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