Link to Article

Capital Group remains true to its history – active, driven by fundamentals

When Robert W. Lovelace, vice chairman of global asset management firm Capital Group, met with leading investment professionals from private banks and wealth management firms with Hubbis at Hong Kong's China Club recently, no one anticipated such a wide-ranging discussion covering so many facets of geopolitics and global finance. It was a 'closed-door' discussion, but even the attributable comments provide some fascinating and thought-provoking insights.

CAPITAL GROUP TODAY is the largest privately-owned investment management firm in the world. What the founder - Jonathan Bell Lovelace - might not have dreamed of some 86 years ago when the firm first opened its doors, was that the firm could have by now accumulated over US$1.6 trillion in assets under management.

Today, Rob Lovelace also serves on the group's small management committee and is an active portfolio manager. With 32 years of experience in the business, he has witnessed first-hand the dramatic twists and turns of the global financial markets in the past three decades and more. Notably, he has also witnessed the seemingly inexorable rise of most of the world's major equity indices.

Also present at the discussion was Johnny Chan, one of the firm's investment analysts in Asia. Based in Hong Kong and with the firm for more than 10 years, he previously worked for JP Morgan in Hong Kong. Chan has a wealth of experience, with a core focus on IT, tech and real estate. Capital has been present in Hong Kong since 1984 and now has a team of more than 80 staff and is on an expansion drive to boost its relationships and handle more globally for its existing Asian clients, and vice versa for clients in North America, Europe and further afield.

Capital: a founder of the fundamental orthodoxy

Lovelace attributes Capital's enormous success to holding on to the core values of the founders of the firm, while positioning itself for the world ahead. He notes that Capital was founded shortly after the Great Depression hit. "We began life in 1931 but our roots actually go back to a fund that launched in the 1920s and which had what was at that time a rather unusual idea - to visit the companies the fund invested in! Remarkably, something that has become so second nature for decades - fundamental analysis - was considered unorthodox, even controversial, back in the very early days of Capital Group."

Capital Group's founders focused in the early years on valuations and on dividend flows. The holy grail then, says Lovelace, was to beat the government bond yield as investors had lost faith in equities as a source of growth. The first fund, Investment Company of America, was a leveraged closed end fund that, before Capital managed it, might be called a 'hedge' fund. It was predicated on research and fundamental analysis.

California was the chosen location for Capital Group, a choice that also flew in the face of the prevailing orthodoxy. But the new frontier out West also helped nurture the new frontier of investing - namely for income first and secondly for capital appreciation - these were the fearful post-Depression years. "Markets were so volatile in the early to mid-30s that equity growth was not sought out, it was viewed as icing on the cake," explains Lovelace.

DNA spawned by tough markets

The lessons from the tough days of Capital's inception remain with the firm today. "Our DNA has always been to try to perform particularly well in difficult markets, to protect wealth and to provide advice and

ROBERT W. LOVELACE
Capital Group

execution replete with a historic perspective," explains Lovelace. "All investors, retail or institutional, know that the biggest - and often easiest - mistake to make is selling at the wrong time. As a generalisation, our funds are structured around this philosophy - higher front-end fees and low ongoing management fees, which combined help to create what I call 'stickiness', in other words reluctance to pull out funds."

Although Lovelace is grandson of the founder, Capital Group has long distanced itself legally from being a family firm. "My father was an innovator and it was he who decided that the firm needed to become a partnership of equals to drive it forward towards the 20th century. Accordingly, he set about gradually selling his stock at a formulaic discounted price to colleagues who then became partners with a stake in the future. It is this inclusiveness and sense of belonging that has helped the firm grow so dramatically from a small family business to the largest private asset manager globally.

And just at home in bull markets

Today, the markets around the world are an eon away from the 1930s. But are the markets so far away from a 1929 or 1987 or 2008 style crash? "Of course, people very often ask are we at the top now and where do we go from here," says Lovelace. "And that is very topical right now after so many years of rising equity indices. Looking at the US as the bellwether first I would note that the underpinnings of the market actually seems to be solid and improving, and it is very rare to have a major market correction when the fundamentals are doing okay."

Lovelace refers to the TMT (Telecommunications, Media and Technology) crisis of 2000. "There were incredible valuations before that crash but the catalyst that drove the market down was deteriorating fundamentals," he recalls. "Today we are seeing a market of high valuations after a long bull run, with almost every investor armed with an extensive list of stocks to buy if only the market would correct, maybe 10% or more. This bull market phase is characterised almost by annoyance on behalf of investors that the market has got this far, so a correction will make people feel better."

No recession looming, no fundamental flaws seen

However, Capital Group does not see a recession looming, so that is not the catalyst that will drive the market lower in the foreseeable future. Nor does the firm see any immediate fundamental weaknesses that will drag valuations down. "That implies," Lovelace says, "that any correction is likely to be short and bought into hard."

But he also notes that there are other events that could arise suddenly to pull the rug from under the market, for example a geopolitical event, or a policy mistake, or some massive M&A deal that goes bad.

"But those are unknowns and unpredictable," he elucidates, "so I can summarise all that by saying we remain in a time when we all seem to desperately want the market to go down, so we can get back to buying it and to me that actually speaks to looking through the correction or the bear market to the renewed bull market on the other side."

Capital's unique fingerprint on the markets

So how then does Capital Group approach its investment mandate? "Curiously enough we have few strategies, but we do have one key approach that we think makes us unique, something called the Capital System, or we might also call it the multiple manager system."

Developed by Capital since the 1950s, it is a team approach by which each portfolio manager within each fund has complete responsibility for their assets; and they are judged against the same benchmark as the entire fund. "So," states Lovelace, "essentially the fund is a fund of funds, but crucially it differs from the traditional type on the street as the portfolio managers are entirely independent and therefore able to run a highly concentrated portfolio. That portfolio manager is thereby encouraged to have high conviction holdings as he or she is only being remunerated on their sleeve of the portfolio. Then the fund achieves further diversification by bringing together all these different sleeves and that irons the whole thing out into one smooth unit."

JOHNNY CHAN
Capital Group

Lovelace expounds: "For example, a fund of $20 billion might for the sake of argument have seven managers each holding about $3 billion. If one manager is struggling, some of that allocation could be passed back to the other managers. In this way, the fund might be growing while some portions of it are shrinking. And when one applies the star systems technique most widely used to analyse performance, our achievements are essentially the reflection of a bunch of stars together in an aggregated portfolio."

Seeing the wide-angle, taking a long-term view

Lovelace's Hong Kong-based colleague, Johnny Chan, has more to add on this. "Another point I would like to highlight, and another unique feature of Capital, is that a typical portfolio wherein around 20% is what we call a 'research' portfolio, is actually managed by a group of investment analysts. This unique - or at least very rare

– approach allows our analysts to learn how to invest, rather than simply making recommendations. So, for example, I personally manage several billion dollars of money in multiple funds."

Chan explains that while there are perhaps five or six managers in each fund there is no strategist. "It might seem at odds with the norm to say this, but there is no one strategy at this firm, there is no 'house' view. Each of the managers might indeed disagree and even at the most extreme, one manager might buy from another in the same fund, or sell, in other words crossing internally."

This in turn means that cash and stock weightings also vary manager to manager, creating a remarkable dynamic within each fund. This helps create incremental diversification within a diversified fund. "For example," Chan adds, "a super value investor might be in the same fund as a growth investor and each approach can over time balance off the other approaches."

Chan's methodology is to hold around 10 stocks out of as many as 200 companies he has under monitor. He is a high concentration investor who holds stocks for the long term and seeks a high return.

Remuneration structure to match long term holds

Capital Group funds tend on average, to hold stocks for about four years in the portfolios. "But we get paid on a one, three, five, and eight-year bonus, weighted to the back end," explains Lovelace. "This helps encourage staff retention and s a focus on longer time horizons."

Capital Group's leaders believe life as a private partnership improves value for investors, as it allows the managers to take a longer view that those in a listed company, which are under permanent short-term pressure. "Away from the public scrutiny as a privately held firm we can build and enhance our strategy for the benefit of our clients rather than in the short-term interests of shareholders."

Lovelace adds, "Being fairly bullet proof in the event of major short or longer-term declines is a luxury we as a private firm can enjoy, for our security as well as that of our investors."

Moreover, unlike most asset managers Capital does not pay out bonuses based on funds under management; instead, the firm operates a formula whereby the cash sits on the balance sheet to prove that it will pay the exact same bonus in the down market as it does in the up market. "As it is not driven by our assets under management," Lovelace elucidates, "there is no reason for the portfolio manager to hold on to assets longer than he or she deems advisable. There is absolutely no way we could do that as a public company."

Keep active, don't go passive

Capital Group's ethos has thus far survived and prospered in a world that is increasingly attracted to passive investment, as evidenced by the dramatic growth of ETFs, trading algorithms, factor investing, smart beta and so forth.

CAPITAL GROUP'S ONGOING HISTORY OF EXCELLENCE

Capital Group was founded in Los Angeles in 1931 and is one of the world's oldest and largest investment management organisations, with over $1.6 trillion in assets under management as of end June this year. It remains privately held and has offices around the globe in the Americas, Asia, Australia and Europe.

The firm reports on its website that Capital Group 'has been singularly focused on delivering superior results for long-term investors using high-conviction portfolios, rigorous research and individual accountability'. Capital Group manages more than $1.6 trillion in equity and fixed income assets for millions of individual and institutional investors around the world.

Thirteen funds under American Funds Distributors, a division of Capital Group, were cited in October for excellence in the Morningstar FundInvestor "Fantastic 43" list – the most of any fund family. This represents more than half of the fund family's assets under management, according to a Capital Group news release. Morningstar's review of nearly 8,000 mutual funds identified a select group of funds considered for criteria such as expenses, manager ownership, returns, stewardship and risk ratings.

"We are honoured that our funds have been recognized by Morningstar for delivering superior results at a low cost to investors," said Matt O'Connor, president of American Funds Distributors after the results were announced. "This speaks to our long-term and successful focus on helping investors save for a secure retirement."

ROBO-ADVISERS? AI?

Asked whether the so-called robo-advisers are here to stay or a fleeting fad, Lovelace is unequivocal. "Looking from the US perspective, the robo-advisors really aren't working, as very soon people want to talk to an actual person. Investors do not mind starting by inputting preferences into the screen but after that they want to talk to someone and have a relationship. So, asset management firms then charge a slightly higher fee to talk to someone. At the same time the ETF market is becoming ever more transactional and not so much relational."

However, Lovelace does not believe the future is purely remote and transactional. "It is a myth that millennials – and I have two daughters firmly in that category – only want to interact through a screen, or that they would like investment advice from a robo-advisor that spits out their preferences or needs. We see millennials as highly engaged socially, highly proficient at conducting research via screens and highly focused on thinking ahead philosophically and financially about their retirement."

Another question arising more and more is, 'will AI spell the demise of the investment analyst or the portfolio manager?' Chan is in no doubt that AI has little chance of supplanting humans in the fund management industry. "The day we have no human emotion is the day AI will takeover the asset management business and I certainly do not see that in the future. AI might help data flows and investors might jump on that to arbitrage short term opportunities, but AI does not seem to apply to longer term investment. Human emotions and the immense diversity of human opinion will likely far outgun the tendency towards shared, or similar opinions of machines."

Capital Group is cognizant of all these issues surrounding technology and the firm's current and future interface with retail and institutional clients. The firm is adjusting its interface to have a distinct personality and to be more user-friendly, not just for professional intermediaries but for the millions of very well-educated, smart, younger people with money to invest. "Ultimately, we are also trying to communicate our strong belief that people's lives can improve though successful investing," says Lovelace. "And that is central to these millennials' thinking."

Lovelace observes that the rise of passive has been multi-decade and it has been accelerated by the proliferation of business schools that tend to emphasise financial engineering, derivatives, trading strategies, asset allocation, portfolio theories and all these things that really are not what Capital does. Add to this the rise of the hedge funds and very strong markets and the firm must work especially hard to achieve its alpha to prove its worth as active managers. Even though in aggregate, he concedes, the active industry has done no better than the passive.

"Does the brave new world of passive investment, trading algorithms and the like pose a potential challenge, or even existential threat, to our model, relying as we do on our bottom-up research as the source of decisions?" asks Lovelace rhetorically. "The answer is yes... and no, in other words it presents a challenge but not a threat."

Lovelace reports that Capital has worked with organisations such as Morningstar to help build the case, namely that the firm categorically adds value over time. He says the firm mined out three core factors. "Number one," he says, "the best asset managers do particularly well in down markets; two, low fees - and we are in the bottom quartile in the US in management fees - also help to add value; and three, good firms like Capital invest in their own strategies. These three screens can help investors identify active managers that likely can perform well over time."

Lovelace argues that armed with this information, the active manager industry needs to fight back with this message, but concedes it is not easy to shout this message with anything approaching a unified voice. "I meet people in the US that will say, literally, 'no active manager ever beats the index'. This is how widespread that mantra has become."

A fundamental mistake on behalf of active managers is to denounce passive. "It is not the enemy," says Lovelace, "it can be a good way and the fees are low and it helps encourage investment in equities.

No, what we at Capital must do - and we are increasingly nowadays - is convey that we can, and do, achieve better results. In fact, when

we add up the history of our 18 U.S. equity funds, they have 653 years of investment experience. Across that span, in good times and bad, we would average about 172 basis points annualized above the relevant index."

Lovelace has a theory as to why Capital's job as fundamental investors will become easier. He refers to the second incarnation of the European Union's 'The Markets in Financial Instruments Directive' (MiFID). "MiFID II is probably going to make our lives easier, not more difficult," he argues, "as it will force us all to be really thoughtful and careful about fees, which will probably result in fewer people doing research and we believe therefore that our ability to differentiate will increase."

The new world of regulation

Lovelace believes his firm's remuneration structure will also help Capital adapt to changes brought about by MiFID II or other new directives or regulations.

"As I highlighted earlier we get paid one, three, five, and eight-year bonuses and the last of these is by far the largest piece. On top of that, many of our investment professionals currently own shares in the company and that we think brings us back to sort of the collective aspect - namely that we will work together to adapt to market and regulatory vicissitudes."

He also notes that as well as appropriate remuneration, the firm's investment analysts have a broader footprint in the industry as they already manage money, meaning there is far less incentive for them to change jobs.

"Without the hierarchical structure of many of our competitors and with our compensation structure we believe that our investment analysts have a better incentive to stay long term with us, which is what happens in reality," he reports.

Chan chips in wittily: "I got asked this question before and I said maybe I will think about it by 2020! Joking aside, I can say that I get a lot of satisfaction out of the analysis and then being able to follow through and get involved with actual investments with actual companies with whom I can develop a relationship. It is very rewarding."

Adapt, survive, thrive

Lovelace recognises that a key element for the firm's success in the future and for the firm's remuneration structure is how to balance out transactional and recurring revenues amidst all the regulatory changes in the pipeline.

"We believe that our model, combined with our willingness to adapt rapidly and be a flag bearer for the active industry will see us survive and thrive," he concludes. "And in the meantime, we will certainly be expanding our footprint and our marketing effort in Asia, this remarkable engine room of global growth and dynamism." ■