Our Approach to Managing Equity Portfolios

The market and the economy

The economy responds to changes in demographics, politics, public health, education, technology, innovation, and capital markets (among many other things). It is constantly in the process of adapting to the shifting forces that are applied to it. Some economies adapt more successfully than others. The U.S. economy is thought by many to adapt the fastest because its rules (like property and bankruptcy law) are written explicitly to expedite and require response to change.
The economy, by definition, is always with us, however, businesses enjoy no such right of existence. They are exposed to all the risks that come with economic variability plus those delivered by competition. The market adapts to these varying fortunes by pushing successful businesses to the foreground and punishing those that are not up to the task.

The flaws with benchmark indices

Some sectors and companies enjoy long periods of expansion and prosperity, while others can wither to a shadow of their former selves or disappear altogether. In 1981 at the peak of the oil boom, eight of the ten largest market capitalization companies in the S&P 500 were energy stocks and the sector accounted for over 40% of the value of the index. By the spring of 2000 there was only one oil left in the top ten (Exxon Mobil, which needed a merger to make it into the list), while "new economy" stocks accounted for seven spots and almost 45% of value. This adaptive market (measured by the S&P) produced all-in returns of 8% per annum over the past sixty years while the economy was growing at 6% per annum.

A managed portfolio has the opportunity to improve on this process of adaptation by selecting for sectors and companies that are suited for the economic and financial environment expected to prevail over the coming several years and that have already demonstrated a proven capability to adapt.

Where the rubber hits the road: Portfolio management

Our approach to portfolio management is a four-step process:

1. Develop a view of where the economy is headed over the next one to two years and an understanding of what that will mean for financial markets.
We get help with this from the RBC Investments Strategy Committee (RISC) which is comprised of senior investment professionals from around the world. Chaired by the Chief Investment Officer of RBC Global Asset Management, it meets regularly to

develop and update a detailed forecast of where the major global economies are headed in the coming two years.
For each region it forecasts the pace of economic growth, inflation, interest rates across the full maturity spectrum, changes in relative value of currencies, projected corporate profit growth as well as the sectoral make-up of that growth, and expected returns for major stock markets.

2. Structure a portfolio to fit the above view.
We translate this forecast into specific recommendations on how to structure and manage an investment portfolio including the recommended mix between various asset classes (i.e., stocks (Canadian, U.S. and International), bonds, and cash). For the equity portion of the portfolio we determine which industry sectors are positioned to prosper in the forecast environment. Then, we assess the opportunity likely to be presented and the capability of the sector to realize on that as well as the risk-adjusted return potential for the group. At the same time we identify those sectors most likely to be challenged over the forecast period. Stocks chosen come from recommended weightings for each sector, which has the effect of tilting the portfolio toward potential, and away from undue risk.

3. Choose stocks that fit the recommended structure, adhering to objective selection criteria (a BUY discipline).

All of our equity asset classes – whether it be Canadian or U.S., conservative or not so conservative – are made up of 20 stocks. An equity selection committee seeks out those stocks in each sector that are best able to take advantage of the environment without exposing the portfolio to undue risk. This selection process tries to satisfy two conditions: 1) find companies that are excellent long-term investments, and 2) find companies where there are compelling reasons to suggest that the stocks should outperform the broad market over the coming one to two years.

Every attempt is made to confine our recommendations to companies that meet these long-term investment criteria:
- A business model that generates excess capital which can be either profitably reinvested or returned to shareholders through dividends and/or share repurchases;
- A strong management team;
- A strong competitive position and the ability to withstand threats from both existing competitors and new entrants;
- A financially healthy customer base that allows the company to meet intermediate and long-term revenue forecasts;
- A favourable industry environment from the standpoint of competitive pressures, pricing power and government regulation;
- A history of product innovation and/or a competitive cost structure.

In order to determine whether these long-term attributes are likely to deliver superior near-term investment performance, the selection committee scores candidates based on three different, objective disciplines:

 Fundamental – What do research analysts think about the company's prospects? Have they changed their opinion recently?

 Quantitative - This proprietary objective measure generates a score based on metrics such as past and current financial performance, growth, valuation, and earnings estimate revisions among others.

 Technical – This rank orders stocks according to several measures of price momentum to determine which are performing better than the market on a trend basis.

Ideally the committee is looking for stocks that score highly by all three disciplines. Perhaps even more important, it specifically rules out stocks where scores may signal above-average risk.

4. Decide *in advance* what would remove a stock from the portfolio (a SELL discipline).

Why is it that so many sell disciplines are based on the stock hitting a price target? For us, it is always about being in the best opportunities. If a stock is viewed as one of the best opportunities and is purchased, it stays in the portfolio until there is a compelling reason to remove it.

We usually end up removing a stock from the portfolio for any one of the following reasons:

Sector shift – From time to time the RBC Investments Strategy Committee may shift its recommendation away from a particular industry sector of the market. If the shift is large enough it may necessitate the sale of a stock even though it might meet all the criteria outlined in #3 above.

Inadequate potential return – If a stock in the portfolio rises to a point where the remaining upside does not offer a return commensurate with risk, the committee may choose to remove it.

Emergence of unacceptably high risk – Sometimes developments arise that were not foreseen at the time of purchase and which substantially alter the risk profile of a business or stock (e.g., lawsuits, competitive shifts, regulation or legislation, etc.). If, in the judgment of the committee, the effect of these cannot be quantified or if they had substantially altered the prospect for earning the forecast returns, the stock would be removed.

Significant deterioration in three-discipline scores – Sometimes even good companies need to be sold. When scores in the three disciplines used to make the 'buy' decision (i.e., fundamental, quantitative, and technical) fall below certain thresholds, the stock will be sold. This is not just because the prospects for near term investment performance have turned negative, but also because such a change can herald deterioration in long-term prospects that may not yet be evident.

What do you get?

Managing financial assets using this disciplined approach means an investor always has a portfolio that is structured to meet the opportunities and challenges presented by the economic environment and that contains outstanding long-term businesses primed to perform well in the coming one to two years.