

ACTIVE SHARE RISK PROFILE: Understanding Portfolio Risk Through Active Share

Active Share methodology can show much more than an equity portfolio's "headline score." Used as a holdings-based risk measure, Active Share can present a detailed risk profile that allows straightforward comparison with benchmarks, peer groups and specific competitors.

For investors in global and international equity portfolios, country, sector and stock-specific risks are among the most important elements of their risk exposure. Active Share Risk Profiles offer an intuitive visual approach to identifying and contrasting these key risk exposures.

Our approach is straightforward. An Active Share calculation sums the differences between the portfolio and benchmark weights for each stock in the portfolio. By grouping those stocks by country, and then by sector, we can identify how much of a portfolio's Active Share relates to country and how much to sector.

Drilling down further, we can see how much Active Share is generated from each country/sector "cell" (see Exhibit 1) and of that amount, how much is because of that cell's exposure difference from benchmark, and how much is due to stock-specific selection within that cell.

In this way we can build a detailed Active Share Risk Profile for a portfolio and differentiate it clearly from its peer group and specific competitors, even if the headline Active Share numbers are similar.



Active Share Risk Profiles offer an intuitive approach to identifying country, sector and stock-specific risks.



Exhibit 1: Active Share Risk Profile Contribution by Cell, End 2018 Difference Between Sample Global Equity Value Portfolio and Value Peer Group Average

Active Share Risk Profile vs PEERS		Cons.Cyc.	Cons.Def.	Energy	Financial	Healthcare	Industrials	Technology	Comm.Serv.	Other
USA	Country/sector	0.7%	0.4%	0.2%	0.7%	-0.1%	0.3%	2.2%	0.8%	-0.2%
	Stock specific	-1.7%	-1.4%	-0.8%	1.4%	2.9%	-1.2%	-3.5%	-2.3%	-1.7%
Japan	Country/sector	0.3%	-0.1%	0.0%	0.0%	0.0%	0.1%	0.0%	-0.1%	-0.1%
	Stock specific	0.7%	-0.1%	0.0%	-0.3%	-0.1%	-0.5%	-0.1%	-0.2%	-0.1%
UK	Country/sector	0.6%	2.0%	-0.1%	-0.6%	0.8%	-0.1%	0.0%	0.2%	-0.2%
	Stock specific	0.2%	0.5%	0.5%	0.1%	0.2%	-0.2%	0.0%	0.1%	-0.1%
France	Country/sector	0.1%	0.1%	0.2%	-0.4%	1.2%	0.4%	0.0%	0.4%	0.4%
	Stock specific	-0.2%	0.3%	0.0%	-0.1%	0.0%	0.3%	0.0%	0.2%	0.0%
Germany	Country/sector	-0.3%	0.0%	0.0%	-0.4%	-0.2%	-0.3%	0.0%	-0.1%	-0.1%
	Stock specific	-0.2%	0.0%	0.0%	-0.1%	0.0%	-0.1%	0.0%	0.0%	0.0%
Rest of Index	Country/sector	-0.7%	-0.4%	1.1%	1.1%	-0.3%	-1.4%	1.0%	0.4%	-1.2%
	Stock specific	0.0%	-0.1%	-0.3%	-0.5%	-0.3%	-0.2%	0.2%	0.0%	-0.3%
Non-index	Country/sector	2.1%	0.4%	0.8%	-0.7%	0.0%	1.2%	0.0%	-0.2%	0.8%

Source: Morningstar data, Brandes Institute. Data as of 12/31/2018. Peer group includes 16 global value equity portfolios. Countries outside the top five, and sectors outside the top eight in risk exposure are grouped together for clarity.

We recommend reading our full paper to see how this works in practice, but with space here for just one chart, this is a good illustration of how we can see where, and by how much, a single, randomly selected global equity value portfolio's ("Sample") risk exposure differs from its peer group's. Each country/sector cell includes two numbers: on top is the Active Share exposure to that cell ("country/sector") and underneath is the stock-specific measure, representing differences in selection within that cell.

We've used a heatmap to highlight the biggest differences between the Sample Portfolio and the peer group (both higher and lower). For example, we can see that in the USA technology cell, this portfolio has significantly greater exposure risk than the peer group (green, 2.2%), but much less stock-specific exposure risk (red, -3.5%).

To highlight some of the results from our research, we invite you to take our Active Share Risk Quiz and see how many questions you get right (hint: you might need to look at the [full-length paper](#) to get every question correct). Some may surprise you, and the answers are at the end of this abstract. Note: all data in the quiz relates to our Global Equity Peer Group as of December 31, 2018.

ACTIVE SHARE RISK QUIZ

1. Which country represented the largest single risk exposure within portfolios we studied?
2. Why do "stock-picking, bottom-up" portfolios tend to have high country and sector exposure risk?
3. The sector with the highest exposure risk for the Value Peer Group is technology, and for the Growth Peer Group it is consumer defensive. Is that correct, or should the order be reversed (consumer defensive for Value and technology for Growth)?
4. Which typically is a more significant driver of high Active Share: country and sector exposure relative to benchmark, or stock-specific selection within each country/sector cell?
5. For both Value and Growth Peer Groups, the same three country/sector cells are the highest contributors to Active Share, in aggregate representing over a quarter of the total. Which three cells are they?

Which country represented the largest single risk exposure within portfolios we studied?



Active Share Risk Profile provides an intuitive and visual risk assessment measure. Global investment managers and their clients can use it to understand a portfolio's holdings-based risks over time.

ACTIVE SHARE RISK QUIZ ANSWERS

1. *United States*
2. *Bottom-up managers tend to find “clusters” of attractive stocks in specific countries or sectors. These clusters tend to push up country and/or sector contributions to Active Share.*
3. *Yes, it's correct. For the Value Peer Group, technology is the highest sector risk, and for Growth, it is consumer defensive. That's because Active Share risk is driven by all differences from benchmark, including underweights. These sectors score the highest for Active Risk because of their significant underweights in these peer groups.*
4. *Country and sector risk exposure has a significantly higher correlation with Active Share than does stock-specific selection. High Active Share portfolios get there due to their country and sector exposure.*
5. *The three country/sector cells with the highest contribution to Active Share are all in the United States: financials, healthcare and technology.*

*Active Share Risk
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Disclosures

Active Share calculations require holdings-level data for all portfolios at all dates. The portfolio holdings data is sourced from Morningstar's mutual fund database of U.S.-registered mutual fund portfolios. The universe used was Foreign Large Cap Equity and within this universe, we downloaded the 69 global equity portfolios benchmarked to the MSCI World Index with inception dates prior to 12/31/2009. Data was downloaded for the 10 calendar year-end dates from 12/31/2009 to 12/31/2018. We then eliminated portfolios from the list if their holdings data was substantially incomplete, or if the portfolio did not substantially consist of equities. A number of the remaining portfolios had a limited amount of missing data. Some portfolio data included equity holdings, but without identifiers or country and sector categories. To the extent practical, these were input manually; however, for some portfolios, the amount of incomplete data was so substantial to make that task impractical.

The final dataset includes 46 funds benchmarked to the MSCI World Index. Not all of these portfolios had holdings data for every year-end date. Using Morningstar's style categorization of these portfolios, the universe was divided into three peer groups: Value (16 portfolios), Growth (17 portfolios) and Blend (13 portfolios).

The sector names and classifications in Morningstar's data are similar but not identical to the industry-standard GICS sectors. As all the downloaded security level data is identified with Morningstar sectors, the Morningstar sector classifications have been used throughout this paper instead of GICS sectors. The following table shows the Morningstar sectors alongside the corresponding GICS sectors. The securities in a Morningstar sector are not always an exact duplicate of those in the equivalent GICS sector.

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