

The Conviction Ratio

Measuring High Conviction in Equity Portfolios

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Interest in so-called High Conviction portfolios is increasingly common, as consultants and clients pursue the concept of “best ideas” manager selection. To some extent, this follows and overlaps the interest in high Active Share.

However, the measurement of High Conviction is less clear-cut than the precisely-defined Active Share, and we aim to remedy that. Currently the typical proxy for conviction level is the number of holdings: the lower the number, the higher the claimed conviction level. With conviction emerging as an increasingly important factor in manager evaluation, it would help to have a clear and practical definition, enabling consultants, clients and managers to compare more precisely conviction levels across portfolios and peer groups.

Both Active Share and number of holdings may be reasonable first approximations for conviction, but both are inadequate as precise measures. To measure conviction, it is important to avoid the fuzziness introduced by multiple share types for a single company, as well as to focus only on equity holdings, not cash-equivalents.

We propose the “Conviction Ratio” as a superior measure for equity portfolios, defined as:

The average contribution to Active Share from each company name in the portfolio.

The numerator of the Conviction Ratio is the amount of Active Share generated solely by the equities in the portfolio, excluding all non-equity (cash, currencies, bonds, etc.). The denominator is the number of companies (not securities) responsible for that amount of Active Share. For any single company, its different share classes (including depository receipts and any stock derivatives) would be counted just once. The definition reveals the Active Share generated by the manager’s average “stock pick”, which we suggest is a better measure of the manager’s conviction level.

We calculated the Conviction Ratio for a peer group of active, global equity portfolios for which we had sufficiently accurate holdings data. This data accuracy requirement meant our peer group contained disproportionately more concentrated and high Active Share portfolios than a typical global equity universe. The median Active Share of 90.6 in Exhibit 1 is consistent with this, because the median Active Share for portfolios benchmarked to the MSCI World is around 86. This skew is acceptable as we believe the primary use of the Conviction Ratio will be to differentiate among high Active Share managers.



Exhibit 1

Peer group of 32 active, global equity portfolios, with Active Share benchmarked to MSCI World Index

	Conviction	Active
	Ratio	Share
Highest	5.08	97.5
Median	1.83	90.6
Lowest	0.52	76.7

Source: Longevity Financial, Morningstar. Data as of December 31, 2018. Note that the requirement for accurate holdings data excluded many portfolios with large numbers of holdings, typically enhanced index or factor-driven portfolios. Accordingly, the peer group is skewed to more concentrated portfolios than the typical industry universe. This peer group includes growth (16), value (7) and blend (9) styles.

The highest Conviction Ratio in our study is an exceptional 5.08. Note that a hypothetical 20-name portfolio with nothing in common with its benchmark would score 5.0, so the 5.08 score represents truly high conviction!

In practice, we believe a Conviction Ratio of around 3 or above demonstrates high conviction, and six of the 32 portfolios achieved that level. Note that this Conviction Ratio of 3 means that on average, every stock picked in the portfolio is contributing 3% in Active Share. At the other end of the scale, Conviction Ratios under one suggest a more diversified, lower conviction approach, and these managers are unlikely to claim to be “high conviction”.

The data now enables us to compare the conviction level of any two portfolios. Interestingly, it also allows us to see whether high Active Share automatically means high conviction. The answer: it doesn’t (and vice versa).

We divided our peer group of 32 into quartiles for both Active Share and Conviction Ratio. Sixteen portfolios were in the same quartile for both measures. Sixteen were not, and four of these were two quartiles apart. The correlation between the two metrics is 70%, showing a strong relationship, but not one that moves in lock-step.

Interestingly, the correlation between Conviction Ratio and Active Share drops when the focus is on the highest Active Share portfolios, those over 90. This is the group of portfolios most likely to be followed by consultants and clients seeking true focus: high conviction and high Active Share. In this group (19 portfolios) the correlation drops to 50%, with Conviction Ratio revealing significant differentiation that might otherwise be missed.

Exhibit 2 includes the four manager portfolios with the biggest differences between Conviction Ratio and Active Share. All four of these move by two quartiles. The two with highest Active Share (A and B) both have below median Conviction Ratios, while C and D have slightly lower Active Share, but first quartile Conviction Ratios (manager C’s 3.10 score is the third highest of the 32-member peer group).



Exhibit 2

High Active Share manager portfolios with significantly different Conviction Ratio rankings

	Conviction	CR	Active	AS
Manager	Ratio ("CR")	Quartile	Share ("AS")	Quartile
A	1.58	3	93.2	1
B	1.45	4	91.7	2
C	3.10	1	90.5	3
D	2.57	1	90.2	3

Source: Longevity Financial, Morningstar. Data as of December 31, 2018.

In sum, Conviction Ratio is a new, practical metric that provides managers, consultants and clients with a precise and easily calculated way of identifying and comparing conviction levels within an equity peer group.