Fund management team

OMAM's quantitative strategies team includes specialists in portfolio construction, research and systems development. The investment process is designed to exploit market inefficiencies and is based on a proprietary multi factor return model. The process calculates a forecast return for each stock and the resulting portfolio is optimised in terms of risk, cost and return.

Old Mutual Quantitative Strategies investment update

OMAM's quantitative models have been used to manage both long only and equity market neutral products since 2001, during which time there have been a number of enhancements to both portfolio construction and risk management. In this document we address the changes that have been made to both the return forecasting model and the risk model in the recent past, as well as the performance of funds run using this strategy.

It would be an understatement to say that 2008 was a difficult year for global equities and 2009 has continued in much the same vein. The end of cheap and plentiful global credit finally came home to roost, with equities suffering extreme negative performance, which accelerated into the year-end as the risk of a significant global recession increased. The US banking sector has changed beyond recognition, with a number of blue-chip financial firms failing or merging at distressed levels. The global response has been significant, although it remains to be seen whether it will prove to be enough. Fiscal and monetary policy has shifted from controlling inflationary pressures driven by a commodity bubble to one of aggressive loosening as the risks in the economy have moved towards more deflationary issues as commodity prices fell and the economic slowdown accelerated.

Return factor enhancements

Performance over the most recent period has been difficult for strategies based on quantitative investment insights and our funds have not been exempt from this. The macro issues outlined above have had a significant impact on an important part of the model, the valuation factor. This theme looks to profit from company stock prices moving away from fundamental asset values and future earnings expectations as investors behave irrationally. Fundamentals reassert themselves over time, leading to cheap stocks outperforming and expensive stocks underperforming. Unfortunately through this period of extreme share price movement the market has overlooked fundamental value in the stock selection process, which has led to cheap stocks becoming cheaper and expensive stocks moving to more expensive valuations relative to fundamentals.

The valuation factor we use is not an historic ratio-based value factor (using such metrics as price to sales or price to book), but instead is an attempt to

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arbitrage the trade-off between value and growth. It contains value characteristics and therefore has been impacted by the value unwind in the broader market. As part of our continued investigation into the valuation phenomenon, it became apparent that an evolutionary change was required to better understand the outperformance of 'cheap' stocks over time. This change took the form of the incorporation of the idea of financial strength, or quality, at the stock level. Underpinning our motivation to introduce a measure of quality is the recognition of the cyclicality of value returns. In periods of low risk appetite, such as now, markets are less prone to reward measures of value, preferring instead the safety of sound balance sheets and earnings. This flight to quality has been captured in out new valuation metric, **Dynamic Valuation**. Our original measure of valuation is now combined with a measure of quality, the amounts of the two being dependant upon the level of risk appetite in the current market.

The team has also been busy improving other areas of the forecasting model. The earnings revisions theme has historically been a strong predictor of share price performance, although it has become less powerful in the recent past. The factor, now entitled **News Adjusted Revisions**, still contains the same basis, i.e. information disseminated to the market takes time to be priced into stocks. However the factor now takes into account that the time lag has significantly shortened as more investors use this type of theme. This results in some of the information already being embedded in the share price and therefore needing to be removed from forecasts. It was also recognised that the signal could be honed much further than was previously the case. Firstly, the reaction to upgrades is less powerful than the reaction to downgrades, in other words the signal is not symmetrical. It is also useful to note that certain companies are more impacted by earnings revisions and will therefore move faster to price in this information. These companies tend to be ones with more aggressive accounting policies.

The old management hubris signal has been recalibrated and named **Investments**. We continue to believe that acquisitions are bad for the acquiring shareholder on average, due to the requirement for a premium to be paid and the notion that management is often unrealistic about the potential cost savings and synergies that can be obtained from corporate activity. The use of changes in shares outstanding to act as a proxy for merger & acquisition activity has been recognised as a limitation and this theme is now captured by assessing changes in the entire capital structure, thereby giving a better understanding of the acquisitive nature of individual companies. In the case of the North American equity model, this represents a significant improvement.

We continue to believe that medium term momentum is a theme expressed separately in stocks and aggregations of similar stocks. Historically, for aggregated momentum, we have used the high level 'GICS' sectors to capture the idea that similar types of stocks tend to move in the same direction, albeit with lags due to delayed data incorporation in stock prices. Using this very broad set of stocks reduces the efficacy of the signal due to the heterogeneous nature of the sectors in question. The sector rotation factor has been redesigned to use similar ideas in the more homogeneous setting of industries, rather than broader sectors. Unsurprisingly the factor now has the name **Industry Rotation**.

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Risk model enhancements

In conjunction with the above changes to the return model, over the last few months we have continued the research efforts in enhancing our proprietary risk model. We have now concluded the first stage of the risk modelling project, resulting in a more robust and dynamic version of the risk model being implemented, while still providing risk estimates that are stable through time in order to avoid unnecessary trading. The change allows the model to react more efficiently to recent changes in both overall market volatility and, perhaps more importantly given that the risk factors are pre-specified with the return model in mind, the changes in the volatility of the underlying risk factors.

Improvements to portfolio construction

In addition to the changes to the return forecasting model and the risk model, portfolio structure has also been improved. The portfolio construction process has moved to a global optimisation from regional optimisations. This allows a more efficient portfolio construction with a better understanding of the relationship between forecast and realised risk in global portfolios.

The changes to the model have been introduced with the help of OMAM's Academic Advisory Board, the members of which continue to function as the gatekeepers of the change control process. With the implementation of these changes and the strong research pipeline, the stability and robustness of the process has been greatly improved.

Increased confidence for the future

In conclusion, whilst the current market uncertainty has impacted portfolio performance, we expect returns to improve in the medium term as we move to a more normal market environment. Our confidence in our investment processes has increased as we have introduced enhancements to the stock selection and portfolio construction tools, which we believe stand us in good stead to add significant value to portfolios in the medium term.

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