Investment update

12 May 2010

Quantitative strategies team: Q&A

Quantitative strategies 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.

What do you mean by quantitative strategies?

At OMAM the quantitative strategies team are active stock pickers using similar investment criteria to more discretionary investors to identify stocks which will either outperform or underperform a relevant index. What sets us apart is the use of sophisticated, systematic investment strategy to do the heavy lifting when deciding which stocks to invest in. We have a view on approximately 3,500 stocks, including North American, European, Asian and Japanese companies, which we update on a daily basis. This is only possible using systems running continuously which incorporate all the new information available to us.

What is the philosophy behind quantitative investing?

We believe markets are not fully efficient. Indeed there are characteristics of individual stocks which can be used to decide which stocks will outperform and underperform in a given market. Quantitative investing targets these characteristics dispassionately. If our outlook changes on a particular stock, its position in the portfolios will change. There are no sacred cows in our portfolios and our approach is built on the premise we don't second guess what the evidence is telling us.

Is this simply a black box?

Absolutely not! We would class our process as active and glass box rather than black box investing. We are able to explain exactly what our processes are targeting in any given period together with what is working and what isn't. We do however invest rigorously using robust portfolio management techniques which target outperformance whilst also managing the risk inherent in active investing.

How does the investment process work?

Our systematic process allows us to analyse the attractiveness of stocks using similar measures to those employed by more traditional fundamental managers, but on a much larger scale. While a traditional analyst might closely monitor fifty companies, our approach allows us to effectively analyse over three thousand companies on a daily basis. So what are we looking for when deciding whether to include a stock in our portfolios?

At the core of our investment approach lies the fact that we like stocks that are cheap relative to their fundamentals and growth characteristics. Stocks in a similar industry are impacted in a similar way by economic conditions but often with a time lag. This lag often leads to industries continuing recent performance traits. Therefore we like stocks belonging to industries which have been outperforming in the recent past, provided the macro environment remains similar. Good company growth which is likely to continue is often underappreciated by the market and is also important. We like companies whose earnings are increasing faster than expected and company management which is making sensible investment decisions. Finally we find that good quality balance sheets are important, particularly in times of market stress. All of these themes are incorporated into a forecast which identifies stocks likely to outperform or underperform. A portfolio is then built of these investment ideas using a risk model and optimisation process to efficiently incorporate our views on individual stocks whilst also controlling risk. The final piece of the puzzle is a forecast of the transaction cost payable to trade a stock, to ensure the profit gained outweighs the costs.

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OLD MUTUAL ASSET MANAGERS

Is this better/worse than active fund management?

Quant investing IS active fund management.

Where we differ from discretionary fund managers is in the number of stocks we can analyse. By analysing and investing in a large number of stocks we build broadly diversified portfolios which allows us to efficiently manage risk. We also look to minimise underperformance driven by irrational thinking (I bought company X at a higher price than it is now so I'll wait till it gets back there to sell it; I know the earnings for company Y are being downgraded but I know better than the market at large and so won't act on this knowledge). Instead we have rigorous and systematic processes for buying and selling stocks in place. We also build portfolios very much with risk in mind, managing the risk of the portfolio whilst also looking to maximise the positive outcome for our investors.

Why don't investors simply buy a tracker fund?

A tracker fund typically tracks an index which moves in line with an underlying market. For example, a fund might track the FTSE All Share which reflects the UK equity market. To achieve this, the fund can simply buy securities in the appropriate market. Our equity benchmarked portfolios look to outperform the same index by identifying stocks likely to outperform and underperform the index and building portfolios consistent with these views. Our absolute return funds on the other hand are not attempting to reflect the performance of a market - on the contrary, they aim to be independent of market movements. Absolute return funds aim to deliver positive performance irrespective of market direction.

Tell me about the investment team

We have a team of 10 investment professionals covering portfolio management, research and systems. Our research effort is supplemented by the use of an academic advisory board and the virtual laboratory, a number of PhDs and post doctorate students with similar research interests to ours.

What products do you manage?

Our core funds include traditional OEICs investing in global equities, North American equities, European and Japanese equities as well as a global absolute returns UCITS fund, the Old Mutual Global Equity Absolute Return Fund, and a hedge fund.

What is the Old Mutual Global Equity Absolute Return Fund?

The Global Equity Absolute Return Fund (GEAR) uses the investment processes discussed earlier to build a market neutral portfolio designed to deliver absolute returns. We buy the stocks we think will outperform the market and sell short those that are likely to underperform. GEAR targets a low level of volatility with consistent returns of cash plus 5-6% p.a. over the long term. GEAR is built to be market neutral and hence is designed to deliver positive returns in all market conditions, i.e. whether the market is going up or down. We invest in global equities, giving us a world of opportunity to add value to our portfolios. The emphasis is on large and mid cap stocks with a strong focus on risk management.

What do you mean by market neutral?

The Old Mutual Global Equity Absolute Return fund is designed to be what is commonly known as market neutral. These types of funds are designed to be unaffected by whether the market is going up or down. GEAR is built to minimise exposure to market movements whilst still allowing us to exploit our stock selections. The performance of the portfolio is dependant on our buy investment ideas outperforming our sell ideas. Our investment

process produces as many stock ideas expected to underperform, which we would look to sell short, as it does stocks expected to outperform, which we would look to buy.

What is the outlook for GEAR?

The market has moved from a macro driven sector selection environment to a stock selection market. This is generally good for our investment approach. We have also seen a move over the last 12 months back to company fundamentals being more important to investors. This again is a good environment for our investment approach. We believe the environment is very conducive for quantitative investment in general and the quality and power of our approach stands us in good stead to add significant positive performance in the medium term.

What might affect the performance of GEAR?

Whilst we expect good performance from the fund, we are not complacent. Periods of aggressive changes in market leadership can dampen performance. However, the dynamic nature of our process allows the portfolio to adapt to changes in market environment quickly.

Which sectors does your process currently favour?

The sector positioning is a direct result of the bottom up stock selection process. In any given period, stocks we expect to outperform congregate in certain sectors of the market, leading to our long positions at a sector level. Similarly the stocks we expect to underperform also congregate giving our short sector positions. Sectors are constrained, meaning we take relatively small positions. Currently we favour economically exposed sectors, consumer discretionary, energy and information technology. We are short more defensive sectors such as consumer staples, utilities and healthcare.

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