FOCUS ON QUALITY: THE CORE OF NEW EQUITY STRATEGIES

Northern Trust research identifies ways to overcome the limitations of traditional low volatility portfolios.

Equity market turbulence often plays havoc with institutional investors’ portfolio objectives, whether it’s leaving a liability stream uncovered or jeopardizing the funding for a spending plan. As a result, investors seek strategies that enable them to minimize portfolio fluctuations without sacrificing return-generating capabilities. Traditionally, their search has led to the implementation of low volatility portfolios, but the risk-return characteristics of these approaches have proven less than desirable.

Northern Trust recently conducted research to better understand the limitations of the traditional low volatility approaches. The result of this study has formed the basis for developing new strategies to overcome these constraints. We recently spoke with members of Northern Trust’s quantitative equity group — Matt Peron, head of active equity; Mark Sodergren, senior portfolio manager; Kristen Steffens, investment strategist; Meggan Friedman, investment strategist; and Scott Ayres, senior product manager — about the research and resulting new strategies.

Recent market volatility has increased discussion of minimum variance portfolios and their related counterpart, low volatility portfolios. What has Northern Trust developed to meet this demand?

Kristen Steffens: We certainly have seen an increase in inquiries related to minimum variance and low volatility portfolios and we believe in the merits of portfolios with either a quality dividend focus or a quality low volatility focus as a response to specific investor needs. Northern Trust currently offers two solutions that directly address this space: Quality Dividend Focus (QDF) and Quality Low Volatility (QLV). Both portfolios utilize a proprietary definition of quality to invest in what we have identified as high-quality securities. When combined with unique risk management and portfolio construction techniques, such as those offered by Northern Trust, the portfolios offer compelling differences from traditional products.

Meggan Friedman: Specifically, QDF seeks to invest at the intersection of high-quality and high-yield, offering a total-return strategy to investors. QLV seeks to minimize volatility of the portfolio, while still providing additional return given the incorporation of our proprietary quality screen. We developed both strategies consistent with our ongoing commitment to addressing clients’ unique needs.

Scott Ayres: The search for high-quality stocks serves as a driver in both the QDF and QLV strategies and is a pervasive theme found in our overall approach to equity management. We embrace the intuitively logical idea that securities of stronger companies will perform better over time and we believe a quality focus has a role in risk management. Our role in this process is straightforward: we identify the most effective ways to define and measure quality and we build efficient methods to exploit these criteria to our clients’ benefit.
What are the limitations of traditional minimum variance approaches?

Matt Peron: With a traditional minimum variance portfolio, it is quite common to find a highly concentrated portfolio. As we highlighted in our recent study, one of the interesting things that we found with the traditional minimum variance portfolio was the extreme stock concentration, resulting in as much as 20% invested in a single name historically. We also found low volatility sectors, such as utilities and consumer staples, received a vast majority of the weight within a portfolio and contributed most of the risk.

Given these limitations, how can investors pursue a low volatility approach while mitigating risks associated with a concentrated portfolio?

Matt Peron: Faced with our study’s initial results, we decided to take a deeper look at how we think institutional investors should focus on risk management. So when we looked at low volatility portfolios, we included some constraints (built upon our years of experience in risk and portfolio management) to reflect what we believe a sensible low volatility portfolio might entail. These constraints included limiting the relative stock positions and sector weights, while still trying to achieve the overall goal of creating a low volatility portfolio. We found it was possible to construct a portfolio that was able to achieve the objective of lowering the overall portfolio volatility, but also had increased diversification.

Explain the basis for the QDF strategy and what implication it holds for low volatility portfolios in general.

Matt Peron: Northern Trust’s proprietary QDF strategy addresses investor concerns surrounding the recent market environment, including the need for a portfolio that focuses on quality, a portfolio that can focus on achieving different levels of dividend yield and a portfolio that can allow the client to control volatility.

As a team, we are focused on quality – and we believe this focus sets us apart from other managers in this space. We define quality by assessing the management, profitability and cash factors for each company. The quality evaluation is done on a region and sector basis, which is important because it enables the investor to control risk in the overall portfolio and to produce a well-diversified portfolio.

In addition to quality and yield exposure, the final benefit for investors is the volatility component. Investors who are a looking to reduce their overall risk profile can control the volatility of the QDF portfolio. This is achieved by targeting lower beta – or lower volatility – in the portfolio, while at the same time trying to maximize the overall utility objectives of delivering quality and dividend yield.

How might an institutional investor use a QDF strategy within their overall investment portfolio?

Meggan Friedman: We encourage investors to consider a QDF strategy as a core equity position, not just an income generation strategy, given the risk-controlled nature and total-return focus of the portfolio. Further, as our QDF strategy is offered in separate account structures, we're seeing increased interest among investors who need that additional layer of flexibility, whether it is by varying the yield or the beta targets, as well as fulfilling SRI mandates or other client-specific needs for excluding certain securities or sectors.
Scott Ayres: For example, investors who might be interested in the QDF strategy include an insurance company that has a liability stream that they need to offset, or a foundation or endowment that has a spending policy that they need to meet, and they’re unable to get sufficient yield from a quality bond portfolio. The appeal of QDF here would be two-fold: the institutions could increase their yield, and a QDF portfolio would have a low correlation to their existing bond portfolios, helping with their diversification needs.

Which strategy(ies) might appeal to investors who are focused solely on minimizing volatility, rather than reducing volatility of an alpha maximizing strategy?

Mark Sodergren: An investor who is focused solely on volatility may want to look beyond QDF, which is focused on maximizing utility (an alpha and risk trade-off), and instead consider our Quality Low Volatility (QLV) portfolio. As Kristen mentioned earlier, we have developed our new QLV strategy with an objective to minimize portfolio variance. Traditionally, low volatility strategies are susceptible to excessive unintended risks. The QLV strategy, however, is designed to take risk in quality, low-volatility securities while minimizing other extraneous risks.

Investors interested in the QLV strategy tend to be benchmark agnostic and instead are seeking a solution to reducing absolute portfolio volatility, as opposed to investors in QDF who are primarily concerned with risk and return relative to traditional capitalization-weighted benchmarks.

When constructing the QLV portfolio, the low quality stocks within the stock universe, as defined by our proprietary measure of quality, are eliminated. The remaining securities define the investable universe and are used to create the low volatility portfolio. As part of the portfolio construction process we control the sector, industry, region, country and risk factors to mitigate any extreme exposure to factors outside of the targeted quality and low volatility parameters. By narrowing the universe, targeting risk contributors and minimizing variance, the QLV strategy addresses many of the pitfalls of traditional low volatility strategies and possesses attractive risk-return characteristics, providing a flexible solution and targeting an increased Sharpe ratio.

Based on the initial research, how might an institutional investor utilize the QLV strategy in their portfolio?

Kristen Steffens: For the QLV strategy, we are seeing particular demand for clients outside the United States. There are certain regulatory schemes in place, notably in the Eurozone, that focus on volatility as it relates to institutional investors’ capital requirements. This regulatory environment has driven some of these investors, notably insurance companies, toward lower volatility equity exposures.

Scott Ayres: Another example would be a pension plan using a liability driven investment scheme, which has been broadly adopted in Europe and increasingly in the United States as well. For an underfunded plan where an equity exposure offers some potential for growth, the low volatility aspect of product QLV strategy may provide that potential without injecting large amounts of uncertainty into their expected funded status.
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