Do you think that investors are taking on too much risk today?

I don’t know that I would characterize it as taking on too much risk. I’d say that investors probably aren’t aware of the different types of risk they’re taking today. “Too much” of something implies one dimension; in reality, there are multiple dimensions.

What should advisors tell investors about portfolio construction and risk?

People tend to look at their portfolios in terms of geographic exposure or asset classes. They’ll say, “Oh, I’ve got so much in emerging markets,” or “I’ve got so much in fixed income.” I think it’s better to look at a portfolio’s sensitivity to increases in risk, to jumps in the Volatility Index (VIX). Once you have that sorted out, you’ll have a much better sense of how the portfolio will do in the inevitable volatility shock.

Does this make a case for long/short equity?

It does if you look at the different ways you can protect your portfolio. A short portfolio will naturally tend to do well in a down market. Shorting speculative stocks, particularly, can provide strong downside protection in unpredictable and volatile markets. By speculative, I mean higher-beta stocks.

What should investors realistically expect from a long/short equity strategy?

Generally, a long/short strategy has a market exposure, or beta, somewhere in the 0.4-0.6 range. If the market is in the normal range, making 10 to 12 percent, the manager’s stock selection will dominate and the long/short portfolio should deliver market-like returns but with less variability. It’ll do even better if the manager’s a really good stock picker.

Is shorting high-beta stocks at the core of Analytic Investors’ strategy? Is that different from the approach of other long/short managers?

Yes on both counts. Low-beta stocks tend to earn returns that beat cap-weighted portfolios, but with less risk. High-beta stocks produce returns that are worse than the market at substantially higher risk. We build portfolios to systematically exploit these tendencies. We’ll construct the long side with a beta slightly under 1 and the short side with a beta substantially greater than 1—maybe 1.3 or so.
The return differential is maintained dynamically on a systematic basis. I don’t know of any other long/short managers that have this propensity or this structural tendency built into their portfolios.

**We’re in a challenging market environment now, don’t you agree?**

If you’re referring to its volatility, yes; for some, I suppose. I was with some friends of mine who work for a fundamental firm. They were very concerned about the surge in market volatility. They tend to get a lot more excited about such things than we do. We just say “It’s not normal, but it isn’t unusual.”

Certainly, volatility is higher than we’ve seen historically, but every five years or so, you should expect an environment like this. You shouldn’t be surprised by it.

Unfortunately, volatility goes away pretty slowly. When the VIX is at 40 and its long-run average is 20, it takes three to four months to get back down to its historical average. Very seldom does volatility go away in a nanosecond.

**What do you anticipate for the market in the coming year (i.e., 2016)?**

Forecasting the market is not something that I try to do. Neither is building portfolios based on the recent past.

Look at the market in the last year. Volatility was incredibly low. Now it’s spiked much higher. You shouldn’t build a portfolio based on last year’s story. What you should do is peer over a longer horizon; you’ll see that you’re bound to get volatility shocks from time to time.

So, if I had to speculate, if I had to look forward for the next year, you really should be building a portfolio with the expectation that you’ll see more selloff days like those in late August.

**What makes Analytic Investors different from other quantitative investment firms?**

The nimbleness of our strategies. We manage around $12 billion; we are employee-owned; there are 12 people in our investment team; we all sit in an open office so we can freely discuss new ideas and research innovations.

We’re committed to the notion that strategies need to evolve over time. Four of our people are dedicated solely to research. That’s all they do. We’ve found that someone focused on a research project 60 hours a week moves the ball a lot faster than someone who can only devote ten hours a week. Our typical time window—from researching a strategy enhancement to portfolio implementation—is just three months. That’s a substantially shorter cycle than you’ll find at larger firms.

**The financial crisis of 2008 must have had an impact on your investment approach. In its aftermath, did your models change?**

I think the biggest change for us since 2008 has been designing structural defensiveness into our strategies. Before 2008, we thought putting a bunch of uncorrelated sources of alpha together would produce a portfolio that’s well diversified. Because the sources of return were uncorrelated, we thought we’d have a good return profile regardless of the market environment. We learned in 2008 that a number of return sources—from the carry trade to the value premium to the momentum premium—suddenly got highly correlated. They all did poorly. That prompted us to design a strategy with a structural but dynamic short element.

**So your decision rules evolve. How fluid are your rules and how often do they change?**

We update our views constantly, but the way we look at the world doesn’t change.
We have a set of stock-picking rules that rely upon weighted factors. There’s a systematic process we go through to update those weights every month based on the market environment.

It’s like driving a car. You constantly glance back and forth between the speedometer and the road ahead, all the time adhering to the rules of proper driving—stay on this side of the road, respect the speed limit and so forth. You constantly collect new information as you go along and you process that information to give you direction.

“That’s very much our job as a quantitative manager. We operate under a set of rules, but in order to ensure adherence, we need to collect new data, update our models and act accordingly.”

And that’s the dynamism of the portfolio management process?

Yes. Sometimes, new data or tools become available that change the process.

When we first started running the long/short strategy, we’d wrestle with the fact that it’s very easy to get news analytics on U.S. stocks but much harder to get such information on non-U.S. stocks. Now, as a quantitative manager, we don’t really read the news very carefully, but we want to be sure that we’re not buying a stock that has a news event around it. We partnered with a research firm whose linguistics engine allowed us to input a news feed and generate news analysis on every single stock. Our next step, of course, was to figure out how we were going to systematically incorporate this analysis into our process. We’re always looking to see if there’s new technology that will improve our process further.

Would you say that’s another difference between your process and that of other quantitative managers?

Yes and no. There are some other managers using news analytics. I don’t know how many, but certainly more now than there were five years ago. What makes us unique is that we’re always looking at new stuff. For example, we were one of the first firms to incorporate a company’s environmental, social and governance scores into the investment process.

It’s constant innovation, rather than a single enhancement, that makes us distinct.

What’s the volatile-minus-stable, or VMS, factor?

It’s the return differential between a portfolio of high-beta, or volatile, stocks and stable stocks.

You could picture the factor in action by comparing the performance of SPLV, an exchange-traded portfolio of low-volatility issues to that of SPHB, a high-beta ETF. This year, SPLV has dramatically outperformed SPHB, so it’s been a very good environment for low-volatility investing.

It’s really important to know your VMS exposure; how much volatility risk you’re really taking. You may think your portfolio is safe because it’s populated with high-quality companies at reasonable valuations, but you could still have a lot of VMS exposure. If so, when the VIX spikes and the market does poorly, your portfolio will do poorly.

So how do you actually gauge a portfolio’s VMS exposure?

If you have individual stocks in your portfolio, it’s easy. You determine how much of the portfolio is made up of securities with betas significantly greater than 1.

If you’re investing in mutual funds, it’s not so easy. You could go to Morningstar and look at the
holdings data for each fund to find an aggregate beta. If the betas of the funds are greater than 1, or even up in the 0.951 range, I would say that you have more than the recommended amount of VMS exposure.

It’s important to look at the holdings beta and not historical beta because mutual funds almost always hold cash. If you hold cash, the realized beta is always going to be less than 1; cash is a drag.

We wrote a paper a while ago called “Know Your VMS Exposure,” which illustrates how to do this analysis.

Are there certain sectors that exhibit greater volatility than others?
That changes over time, obviously. Five years ago, banking was the most volatile sector. No longer. Right now, the most volatile sectors are energy and commodities.

And the least volatile?
The least is utilities. Utilities have consistently been low volatility issues but they’ve suffered macro shocks, too. Remember the Enron-era crisis when a number of utilities flirted with bankruptcy? Their stocks were very volatile then. The other issue with utilities is their interest rate exposure. In a rising rate environment, you might want to look at the consumer staples sector which also exhibits relatively low volatility.

Can you describe the low-volatility anomaly in a succinct manner?
It’s the tendency of stocks with low betas to outperform stocks with high betas.

This was established in your research?
Yes, but I wouldn’t say we were the ones to discover it. I think it was first discovered in 1974 in a paper by Fischer Black, Mike Jensen and Myron Scholes.

Then, in 1992, Gene Fama and Ken French came out with a paper arguing that value stocks beat growth stocks, that small cap stocks outdo large cap stocks and that beta doesn’t matter.

The assumption was that high-beta stocks do the same or worse than low-beta stocks. Nobody really picked up on that. We were one of the first investment firms that looked at that and said, “If high-beta stocks have the same or worse return than low-beta stocks, why not build a portfolio with just low-beta stocks?” You’re going to get the same return with a lot less heartache. I think our insight was not so much about discovering the anomaly, but realizing that you can use it to build a better investment product.

Was that the compelling reason for your original white paper on low-volatility investing? To deal with the contentions in the Fama-French model?
Yes, to exploit that tendency. Others had documented the propensities, but when Fama and French came out and said it, they won the award for best paper in the Journal of Finance. It received a lot of press.

Your company has undergone some changes recently. You’re now independent and employee-owned. Has that changed the way you manage the firm?
From a management standpoint, it really hasn’t changed things much. Our prior owner was really committed to our autonomy and we were always positioned as a boutique firm, completely independent from an investment standpoint.

What has changed? Well, when you’re part of a bigger firm, there are things you’re obliged to do, like going to annual conferences and the like. Now I have a lot more time to spend doing the things I really enjoy.
Like cooking up NFL Alpha?
Right. That’s done by one of my colleagues. I like the modeling part of it, and he likes the application to football. I know nothing about football, really.

You’ve seen significant asset growth recently. Any impacts?
As our low-volatility strategy has grown, I’ve often heard from people about how great it’s performing. That makes me shudder. I really don’t want to hear that. That’s the worst reason to buy a strategy.

“Our biggest challenge is getting people to understand what they’re buying.”

Let me explain. We started running low-volatility strategies back in 2004. The first people who got into the strategy bought in because they looked at the research and they fully understood the strategy. I firmly believe that’s why they’re still with us today.

As I meet our newer clients, I wonder if they’re buying the strategy for the right reasons. Some buy because of its strong performance. Others buy because they think low beta and low correlation have merit in their portfolios. It’s the second type of client that will be able to stick with the strategy and reap its benefits. People who buy it just for performance will be disappointed. They’re more likely, too, to pull out of the strategy at precisely the wrong time. So, as we’ve grown, we’ve strived to ensure that people buy the strategy for the right reasons. That’s the best way to avoid disappointment going forward.

Were you able to bring on more talent into the organization as a result of your asset growth?
We’ve added two people to the investment team since we became independent and we’ll probably add another person this year. We’ve also been able to invest in trading technologies.

Over the last three years, trading has evolved tremendously with the growth of dark pools and trading venues. We’ve really embraced the trading evolution because we believe every penny saved in execution goes straight to the performance line. For example, we’ve cut our trading cost in the U.S. almost 50 percent in the last two or three years.

Do you have people dedicated to research on particular strategies? Are there people who are performing research for the global long/short equity strategy exclusively?
No. We don’t allocate research to individuals by strategy.

The global long/short equity strategy uses three signals. The first is beta, so we’ll conduct ongoing research to improve our beta forecasts. We use a stock selection model, too, so we’ll research improvements in our ability to make picks. That model is used across the firm, so it’s not specific to the long/short strategy. We’ll also do research on forecasting stock-specific risk or stock-specific events. That’s also applied across the firm.

What’s the most interesting research you’re currently performing?
Right now? I’d say the differential effect of certain factors on a portfolio’s long and short sides.

Case in point: Everybody knows about the value premium. If you ask most people, they’ll tell you buying undervalued, or low P/E, stocks beats the market. That’s generally true, but what they won’t tell you is that stocks with high P/Es do significantly worse than the market and, in fact, do so to a greater degree than cheap stocks outperform.

Your long/short strategy has evolved since its inception. What’s been the most significant change over time?
The biggest change is the way in which we estimate beta. From inception, we’d estimated beta using
two different models so we’d have diversified risk forecast. A year and a half ago, though, we started a research project to find the best model for predicting beta. We found beta’s actually more stable than you might imagine. We also found that we’re better off using a five-year, rather than a one-year horizon in our forecasts. A lot of off-the-shelf risk models use a one-year span. A short-run beta is just too volatile.

We made the enhancement seven or eight months ago and it’s helped the portfolio quite a bit. A more stable beta estimate translates to less turnover.

Then there’s the performance of high-beta stocks, the short side of our portfolio. We wondered if there were any environments in which these stocks could be expected to rebound. It turns out there are.

Bottom line: It’s not a good idea to short stocks with really high betas in markets where those issues have already sold off.

“When everyone’s worried about the state of the world, you’re actually better off shorting beta 1 stocks.”

Think of our current environment. We recently saw the VIX spike to the 35-40 level. If somebody were to come to me and say, “Do you think I should short high-beta stocks now?” I’d say, “In the long run, that’s a good bet; I just wouldn’t do it right now. I’d wait until the VIX decays to maybe 25 or 26 and then put on your best short.” We’ve incorporated this kind of thinking into our strategy.

What about exogenous events such as increasing globalization and market efficiency. Have you had to adapt to that in some way?

Investors think about stocks as belonging to a certain country, a certain region or a certain industry. They use fundamental risk models to build their portfolio. I think those models are susceptible to changes in the global structure. Take a company like Nestlé, which is based in Switzerland; it’s not really a Swiss company because so much of its revenues actually come from emerging markets. So how will Nestlé behave? Like a developed country stock or an emerging market issue? I think the way you can get around this dilemma is to build models that are purely return-based. Take all the stock returns and put them into groups based on their correlations. Correlations and geography are related, but only to a degree. Developed market stocks generally tend to be highly correlated. Second-tier correlations are found mainly in emerging markets, especially China. A third cluster of lower-correlation issues, like those from Brazil, tend to operate more or less on their own. We’ve come to recognize the weakness in using country-of-domicile as a proxy for where a company operates.

What about differing levels of market efficiency? Obviously, liquidity is a factor in some markets more than others.

If we were running an equity portfolio which included emerging and frontier market securities that would be an issue. In the global long/short portfolio, we’ve been very careful to select stocks that generally have very similar accounting and disclosure standards. With regard to efficiency, I’m not so sure. Efficiency differs widely across these markets.

Have you seen changes in investing behavior or attitudes over the last few years? Any trends? Any red flags?

In the last five years I’ve seen growing appreciation for risk-reducing strategies. I think people have become much more focused on the Sharpe Ratio and much less fixated on the Information Ratio. Ten years ago, I’d go into a meeting and I’d talk about the Sharpe Ratio. People would say, “I don’t really care about your Sharpe Ratio; tell me about your Information Ratio.”
In other words, they were asking how good you were as a stock picker?

Yes. Now people recognize that they have a certain risk budget in their portfolios and they’re asking us about the best places to spend it. That question wasn’t asked much until ’08 or ’09. Earlier, if people had strategic 60/40 [stocks/bonds] allocations, all they had to do was pick some really good stock managers and some really good bond managers to show value added. It’s a very different decision-making process now.

Has this been across the board in terms of investor types? Are we talking about endowments making these kinds of decisions or are we talking about other kinds of investors?

My exposure is mostly institutions and sophisticated RIAs. The change in attitude has been pretty much across the board. Another thing to keep in mind is that there used to be a low-risk alternative that generated positive returns. If everything else failed, you could always go to T-bills and they’d produce two-, three-, four-, five-per cent returns. Now you don’t have that, so it’s really become a more difficult investment environment. Years ago, an advisor could say, “Well, if my client wants lower risk, I’ll just put more money into cash.” You can’t think that way now, because you have negative real rates. The current environment has allowed people clever at portfolio construction to rise above the pack.

You mentioned a trend toward risk reduction. That’s a positive. Are there any trends that are worrisome?

If I had to pick one red flag, it would be the current fascination with smart beta. I think it’s a great idea to know about different exposures—I’ve written a lot about this—but I think the idea that you can somehow buy a combination of ETFs and replicate fully what an active manager is doing is unrealistic.

There are so many backtests and ETFs touted that it’s become hard to discern what’s really good and bad. I’m not sure what the outcome will be, but there will certainly be a lot of disappointment.

Are people thinking that if they can get just the right mix of betas, the end result is going to be alpha?

They may think it’s going to be alpha, but in reality it may be something else altogether. People who buy a value ETF together with a momentum ETF may think, “Now I have value plus momentum,” but what they don’t realize is these ETFs come with a bunch of other embedded exposures. Unless they’re sophisticated, they’ll end up having difficulty when they put the whole thing together. I always point people to the fact that there’s a large number of quantitative managers systematically trying to exploit these tendencies. Only 25 percent are successful, so it’s relatively hard to do. You shouldn’t think that you can do it on the back of an envelope with a bunch of ETFs.

What’s the impact of emerging market volatility, particularly that of Chinese equities, on the long/short fund?

The volatility that China brings in isn’t really new. If you have a risk model that looks at correlations, the impact China has had in the last five years should already be reflected. The volatility impact shouldn’t be a complete surprise.

What you’re saying, considering your universe of stocks, is that China is really an exogenous event?

Right. China’s stocks are not within our universe. But if you look at the global market, exposure to the China factor is something we monitor and it’s something we manage against. From a risk standpoint, I think the portfolio has done okay in this current shock.
Among long/short managers, there’s great dispersion in performance. Your strategy seems to be succeeding while many others falter. What accounts for that?

First of all, I think the “long/short” category title is a little misleading. “Long/short” simply refers to market exposure, to an overall beta somewhere in the 0.5, 0.6 range. You have to consider the embedded tilts in each strategy. Where’s the rest of the return coming from? If you look at us, we’re pretty clear – we’re a long low-beta, short high-beta play and we use a quantitative stock selection model. Another manager taking long and short positions in sectors is really a macro play. Going long value and short growth is a valuation trade. In each of these strategies, returns come from widely different sources. With such variation, it’s no surprise that returns are dispersed. A lot of divergent styles have been poured into the long/short bucket.

So it’s a matter of nomenclature. The long/short category actually covers a multitude of styles.

Right. Suppose Morningstar had a “long-only” category. Every small-cap, medium-cap, large-cap, growth and value manager would get dumped into the category. Wouldn’t you wonder about the underlying stock selection style of each manager? When advisors look at a long/short fund, they have to ask about the manager’s philosophy and where the returns come from. And, in a lot of cases, the returns aren’t as bad as they may look; often, the manager’s style may just be out of favor.

Lots of managers get fired because of this. For us, if high-beta stocks act up and rise for a time, we’ll do poorly. It’s not that we’re doing a bad job; it’s just that our particular style of investing is out of favor.

But you’re adaptive in your strategy, are you not?

We are, but there’s an embedded tilt in our strategy. Investors need to be aware that we’ll always be short high-beta stocks. We may short different issues over time, so our stock selection may drown out the high-beta factor. The bottom line is this: if high-beta stocks rise, this strategy’s sailing into a headwind.

What niche does your long/short fund occupy in a portfolio? Does your fund balance some other tilt?

It would be good to combine our strategy with other risk premia. The fund can free up an investor’s risk budget and make room for things like emerging market debt or high-yield bonds. What you shouldn’t do is go out and buy another equity fund because our strategy already has equity market exposure. The best way to use the freed-up risk in the portfolio is to buy uncorrelated assets.

Analytic Investors is the sub-advisor of 361 Global Long/Short Equity Fund. For more information, contact 866.361.1720 or visit 361capital.com.
About Harin de Silva, Ph.D., CFA, President, Portfolio Manager Analytic Investors:

Harindra ("Harin") de Silva is responsible for the firm’s strategic direction and the ongoing development of its investment processes. As a portfolio manager, Harin focuses on the ongoing research effort for equity and factor-based allocation strategies. Harin has authored several articles and studies on finance-related topics including stock market anomalies, market volatility and asset valuation. Prior to joining Analytic Investors, he was a Principal at Analysis Group, Inc., where he was responsible for providing economic research services to institutional investors including investment managers, large pension funds, and endowments. This included the development of quantitative equity strategies and econometric models for use in asset allocation strategies. Harin received a Ph.D. in Finance from the University of California, Irvine. He holds a BS in Mechanical Engineering from the University of Manchester, Institute of Science and Technology, an MBA in Finance and a MS in Economic Forecasting from the University of Rochester. He is a member of Association for Investment Management and Research, the American Finance Association, and the International Association of Financial Analysts.

About Analytic Investors:

Analytic Investors employs a quantitative investment process in managing assets for institutional and mutual fund investors in the United States, Australia, Europe, Canada, and Japan. The Los Angeles-based firm offers a variety of global and regional investment products including traditional equity, low volatility equity, long/short equity, and option-based strategies. Analytic Investors specializes in the application of modern quantitative tools and is a leader in the application of risk-managed strategies. The firm believes that the use of such techniques allows it to fulfill clients’ objectives through rational, systematic identification of market opportunities. As of June 30, 2015, Analytic Investors managed $11.9 Billion in discretionary and non-discretionary assets. More information about Analytic Investors is available at www.aninvestor.com.

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