The Portfolio Doctor Is In

Disruptive Forces in Investing **January 10, 2023**

Anu Rajakumar: 2022 was another year of volatile markets. We saw unprecedented shifts in rates and inflation all while geopolitical events rattled markets. Many investors were left to navigate uncertainty without a clear next step. And as we begin 2023, investors should be asking themselves, what factors do they want to consider to better prepare for what lies ahead? My name is Anu Rajakumar, and today I am delighted to welcome my colleague, Maarten Nederlof, Neuberger Berman's Head of Portfolio Solutions to discuss how to build resilient portfolios to navigate difficult markets ahead. Maarten, thank you very much for joining me today.

Maarten Nederlof: Thanks, Anu. It's great to be here.

Anu: So Maarten, your title at Neuberger Berman is Head of Portfolio Solutions, but some of us around here refer to you as the portfolio doctor, why don't we start by explaining to our listeners why that's become your nickname?

Maarten: First off, I'm not a doctor, but I do tend to play a role that looks a lot like a portfolio doctor in that I spend a lot of my time diagnosing portfolios. Sometimes it's treating those portfolios and I very much enjoy that challenge. My role has evolved to helping analyze and build portfolios of securities. I build them for Neuberger investments. Most of them are designed to achieve very specific investment goals. But sometimes people need help understanding whether their portfolios are best suited to meet those goals.

So sometimes portfolio managers within Neuberger will call on me and my team to take a look at their portfolio because it isn't really behaving the way they thought it would or because they want to improve the resilience of their portfolio as the markets change. Sometimes these are preventative checkups and we've built a pretty specialized toolkit for that. Sometimes clients call us and ask for a second opinion. You know they'll have built portfolios for a specific purpose, but maybe they're interested in seeing whether tools that we have might show them a perspective that they weren't considering. Either because they want to make sure their portfolio is the way they expect it to be, or because they're considering making a change.

Anu: Excellent. You work with both you know internal constituents at Neuberger Berman, the portfolio managers here, as well as with clients. And you mentioned you use a toolkit. There are other toolkits if you will available in the marketplace. There's Aladdin from BlackRock and MSCI Barra, et cetera. How does the toolkit that you have developed differ from some of those that they're already out there in the market?

Maarten: That's an important question and when we set out to develop these tools, we didn't just sit down and say, wow, maybe we can build something better than what's already out there. We actually evolved into having these tools because we began as an investment team that was trying to very precisely mix exposures to factors and different styles of investment in order to meet specific investment goals. And we found that while we were doing that type of work with clients, more often than not, clients were asking us, "Well, could you help us understand the factors that are already in our portfolio and help us better meet our goals?"

In other words, can you use the tools that you've built for actual investing do a better job of helping us build goal-driven portfolios than using traditional risk tools? And the complaints they had about some of these traditional risk tools is these tools are meant to figure out well, what are the factor exposures in my portfolio in order to figure out how they behave and how much of the performance is driven by those risks? But very often, the work stopped after the risks have been identified. And what we've found is that actually investing is about seeking returns above and beyond what some of these factors deliver.

So what we set out to do is to say, "Well, listen, if we're faced with a world of investment possibilities, how can we best understand you know what exposures are driving those returns? When are they contributing or detracting from performance? What kind of regimes will a particular strategy or a particular characteristic perform well in and how much?"

Once you start dissecting investments, it's less about looking at what we do as a risk analysis tool or another risk platform, and much more about an investment return attribution platform. And so Strategy Detective, which is what we call the platform that we've developed, grew out of that, it is essentially exactly what it says it is.

It's a tool for a detective to use to better understand what's going inside a single investment strategy or a portfolio of investment strategy. We use it as our tool of choice in both analyzing portfolios and constructing portfolios.

Anu: Terrific. So you could be the portfolio detective and or the portfolio doctor. Now just to clarify the way that you do this I understand is through historical returns. Why historical returns and why not holdings? Is there any reason that you chose to do that for this particular analysis?

Maarten: Yes. I think there are some very specific reasons. I mean first off, there are a lot of tools available to investors that will allow you to load up a portfolio of securities and then describe that portfolio using, for example, some of the aforementioned risk tools. And those descriptions are helpful for understanding you know what's in my portfolio right now.

But one of the interesting characteristics of active managers, is that well, they're constantly changing their portfolios. And so, if you really want to keep on top of what's going on in a portfolio like that, you're going to have to load up those portfolios every day. But if you're an allocator who is in the process of building a portfolio and you're considering hiring a portfolio manager, it's less important to know exactly which securities are in their portfolio at any one point in time. It's much more important, I think, to understand the behavior over time.

So if I know for example that a portfolio manager is very disciplined and has great focus on the valuation of companies and they are disciplined about buying undervalued companies only so they have a value tilt, in air quotes, then if I know that that's their discipline and when I study their past returns, I can verify that that's their discipline. Then when I build my portfolio, I can count on them to deliver a value discipline. That is something you can only do with returns.

Doing that from a position-based perspective is much harder. If I can come up with a more practical way to summarize historical performance, understand what drives it, and then weave those together into balanced portfolios, we think because it really describes behavior over time, it's a nice complement to positions-based analysis.

Anu: Yep, thank you very much, Maarten. That's a very clear explanation. Now you mentioned that strategy detective is, you explained why it's not a risk platform. You mentioned it's an investment return attribution platform, and so that's why you are really looking to study the alpha. Let's dig into that a little bit. When you say alpha, what exactly do you mean by that? And tell us what you're measuring exactly.

Maarten: Well, I think risk platforms describe the systematic exposures, the factor exposures, the style exposures, the sector exposures of investments, and then anything in the performance that's not explained by those, we'll generically call them factor exposures, often get labeled security selection. Some people will call that alpha.

But one of the things that we've noticed is that understanding how these alphas behave is just as important as understanding how the factors behave. So when we look at a particular investment, be it a single security or a portfolio of securities or a portfolio of managers, we try to break their performance into those two buckets. You know, what are the factor exposures and what are the alpha? So it's really all of the performance different than the benchmark that I'm getting that isn't explained by these simple tilts.

So there's really two kinds of alpha in the way I think about it. One is security selection, which is that how good are they at picking stocks that above and beyond the sector or the style bet that it delivers superior performance. Then secondly, it's timing skill. If you're not good at selecting security, but you're really good at timing, which factors to focus on at different points in time, then that by itself can deliver performance. So if I compare a static mix like owning an index fund or somebody who can anticipate changes in the market and rotate between factors and add value by doing that, that's timing alpha.

Interestingly, the timing skill is one that people have a hard time measuring and I will tell you in the thousands of managers we've seen that, in fact, most managers are better at security selection than they are at timing, and timing is very, very hard. But secondly, there's another kind of timing alpha that's really important, and that is by allocators and investors themselves. If I'm building a portfolio of mutual funds, for example, and I try to piece together a global portfolio by buying a US manager and a European manager, and an Asian manager, maybe a small cap manager, and in those proportions when I put that together, the fits not going to be perfect, so how much I've allocated to the US versus Europe, how much I've allocated to Asia, am I over or underweighting emerging markets, for example?

Each of those decisions also creates an opportunity for timing, and it's possible to add alpha in that allocation layer by being clever about my allocation. So whereas most people will focus on the allocations by a portfolio manager that picks securities and times the sectors, there's also a lot of responsibility on the allocator to sort of put their portfolio together in a smart way.

So for us, it's not only then first identifying, "Are any of these types of alphas there?" but secondly, we try to understand how they behave in different regimes, and I think this really differentiates what we do from other risk systems or attribution systems that are out there. We'll, for example, take a look at the alphas that we've identified in a particular strategy but then see how they behave potentially differently in rising and falling markets.

So it could be that they deliver the same amount of alpha in markets going up and down. That might be ideal, but, in fact, more often than not we'll find that that varies. It may be that the alpha in a particular manager does much better in periods when value outperforms growth or the reverse. We also look at times when large-cap stocks outperform small-caps or interest rates are going up or inflation is going down or the dollar is outperforming foreign currencies. And each one of those we'll call them regimes are environments that tend to really impact active investment processes. We look at both how all of the factors in portfolios behave across these regimes, and we also look at how the alphas behave across those regimes. And building good portfolios is keeping track of all of those.

Anu: Terrific. Now, Maarten, can you clarify is Strategy Detective limited to equities only or can it be broadened out to other asset classes, and what are some of the challenges from doing similar analysis across, whether it's fixed income or alternatives hedge funds, et cetera?

Maarten: It very much works outside of equities. I'll tend to use equity examples because that is probably the largest proportion of portfolios that our clients hold. But Strategy Detective actually grew out of the hedge fund business at a predecessor firm that my team and I built that joined Neuberger Berman in November of 2019.

We were building quantitatively driven hedge fund strategies and it was that trading platform that actually built the original factors that are in Strategy Detective. And it's comparing the performance of hedge funds to those factors, where this notion that we could use a series of reference strategies to try to explain what was going on in a manager in the wild was born together with a large pension client, that was who we collaborated with on this.

And so, in that case, the types of factors we were looking for were long short factors. And so comparing those to hedge funds, they were also able to go long and short was was how Strategy Detective got started. And we added other factors. We added factors in commodities and in interest rates and across asset classes. And it became a pretty thorough set of measuring sticks to hold next to an investment that we might be trying to understand. But we quickly discovered clients were also interested in this help in fixed income, in equities, and increasingly in private markets, which we can talk about a little bit later.

And what we found was that when you're looking at a long-only equity manager, well, they can't really short stocks, all they can do is skip stocks that might be in their benchmark. So we quickly built equivalent factors for the long-only space, which just allow you to go long undervalued companies, for example, to capture a value factor. So, when we're looking at managers that can go long short, we'll use long-short factors. When we're looking at managers that can only go long where, for example, can't use leverage, we'll use a different set of factors.

And so one of the secrets to Strategy Detective’s success is the fact that we try to make the factors as realistic as possible when comparing to managers because our thinking is, is that using investible factors does a much better job of explaining than using, for example, factors that might come out of academia or based on indexes, which we find are not really as easily investible. So our thinking is the more realistic the factor is, the more likely it is to explain a real-world manager, and so far our experience in the last 10 years has indicated that that's the case.

Anu: Excellent. Terrific. Well, I know you've been very busy working with a number of clients and prospects using this tool. Maarten, what are some of the biggest lessons that you learned in 2022?

Maarten: Well, we've learned that understanding the drivers of investment performance are critical. I've mentioned that regime framework, being able to understand, for example, whether a strategy is more value-oriented or growth-oriented, whether it's driven and follows a momentum strategy. Those characteristics have had very significant impact on performance in 2022.

And so when we look at a manager, and we look at its historical performance record, we're trying to figure out is that performance due to a persistent market or style factor tilt? Is it due to an industry tilt? Because those types of tilts can be vulnerable to market shocks and how much it is due to security selection which is totally independent of sharp turns in the market. And it turns out that upon closer inspection, a lot of the portfolios we've diagnosed had more vulnerabilities than their owners realized.

So I think there's two kinds of vulnerability that I want to focus on. I mean, the first one is, hey, you have a common tilt across multiple managers in your portfolio to a common set of types of companies. If you feel you have a tilt and maybe you can predict whether that tilt is good now, and maybe it's not going to be good tomorrow, so I'm going to change my tilt, if you have that skill, you should do that, but I think a lot of investors don't feel they're very good at timing these things and so striving for more balance and being all-weather is a good way to deal with that.

The second is, outside of that basic where am I getting my my feed stock of stocks from? After that, when I start actually selecting the specific names I want to own, so now we're operating in that security selection part of the stack of returns. Well, it could be that works in some regimes and not others, and one of the things we found is there are security selection processes which are vulnerable during certain regimes.

So you know it could be that growth managers do better when growth is doing well. When growth is not doing well, well, maybe some of them can still pick stocks. Maybe they're truly all-weather security selectors, but it could also be that their performance just stops. And actually, I'd say the third case the possibility is even worse, and that is where managers start giving back the performance they've been earning for the prior five years. Obviously that's the worst possible case.

Anu: Excellent. Well thank you very much, Maarten. Um it might be helpful to just to bring all of this to life. Give us a couple of examples of some of the projects that you've worked on recently.

Maarten: I often think about like the worst portfolio I saw in 2022 and the best portfolio I saw in 2022. There's some competition for who was the worst portfolio I saw. It has been a rough year, but I would say that it was a pension portfolio. It had a heavy tilt to growth managers, and when we looked at their manager lineup, it looked like it was a pretty equally distributed mix of growth value in core managers. Just to simplify it a bit.

But when we looked at how each manager responded to regime shifts, we found that more than two-thirds did horribly when growth was out of favor and when interest rates were going up, which, of course, is what happened in 2022.

It was our prediction that should such a rotation occur, that this portfolio would go from outperforming the equity market for the last seven years at about its average annualized outperformance was about 4% a year. That if this rotation were to happen, it would suddenly go to underperforming about 4% a year. That's an 8% swing in performance. So that's relative to the equity markets, that's relative to their benchmark, and so an 8% swing was way more than any risk system had ever predicted to them. Looking at positions it didn't look like it could be that bad, but remember this is how the behavior sort of compounds across an imbalanced portfolio.

We had clients who decided to do something about it and say, "You know what? I think I can have a good portfolio and be balanced. I don't have to give up on the growth trade, but at the very least I can take some of the risk off-the-table." There were managers who looked at us and said, "Oh, I'm good."

Anu: I imagine a lot of people just said, "We're probably good."

Maarten: Yeah.

Anu: And that probably didn't end up well for them in 2022. So I'm sure that one portfolio was not the only "worst portfolio" that you saw for the record.

Maarten: No. Well, and importantly, I think that for people that thought they were good in fairness to them, for everyone that had been telling them, "You really should put some money on the value trade." They've been saying that for the prior seven or eight years and value really had not been performing well up through early 2021. So I think this notion that they should have known better I think is not fair.

Anu: All right. Well, let's contrast that with a portfolio which you found was actually fairly resilient.

Maarten: I will go so far as to say this might just be the best portfolio I ever saw. I've seen a lot of portfolios in 37 years in the business. So this a portfolio managed by a private bank. And it's a collection of equity managers across styles and regions. And unlike the prior example, it turns out it's actually very well balanced. And this investor had meticulously identified managers. They had some managers that were true sort of all-weather, all regime managers, that just added alpha in all environments.

But most importantly, when these managers were not all-weather, they made sure that they had such a mix that when a particular manager was out of favor, there was always another one that was in favor in such a way that they really were much more stable than some of the earlier examples I named. And importantly, when they couldn't find strong active managers, they made use of ETFs to fill in certain factor exposures. So the result was the portfolio was always looks like it's in-balance.

And this is a portfolio that had outperformed historically their benchmarks more than 4% for seven or eight years that we studied the portfolio. And it delivered 4% of outperformance in just about every regime we studied. The elegance of being able to combine specialists to tap multiple alpha sources from a broad set of skilled contributors to a portfolio, using that alpha to drive a portfolio and then make it resilient in terms of its risk balancing, I think that's the, that defines the art.

Anu: That's great. It's an excellent example of a really resilient, alpha-driven portfolio, again, through different regimes. So Maarten, let's just discuss a little bit further. When you work with clients or your patients as it were, how would you say that you help them? What are some things that you walk into a meeting looking to achieve?

Maarten: I think they probably break down to three things: questions, actions, and maintenance. When we're working with a client, we're often trying to provide insight to them so that they can answer these questions inside their own shops.

One big question is, you know, what is the implied view of their portfolio? And based on how that portfolio is positioned, what must be their outlook for the direction of the equity market or growth versus value or interest rates or inflation? Because if they knew how those things were going to evolve, they'd probably build a very specific portfolio.

You know, I mentioned earlier how hard timing is. I don't think even now where I think we're staring down one of the most widely forecasted recessions, everyone can agree something's coming. Even for people who have an implied view in their portfolio, they typically want to get rid of it because they don't have strong conviction in that. And then the other question we get a lot is, what am I missing? We get people come in and say, I think I've got a pretty sweet hedge fund portfolio. It's very complex, it's very sophisticated, but we noticed that they might not have as complete a set of alpha sources as they think they do or we just have suggestions for strategies that might be diversifying. So that's, what am I missing? What's my view? How vulnerable am I? So those are questions.

It's more fulfilling when we can help them with actions. And we're not brought in to act on their portfolio. Typically, we're brought in, more like a second opinion or like a doctor's visit. So they might, for example, ask us for our suggestions or they will run by us changes they're considering making in their portfolio. So what if analysis, for example. Sometimes it's helping them identify and design and add strategies they've been missing.

Another very fulfilling action can be when we design custom strategies to complete portfolios. So a client might determine that their portfolio is underexposed to equity market beta, or it has too much interest rate exposure and they may look for investments that offset that. Sometimes finding a very specific combination of available strategies to accomplish that, creates a nice custom fit for their portfolio which can help them reduce or fill in those risk gaps and help balance portfolios.

And then, I mentioned maintenance. Some investors come to us periodically for preventative maintenance. They want us to do a portfolio checkup. They want to check does the portfolio reflect their views? They might want our view of, "Hey, what do you think? I'm missing?" And sometimes they are doing a periodic exercise, which I'm seeing more and more, which is a type of blank sheet exercise. They want to know, "Instead of being influenced by the portfolio I already have, what if I started with a blank sheet of paper and looked at the opportunity set and started fresh? What might I build as a replacement for this portfolio?" And then they compare that to their actual portfolio to see if they can learn new things.

Anu: Well, terrific. That's very helpful. And the three steps that you just went through, questions, actions, maintenance. One observation that I want to make here, Maarten, is that I think through your engagements with clients, whether that's a CIO or a board member with fiduciary duty, whomever it may be. Through these tools, what I've observed is that you can really empower them to ask the important questions of themselves or their investment managers or their consultants to better understand things like what is being done to mitigate or manage risks and really understanding whether or not they should expect to be fully rewarded for the risks that their portfolios are taking. And I think that's a really important element of the value add that I think you and your team provide.

You know, as we start to wrap up here, Maarten, I'd love to know what 2023 has in store for, for you and the Strategy Detective tool. How will you be spending your time in 2023?

Maarten: We think fortunately it is still a really good time to be in the straightening out portfolios business. We've had a real pickup in inquiries from people that manage hedge fund portfolios. Hedge funds have been one of the stars of 2022 from a performance perspective, both on an absolute basis and on a relative basis. So I think for investors who had felt that they could pay less for active management and, for example, invest passively, which was a pretty good strategy up until about two years ago. They are suddenly recognizing that in many cases you get what you pay for in terms of the hedge fund space, and I would say the same thing is happening in active management.

I would say that we have a significant number of funds, who have been investing passively, for example, in equities that are realizing that sitting on an index portfolio isn't going to work as well for the next few years as it has for the past few years. And most importantly, I think to the extent that the past decade was the decade of beta there seems to be a strong suspicion that the next decade is going to be the decade of alpha. So as a result, a lot of people are looking at their portfolios.

We've been working with quite a few investors that are being asked to implement sustainable investment programs focusing on zero carbon goals, focusing on various other measures of E, S and G in their portfolios. And they have recognized that early portfolios and early attempts to build strategies that are sustainable come with side effects. So in the same way we look for what's really driving a portfolio, comparing sustainable portfolios versus traditional portfolios can give us insights into that.

You know most of the investors I work with are pretty sophisticated. They tend to have significant private markets portfolios. Probably one of the top questions I get is, can I and or Strategy Detective help them better understand their private markets portfolios? If not that, can they use information from private market portfolios to help them build better public portfolios?

Strategy Detective is a returns-based attribution tool. It's not going to work particularly well on the returns that we have available from private market investments, but there is a lot of cross-sectional information about those portfolios. And we're starting a project now with our private markets teams to see whether we can take cross-sectional information from private portfolios to better guide our public investments and that's a major initiative for next year, so we're quite excited about that.

Anu: Well, it sounds like 2023 will be another busy and very exciting year for you and your team. Now, finally, Maarten, I have to admit, I did take a quick peek at your biography before today's episode and saw that over your career you've had a number of impressive titles from Portfolio Manager, Head of Pension Strategies Group, Co-Head of Hedge Fund Group, Head of Investor Risk Management, and now at Neuberger Berman, Head of Portfolio Solutions.

But for your bonus question today, Maarten, I would love for you to tell us about one of your first-ever jobs, whether it's inside or outside of the industry, and tell us some of the lessons that you learned from that early career experience.

Maarten: Well, my journey into finance was not a traditional path. And I found myself after studying chemistry suddenly being a quant on Wall Street in the '80s when there weren't many of us, and also without a formal finance education. So one of the first jobs I was given was to build a model to forecast the UK Gilt Edge Stock Market Yield Curve. So the UK Yield Curve. And they wanted me to do that using an econometric model. I went set to building my models and was trying to use currency rates to forecast the interest rate curve. And I kept discovering that the reverse was possible, but not what they were asking me to do. In other words, I felt like I could forecast currency returns using interest rates, not the other way around. So I went to my bosses and said, "I keep finding that I think I can forecast currency returns." Most of them, PhDs in finance and econometrics, were looking at me going like, "Well, kid, that's not possible. Everyone knows that's not possible." And so I persisted and said, "I think I can. Do you mind if I try? They were like, "Yes, sure, kid, go ahead."

And so I kept working on it and built 10 currency forecast models, which, couple years later, we were running proprietary capital for Salomon Brothers in, we were applying these models to a bunch of different products, and it actually worked surprisingly well. It was one of the first examples of where me asking the question, why not? It turned out to be very important.

Anu: Great. Well, thank you very much for sharing and for coming on the show today to discuss how your tools help clients and your colleagues understand the drivers of investment returns and risk in active and passive and hybrid portfolios. You know, as I said, some call you the portfolio doctor, but I'm glad to call you a colleague and a friend. So thank you very much for joining me today on a very timely topic that one I know is front and center for a number of our listeners.

Maarten: Thank you very much for having me, Anu.

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