Q&A

Dynamic portfolio management

With: Megan Roach, CFA, Portfolio Manager
and Keith Brakebill, CFA, Senior Portfolio Manager

Q1: RUSSELL INVESTMENTS HAS BEEN MANAGING PORTFOLIOS FOR OVER 35 YEARS. HOW MUCH MORE DYNAMIC IS THAT PROCESS TODAY THAN IN THE PAST?

Megan (M) We are much more hands-on in our approach today. With the monitoring systems that now exist, and so many opportunities to adjust exposures, we’re able to directly manage portfolio positioning more precisely than ever, whether it’s factors, countries, sectors, industries or currencies. Behind this is the recognition that, in a low-return environment, investors cannot afford to ignore opportunities to improve returns, however incremental, and we cannot afford to take risks that we don’t expect to be compensated for. Our dynamic positioning is designed both to add incremental returns and to manage unwanted risks that we don’t expect to get paid for.

Keith (K) Yes. As a fixed-income manager, for example, there’s nothing that says “opportunity for dynamic management” to me quite like the history of high yield bond spreads. When that spread over Treasuries moves out to extremes, we cannot be sure how far it will go, but we can be confident that it won’t stay there for too long. Until the past few years, we had limited means of acting on that signal, but we can be much more nimble today.

Q2. WHAT ARE THE INPUTS YOU TAKE INTO ACCOUNT IN YOUR DYNAMIC POSITIONING?

(M) We try to gather information from a wide range of sources to ensure we get as full a picture as possible. There are five main inputs (see figure 1). Some of these are quantitative, and some are qualitative. At different points in time, some become more important than others. When two or three of the inputs align with a similar indication of opportunity or risk, we would consider this a meaningful signal for potential action.

Q3. COULD YOU RUN US THROUGH AN EXAMPLE OF HOW THIS WORKS IN PRACTICE?

(K) Credit is a good example. That’s an exposure where we hold a clear strategic belief: We believe credit exposure is systematically rewarded. But that exposure was deemphasized for a period as valuations became unattractive. Then, over 2015 and into 2016, the signals became more positive. Our strategist team started to see this area as attractive, and we became more confident that there would be back-stop purchasers of our positions if we needed them. And then signals from our sub-advisors (the external money managers we use) were also positive. So, we started to add exposure to credit.
Q4: MEGAN, HOW DIFFERENT IS IT WITHIN EQUITIES?

(M) Conceptually, the process is the same but we’ve had a couple other inputs shape our preferred positioning this year. In equities, our strategic beliefs are focused on return premiums like value, quality, momentum, size and volatility. For each of those factors, we use a quantitative framework called “CVS” that focuses on the economic Cycle as well as current Valuation levels and market Sentiment. For example, from 2015 into 2016, we’ve seen that CVS analysis point to quality stocks being as attractive as they’ve been since 2008 in the U.S. market. That, coupled with chronic active manager sector biases that exist – especially in U.S. small cap portfolios – led us to temper our weight in lower quality and more volatile sectors, such as energy and industrials, instead favoring underrepresented and more profitable sectors, such as utilities and financials. That had a dual intent: enhancing returns by accentuating the sub-advisor managers’ active stock positions, while reducing risk by managing the unintended factor and sector biases.

Q5. AND HOW EXACTLY ARE THESE POSITIONING STRATEGIES IMPLEMENTED IN PRACTICE?

(M) There are three main levers we have in managing multi-manager portfolio exposures. One is to change the money managers, which takes time and happens fairly infrequently. The second is to adjust manager weights. The third is to take direct portfolio positions. For the quality factor exposure I just mentioned, we created a long-only portfolio of physical securities optimized to create the overall factor and sector exposures we wanted at the total portfolio level.

(K) Whereas for the credit exposure, it made more sense to use a credit derivative overlay. For that exposure, this was the quickest route to the size of exposure we wanted. So, in each case, we’ll look at the implementation choices available and use either derivatives or physical securities depending on the costs, liquidity and flexibility.

Thank you,
Megan and Keith.

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Figure 1: Five inputs for dynamic positioning
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