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Equity Market Volatility and Long/Short Investing

A Q&A with Jay Feeney of Boston Partners - May 8, 2018

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After a year of unusually low stock market volatility in 2017, 2018 kicked off with far more ups and downs in the market. At the same time, interest rates are rising, albeit from historic low yields. Bronfman Rothschild recently hosted a discussion with Chief Investment Officer Dmitriy Katsnelson and Boston Partners Portfolio Manager Jay Feeney to discuss strategies for managing market volatility. Part of this discussion focused on long/short investing, an investment strategy that includes buying investments that are expected to increase in value over time while also selling short investments that are expected to decrease in value. Following are some of the highlights of that discussion.

Q: THE EARLY PART OF 2018 WAS CHARACTERIZED BY US EQUITY MARKET VOLATILITY. WHAT STANDS OUT?

Feeney - What strikes me is the contrast with abnormally low volatility last year. The S&P rose over the 12 months of 2017 with a benign economic backdrop. The VIX, a measure of equity market volatility, measured only 8-9% vs a 13% average. Today, if you consider rising interest rates and bubbly stock valuations, no one should be surprised by volatility. Actually, we think true investment risk has probably declined since January as equity valuations are now at more normal levels creating more interesting opportunities.

Katsnelson - On the bond side, we are watching what is happening with the yield curve. After five interest rate hikes since 2015, investors are now earning something on savings. But the shape of the yield curve is a concern. The curve, which reflects yield levels at various maturities, is normally upward sloping with longer maturities offering higher yields. Yet today, we are watching the yield curve flatten. A yield curve inversion, when shorter maturity bond yields are higher than longer maturity bond yields, is often a precursor to recession.

Feeney - It is true that an inverted yield curve portends a recession 9 out of 10 times, but it fails to predict how bad it will be or even when. The press has a way of oversimplifying this.

Q: WHAT ELSE ARE THE HEADLINES MISSING?

Feeney - Stimulus in the form of tax cuts has led to a rebound in consumer confidence and a long overdue increase in capital spending. Small business confidence is also at record highs. This has a multiplier effect and will take time to fully play out. In our view, there is far too much focus on tariffs and trade and too little emphasis on what is happening in the underlying economy.

Q: WHAT DOES THAT MEAN FOR YOU AS AN INVESTOR?

Feeney - Good investing is boring; what keeps me up is trying to filter out inconsequential and extraneous noise. Every day I wake up and am bombarded with information, but most of it is meaningless. What is important is earnings. Earnings drive the stock market. S&P 500 stocks earned about $39 on average at the last market bottom. This year those same companies earned $160. That is up about 295% since March 2009. Interestingly, the return on the S&P 500 is up about 295% over the same time period. We really shouldn't worry about Trump pulling out of Iran, or the Fed, or Mario Draghi, or Japan. In the end earnings drive returns.

Katsnelson - I couldn't agree more. Every day our job is to separate the interesting from the relevant. Few people are actually paying attention to the boring and the relevant. Instead they focus on temporary tempests in teapots. You cannot underwrite these events as no one knows what will happen or how. Trying to run your portfolio to take advantage of this noise is punitive and hard. Today we are in a very different environment where supply and demand play a major role; there are less than half the US stocks today than there were in the 90's, yet there is so much more information.

Feeney - We like to think in terms of complicated systems. Presumably, if you can break down a system into its steps, you can better understand and predict the results. But these systems are rarely linear.

Instead, they are complex adaptive systems with feedback loops and spontaneous reactions. They are unpredictable and unforecastable. So, we spend less time thinking about forecasts and instead try to find tangible information on earnings.

Q: IS THERE A SECTOR OR INVESTMENT THEME THAT WILL SEEM OBVIOUS (LONG OR SHORT) IN 10 YEARS?

Feeney - There are many hot stocks today that I doubt will be remembered in 10 years. Some of these same companies are dismissive of investment analysts and it feels a little like 1998-99, a near death experience for value investors when many thought earnings were obsolete, and those buying inexpensive stocks were viewed as dinosaurs. There are really only five things companies can do to add value - pay dividends, buy back stock, pay down debt, reinvest in the business, or make an acquisition. Three of these - dividends, stock buybacks, and debt reduction - are unambiguously favorable for investors. While sometimes positive, acquisitions and capital reinvestments are a question.

Katsnelson - While there aren't obvious companies that will be the next Apple, today we are seeing a lot of micro bubbles when a sector pops in price. Most recently it was rare metals, and it was solar for a while. These companies often raise a lot of capital and then make poor capital allocation decisions. In our experience you always need to be selective.

Q: SHIFTING GEARS, HOW DOES LONG/SHORT INVESTING WORK?

Feeney - I can tell you what it is not. It is not a hedge fund and it can mean different things to different managers. In our case, a simple example is we may invest $100 across a portfolio of securities we want to invest in. Then we go out and borrow some securities we believe will decline in price and sell them short. On average we borrow and sell about $50 worth of securities short for every $100 invested. What this means is that for every $100, investors have roughly $150 in capital working for them both long and short. On the long side we buy securities we expect to appreciate that exhibit excellent valuations, positive momentum, good cash flows, and good capital allocation. On the short side, we look for just the opposite - excessive valuations, stretched balance sheets, and poor capital allocation. We view our long and short investments as two independent sources of potential profit. Our goal is to generate meaningful returns with significantly less volatility than the S&P 500.

Q: WHAT ARE THE PITFALLS OF LONG/SHORT INVESTING?

Feeney - It is more complicated to borrow to short shares of stock and it comes with a cost. Fees are going to be higher than a traditional fund or an ETF due to this borrowing and lending. Keep in mind that, due to the nature of the short part of the portfolio, the higher fees are spread across a greater amount of invested capital.

Q: HOW SHOULD INVESTORS THINK ABOUT AN ALLOCATION TO A LONG/SHORT FUND IN A DIVERSE PORTFOLIO?

Feeney - The fund should go up less than the market when stocks are up, but also fall less when stocks are down. The goal is to capture 60% of the market's upside and only 40% of its downside and to compound the difference in your favor. This strategy tends to be more compelling with more volatility.

It is important to recognize the challenges of overcoming losses. To overcome an investment that falls 50% from $100 to $50, an investor needs to earn 100% to get back to even.

Q: WHAT ABOUT BITCOIN AND CRYPTOCURRENCIES?

Feeney - No one has been able to effectively explain block chain technology to me. For now we view it as a speculative tool to double your money or lose it all, and we are staying away.

Katsnelson - Investors frequently overestimate what they can do in a year and underestimate what they can do in 10. We believe the technology is a relevant innovation. Our question is whether it is monetizable or not. Today there are over a 1,000 of the currencies. We are watching from afar.