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How to navigate market noise to build a portfolio that will perform

Stock market volatility returned vigorously in the first quarter this year. Throughout all of last year, the S&P 500 index never moved 2% or more in a single day. It did that six times in the first three months of 2018 alone.

Volatility is not likely to subside to 2017 levels anytime soon, with interest rates on the rise, uncertainty about a trade war in the air and jittery investors ready to react to any hint of good or bad news.

But according to Vladimir de Vassal, portfolio manager and director of quantitative research at Glenmede Investment Management, the first quarter spike in volatility was just a return to normal.

"We've been in an environment of remarkably low volatility," de Vassal said in an interview on the sidelines of **P&I's Active, Alpha and the Next Frontier Breakfast Briefing**. "The S&P 500 total return was positive for 15 consecutive months. The last time we saw that was in the late 1950s."

This year's increase in volatility has been accompanied by a greater penchant on the part of investors to buy or sell on the hint of news or rumor, action that is not helpful for long-term institutional investors overseeing large sums of money for retirees, future retirees, colleges or other organizations.

TAKING EMOTION OUT

Fortunately, money managers have quantitative tools that can help take the emotion out of investment decisions and keep investors focused on what's important: capturing return or protecting the downside.

De Vassal and his team use their quantitative models to help navigate the market's choppy waters without succumbing to these sudden squalls.

But even the best institutional quality models are not static, a point de Vassal emphasized as he commented on the proliferation of smart beta funds and related exchange-traded funds. De Vassal said investors in such strategies may become vulnerable to so-called factor crowding, when they pile into similar strategies. When that happens, the opportunity set shrinks, which often leads to a period of underperformance.

A multi-factor approach, which uses a variety of valuation, growth, fundamental and technical criteria combined with leading industry group indicators and downside risk screens, may provide more consistent performance through market cycles, he said.

De Vassal said he believes that "multi-factor models should not be constant, but rather refreshed on a periodic basis to account for recent time periods, removal of decaying factors, inclusion of new criteria and improved future risk-adjusted performance."

Two other key components to building a portfolio for an increasingly volatile market are liquidity and transaction costs.

"Those are critical," de Vassal said. "When we look at estimated alpha scores for the universe, we adjust for round trip estimated market impact costs."

> It's important that we help clients understand how the portfolio is constructed and currently positioned.

"For our large cap strategies, the universe is the Russell 1000 index, but at the same time we have liquidity constraints," he said. "We're not going to be buying a stock that has poor average daily volume, and we are cognizant of shorting costs and short interest.

"Ideally, I want to own a portfolio that is reasonably priced, has high cash flow yields and is focused on companies that have consistent earnings and revenue trends, strong dividend growth, strong fundamental ratios and profitability metrics," he said. "Also, I want to have companies that are more likely to have positive earnings surprises and fewer negative surprises than the average. That's a winning long-term combination."

BUY LOW, SELL HIGH

While headlines may scream about overpriced stocks, a missed earnings report or a sharp, one-day surge or drop in one of today's tech darlings, de Vassal said stocks with reasonable valuations are not that hard to find. Additionally, those valuations are supported by earnings growth that's powered by high employment and strong housing trends in the U.S., and synchronized economic growth globally. The key is to follow the signals and avoid irrational behavior.

"A lot of investors are reacting to the same news," he said, "causing stock prices to overshoot" up or down, depending on the news.

As an example, he pointed to the initial report of average hourly earnings for private sector workers, which showed a 2.9% uptick in January.

"Everyone thought it meant runaway wage inflation and the market sold off," de Vassal said. "The next month, that January number was revised down, and February was 2.6% [year-over-year], so people said 'Oh, maybe it's not so bad.'"

By leveraging signals the models are throwing off, the team can, in some cases, use investor overreaction to their favor, de Vassal said.

"To the extent there is noise every day or every other day, and the fact that stock prices may be overshooting up or down, hopefully we can take advantage of that when we refresh the portfolio to get stocks in at good prices or push out names that reach our price targets," he said.

ALIGNMENT IS KEY

The other key is keeping clients informed on the strategy to be confident that their interests are fully aligned.

"We make sure the client knows where we are in the style box and what the exposure is, and that we're not going to be doing something different," de Vassal said. "The client understands what we're doing."

Still, he does need to remind clients that the portfolios are built to withstand the noise and investors' irrational behavior.

"Clients are worried about potential market volatility and the fear of the unknown," he said. "There's always a possibility of a market selloff or a relative underperformance of a strategy. So, it's important that we help clients understand how the portfolio is constructed and currently positioned. We also must be clear about why we think the stocks we own have better probabilities of positive vs. negative earnings surprises.

"In other words, don't look at short-term noise and tweets and keep a long-term perspective." •

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