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Building an Equity Portfolio to Meet Return and Risk Objectives: It's All About Balance

Rising stock-market volatility and increasing interest rates have left many institutional investors wondering where capital appreciation will come from in their portfolios. At the same time, as signs of an equities-market correction grow, investors are also wondering about the downside risk embedded in their portfolios.

Most institutional investors allocate assets to equities for capital appreciation and to fixed income for downside protection.

Olivia Engel, senior managing director and chief investment officer of active quantitative equity at State Street Global Advisors, told the audience at a recent *Pensions & Investments* event that it's possible to build equity portfolios that meet both objectives. This approach can allow investors to participate in the upside growth potential of equity markets — increasingly essential in a lower-return environment — while managing risk amid mounting jitters that the long-running equity bull market may be drawing to a close.

To cushion against a market dislocation, the active quant equity team at State Street currently sees opportunities in utilities, financials, industrials and select cyclicals, Engel said.

THREE KEYS

There are three keys to constructing equity portfolios that respond to a dual risk-and-return mandate: Ignore the benchmark, target companies with the highest expected return, and optimize for risk, volatility and cost, she said.

"The benchmark doesn't reflect any forward-looking objectives. By ignoring the benchmark when choosing stocks, you can target the portfolio to meet your objectives," Engel said. "You need active managers, so you can hold companies that you expect to have the highest expected return. Finally, your active managers need to have a view on expected risk — how volatile the companies in the portfolio are anticipated to be."

To find stocks worth owning, Engel first pointed to dispersion — the difference between the performance of the best and worst sectors during market drawdowns — adding that dispersion within sectors can reach nearly 20%. "There are plenty of places to find a cushion against a market dislocation," she said.

"We have a number of utilities that look good. They have a very important role to play in the portfolio from a risk perspective," Engel said. "Yes, they have interest rate exposure, but you can balance that with other exposures." She added that outside the U.S., industrials in Japan and select European banks look attractive.

BOTTOM-UP APPROACH

Her bottom-up approach to stock selection focuses on companies that are undervalued and of high quality, based on the quant metrics incorporated in her team's stock-selection model, which forecasts expected returns.

"We're not looking at the late-cycle stocks that are making the whole market look expensive," she said. "There are a number of secular growth themes that are attractive in the U.S. We have managed to find a lot of great healthcare companies, banks and utilities."

Sustainability is another dimension of return and risk that Engel measures.

"From a quantitative perspective, the way we can incorporate companies' sustainability practices into our forecasts is with data and evidence through research," she said. "We're not trying to make sustainability the most important decision as to whether to buy a company or not — but why not consider sustainability alongside all the other attributes we care about?"

The environmental, social and governance component can get tricky, because tracking sustainability metrics does not mean avoiding companies that some clients might take exception to.

"Some asset owners say, 'We want ESG,' and they equate that to, 'We're not going to hold any fossil fuels or any other screened-out sin stock'" Engel said. "It can be difficult explaining to asset owners that yes, some of the companies we hold may have sustainability issues, but if we're going to deliver on our return target and achieve their investment objectives, we need to own these companies. Some companies will look very attractive for other reasons, particularly if they are experiencing near-term price appreciation because they are extremely undervalued and are facing an increase in their revenue forecasts. A company that scores well on these attributes may still be attractive even if its sustainability metrics are poor. Sustainability is just one dimension among many to assess the attractiveness of a company."

Identifying stocks with the highest-return potential is the first step of her team's investment process, Engel said. The next step is balancing expected returns with potential risk, costs and other considerations, including liquidity. Finding the right balance between return and risk is the starting point, she said, adding that her team calculates the return component net of transaction costs.

Here again, quantitative methods play an important role. "There is an algorithm to solve for that, which gives you an optimal portfolio," she said. "As one of the largest asset managers in the world, we do a lot of transactions. So we have a rich database of what it costs us to transact, [which lets us] get very granular about how we forecast transaction costs."

On the liquidity side, Engel said she has limits on the amount she can build in any one position in the portfolio.

"We don't want to hold a stock that takes more than several days to trade out of," she said. "We don't want to have a trade that's too hard to do. That's usually reflected in the transaction cost anyway, but then we'll use an additional constraint [that] puts a hard stop on the amount of any stock we'll build up."

In addition, she and her team will discuss liquidity across State Street Global Advisors' business with the investment risk team.

"Understanding the capacity of all the strategies is very important," she said. "It's important to be disciplined about how you treat capacity."

According to Engel, every trade in the portfolio is made to improve the forward-looking outcome. Every day, she and her team run the portfolio-optimization model to determine whether — and how — expected returns and expected risk might be changing. This, in turn, informs the team's exit strategy.

A PLACE FOR UTILITIES

"Because we are fully invested in equities all the time, there's always a stock that's preferred and a stock that's not preferred," she said. "As a stock's expected return falls or as its expected risk starts to rise, and you can bring in a new company that, net of transaction costs, gets you to a better place, then the optimal portfolio will look like that. It's not so much about a price target; it's about whether there's a better company out there."

In the current market environment, clients often question Engel about the makeup of the portfolio. They wonder, for example, why stocks sensitive to interest rates, like utilities, have a place at all.

"I tell them everything is in the portfolio for a reason," she said. "Utilities are there for a specific purpose, and if the market environment looks like this, this is what utilities will give you. Balancing that are cyclicals and financials.

"It's all about balance," Engel said. "You can't look at every position in isolation." •

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