MAKING 130/30 MORE THAN A NUMBERS GAME

On the cusp of celebrating its 20th anniversary next year, First Quadrant is rolling out a 130/30 platform to augment the $27bn the firm manages in active long-only and long-short market neutral equity strategies as well as global macro. First Quadrant partner and director of international marketing, Rick Roberts, spoke to FT Mandate about the Extended Equity concept and about the firm's competitive edge in the product

FT Mandate: ***First Quadrant's new "Extended Equity" programme is its contribution to the increasingly popular "130/30" genre. How does FQ think about 130/30, and what strategies does it offer at the moment?***

Rick Roberts: Extended Equity, or 130/30 as the marketplace calls it, is the latest evolution in portfolio construction technique to sweep the institutional investment management industry. In its simplest form, it's the relaxation of portfolio constraints so an investment manager can allocate risk symmetrically across a benchmark to obtain beta-one. For clients, the ability to distribute risk symmetrically across all opportunities is the reason to enter this space. For investment managers, Extended Equity brings us closer to being able to overcome inefficiencies in benchmark construction and thereby improve the portfolio's risk-adjusted return. That's a win for client, a win for consultant, and a win for manager–and why these strategies are so popular.

Now, our firm has been managing long-short equity strategies since 1991, so for us Extended Equity is merely a further development of a long list of global long-short strategies we've managed for years. It's an extension of our global equity platform that utilises a slightly different portfolio construction technique. We presently manage long-short portfolios in the US, Europe, Japan, and global portfolios and we offer a large-cap US and a global equity portfolio managed to the S&P 500 and the MSCI World Index respectively. I do however expect the mix of benchmarks to expand as demand evolves.

One feature of Extended Equity not often discussed is how one decides, if at all, to adjust the gearing from 130/30 to between 110/10 to 140/40. Since market opportunities vary over time the flexibility to alter the gearing represents another layer of value-added – in short, more choice is better for investors.

FTM: ***Extended Equity is beta-one and not a hedge fund or market-neutral strategy. But having 16 years of long-short equity experience must be an advantage in the 130/30 space?***

RR: Yes, absolutely, our long history managing long/short equity is a true advantage. The tools we have developed in this area–our research platform, trading capability, and risk management process–date to 1991. All of this experience feeds our ability to implement 130/30 portfolios, applying innovative and efficient methods that extend beyond the conventional wisdom circulating in the market today. It is very exciting to find ourselves on the leading edge.

As for hedge funds and market neutral strategies, the market's view of alpha is evolving beyond those broad categorisations that truly mean different things to different people. It is important to not confuse Extended Equity with hedge funds. Extended Equity strategies offer investors neither a 'hedge', capital preservation, nor a market neutral bias. Our definition bears repeating: the investment process is simply the freedom to invest symmetrically across the benchmark to improve risk-adjusted returns or the information ratio.

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The observation that this is a beta-one strategy indirectly speaks to the cost of portable alpha programs, or how market neutral or hedge funds may combine alpha and beta. The cost of reintroducing beta to alpha strategies, or portable alpha, is not insignificant. To be precise, costs arise from inefficient use of cash, tracking error of underlying futures or spreads attached to swaps, to name a few. All of this has the potential to materially drag on performance. Extended Equity strategies inherently carry beta exposures for free.

It is the release of constraints and the ability to distribute risk more symmetrically and the resulting long-short positions that tend to cause the confusion with hedge funds. In my view, all of these innovative approaches have a place in institutional portfolios. The advantage of Extended Equity is that it has capacity that hedge funds and market neutral lack. This is an natural evolution in equity management. I believe it will ultimately cannibalise *some* long-only strategies and make a large dent in index management.

FTM: ***How does one differentiate one quantitative approach from another?***
RR: This is a difficult question because we use 'quantitative' primarily to distinguish an investment process that implements ideas in ways that are more systematic than a traditional discretionary approach. Therefore, for us a quantitative approach is a tool, not a differentiating feature. That said, traditional metrics do exist that divine the cornerstone of a firm's investment process or its skill in risk management.

At the core of any approach is an investment philosophy. So the question is whether a firm's philosophy is focused on fundamental drivers of returns or on statistical or technically oriented measures that cycle in and out of favour? A thorough understanding of a firm's investment philosophy is key to understanding how portfolios will behave in good versus difficult markets. First Quadrant falls squarely in the systematic fundamental camp. There is also the issue of a firm's brand identity and the role it plays in gathering assets and attracting institutional investors. While with savvy marketing this can be more perception than reality, it's undeniably a very powerful driver of success early in a strategy's formation.

The combination of a sound philosophy, trusted brand, history of thought leadership, skill in managing a broad array of equity strategies, and a roster of long tenured clients is to my mind a winning combination. Last, and not to be overlooked, is an evaluation of a firm's layers of risk management. Many questions need to be asked about risk, e.g., on what dimensions is risk measured and reported, and how independent is the risk system? At First Quadrant, we allocate tremendous resources to research and risk management and apply them in every corner of our firm from our global macro and other alpha strategies to our Extended Equity portfolios.

FTM: ***So that touches on FQ's expertise and experience in global macro?***
RR: We've been managing equity and global tactical asset allocation (GTAA) for a long time: GTAA since 1989, and long-short equity since 1991. The unique combination of skills arising from this work separates us from our peers. It allows us to combine top-down and bottom-up analysis. Both of these disciplines, coupled with a commitment to risk management, puts us in a sweet spot. Simply put, a global Extended Equity portfolio can now isolate sources of alpha at multiple levels: stock selection, country allocation, currency, sector, industry analysis, or more broadly – top down and bottom up. You can evaluate stocks and their drivers, e.g., growth or value, large- or small-cap, tilt toward volatile or stable earnings. That's one category. You can replicate the same example vis-a-vis country weights, currency, etc. This extends the likelihood of success even farther.

We are often asked if we gear our views in equity selection. Indeed we do. Conceptually, it resembles the classic 130/30 approach. But we are also isolating returns in areas where we have skill as opposed to simply leveraging one driver of return. So the second category, in a global portfolio, would be country allocation.

Moving away from how the portfolio is constructed in the physical sense, why use stocks that carry high transaction costs to adjust country allocation when isolating that decision and implementing with a futures contract? It's 10 times cheaper to use futures. The same can be said about currency, an independent decision governed by uncorrelated drivers of return. The way we combine these three elements – stock risk, country risk, currency risk – give us an edge.

FTM: ***In global macro you offer a full range of strategies from tactical asset allocation through currency management to volatility arbitrage, using instruments across the equity, fixed income and commodity sectors. You even offer products that combine these global macro strategies with your equity alpha plays. Do you think there is scope to expand beta-one 130/30-style strategies into the sphere of true global macro?***
RR: Very much so. In fact we already have clients investing in equitised global macro–they simply introduce the beta themselves using futures contracts. Active equity portfolios can also be used. The only constraint then is portfolio construction techniques, target risk, and the ability to monitor and manage risk. What we're getting to rests at the heart of 130/30 strategies: the freedom to exercise greater discretion. Extended Equity, or 130/30, is a natural and intuitive first step. I believe this new paradigm in investment management will affect the implementation of long-only strategies and draw most of its assets from passive equity allocations. 130/30 does not ring the death knell for long-only strategies, but it will favour those who have the ability to provide a consistent return. It's not a replacement, simply another choice, and a better one at that.

FTM: ***What stage has FQ reached in rolling out the Extended Equity platform? And what demand has there been for the strategies?***
RR: First Quadrant is managing both US large-cap and global 130/30 portfolios. We are also working closely with several clients who are considering similar programmes in the near future. We should be in a position to accept new clients into funds (now being registered) later this summer. We have no preference for discretionary or pooled vehicles in US large-cap strategies, but operational and regulatory hurdles favour a fund investment on the global side. We are keen to involve emerging markets in the global portfolios and costs of implementation provide advantages over separate accounts. As we move towards fund launch, we are offering early entrants a substantial fee concession – an incentive, as it were, to adopt the programme sooner rather than later.

Early demand for both the US and global portfolios has been offshore–Europe and Australia are first movers. Many US investors have been quick to grant their existing relationships the ability to implement the technique to help improve prospective risk-adjusted returns. We operate in the institutional space – but I suspect that interest from the wealth-management and retail communities will grow and I hear there are already fund managers allocating sub-advisory relationships to the strategy. It falls outside the scope of this interview, but Extended Equity portfolios have tremendous potential advantages for taxable investors. I am confident that a tax-efficient 130/30 is on the horizon. Finally there are a few early adopters among consultants who will have a material impact on the speed with which Extended Equity gains acceptance.