

US Quant Fund Manager Change

We have enhanced the manager mix of the FRIC II US Quant Fund by replacing core quantitative (quant) manager, BGI, with another core quant manager, Goldman Sachs Asset Management (GSAM).

These two managers are broadly similar in process, both managing well-diversified, core portfolios. GSAM is a recent addition to our buy-list in the US quantitative arena. Although we have been researching this manager for many years, it has recently significantly upgraded its investment process, particularly its risk and portfolio construction models, which made it a good replacement for BGI. GSAM's process also incorporates a focus on management quality, bringing diversification benefits to the fund as well as access to another possible source of performance.

We have also used this opportunity to marginally change the weights of the other managers in the portfolio, reflecting our increased confidence in Aronson + Johnson + Ortiz.

How do quantitative managers invest?

At Russell, we define a quant manager as one where quantitative (mathematical) models determine stock selection and/or portfolio construction.

Quantitative investment has come a long way since its beginnings in the 1970s. Improved technology allows quant managers to incorporate a vast amount of information in their models. And this information is not just limited to company balance sheet data; managers now assign numbers to less tangible factors such as newsflow and company management quality. Because of the high number of factors each model uses, the level of diversification within quantitative portfolios is normally high.

So, if quant managers run diversified portfolios, why would we construct a multi manager fund? Many quant managers are converts from qualitative approaches to investment management, convinced that their way of investing, and the type of data they use, is the most effective. This gives quant managers biases towards particular market factors and different types of stocks; some even incorporate qualitative elements in their processes – the case for process diversification remains compelling.

Who is Goldman Sachs Asset Management (GSAM)?

GSAM is a global asset management company established in 1989 which manages over \$381 billion for clients all across the world. It forms a part, and has the financial backing of, Goldman Sachs, the investment banking firm. GSAM runs its entire equity quantitative product from the US, where its mathematical expertise is centred and from where all of its quantitative models are developed and maintained.

GSAM's investment process

GSAM's stock selection process employs six broad factors:

1. Momentum
2. Analyst sentiment
3. Valuation
4. Profitability
5. Earnings quality
6. Management impact

This is merely an overview of GSAM's process – the underlying machinery of its model is much more complex. Each factor is based on several different metrics: for example, the momentum factor is based on short, medium and long-term signals. GSAM scores management impact from net external financing information and changes in shares outstanding and several other variables.

GSAM's process then assigns an 'alpha score' to each factor – ie an assessment of whether or not the market is likely to reward that particular factor. It then uses an optimiser to construct a broadly sector-neutral portfolio with a bias to those stocks that represent those factors with higher alpha scores, GSAM's focus on earnings quality and management impact results in a portfolio with an emphasis on higher-quality companies.

GSAM's core approach combines well with the other, more specialist managers in the fund. Jacobs Levy Equity Management (Jacobs Levy) researches a far greater number of stocks, and in more depth, than GSAM. Jacobs Levy's process is highly sophisticated; its 70 different models incorporate a huge level of detail. It also incorporates a greater focus on investor behaviour than GSAM, quantifying investor risk tolerance, herd behaviour patterns and overreaction to corporate announcements.

Franklin Portfolio Associate's (Franklin's) process is slightly less complex than that of GSAM and looks at four main factors:

- Relative value;
- long-term value;
- momentum; and
- insider-trading.

The first two factors give Franklin a greater value-bias than the other managers in the fund. In addition, Franklin's philosophy is to consistently add small amounts of value in incremental stages. It has a strong sell-discipline and offers the fund a less volatile return stream than the other managers.

This contrasts sharply with Aronson + Johnson + Ortiz (AJO), which runs a smaller, more concentrated portfolio than the other managers – it only holds around 90 stocks. This gives it a greater return variability and, while it does incorporate many value factors in its model, it has a strong focus on price momentum, making it is less dependent on market factor scenarios than Franklin.

Summary

So, we can still find good diversification in quant managers' processes despite their tendency to run more diversified portfolios than traditional investment managers. We view GSAM as the fund's core portfolio, and the other managers as more specialists. AJO runs a concentrated, market-oriented portfolio, Franklin has a less volatile return stream with a greater value bias and Jacobs Levy runs the most complex process – it researches stocks in such detail that it finds investment opportunities across the entire market.

Manager weights

| Manager | Previous Fund Weight | New Fund Weight |
|-------------|----------------------|-----------------|
| AJO | 18% | 23% |
| Franklin | 23% | 25% |
| Jacobs Levy | 27% | 27% |
| BGI | 32% | 0% |
| GSAM | 0% | 25% |