Portfolio manager Q&A: MDT Market Neutral

Federated Hermes

Federated Hermes MDT Advisers

For professional investors only

We asked Dan Mahr, Head of MDT, to discuss MDT's market neutral strategy — its history, approach and how it may fit within a portfolio. Please find edited excerpts from the conversation below.

MDT has been managing a market neutral approach for nearly 30 years, correct?

Yes, we started managing a market neutral portfolio in 1997.

It evolved from the observation that our quantitative approach, which seeks to predict the relative performance of all stocks in the US equity market, lent itself not only to selecting stocks with expected outperformance for traditional long-only portfolios, but with a long/short construct could also target companies with a high likelihood of underperforming. That insight opened the door to a broader opportunity set — and with it, the potential to generate more alpha.

What makes your strategy "market neutral"?

Beta is a measure of a security's tendency to covary with the market. What we seek with this strategy is to build portfolios with an equity beta target of zero — a low sensitivity to overall market movement. Of course, we aim to do this while also seeking to generate a positive return above the risk-free rate.

We construct portfolios by taking long positions in stocks that our model forecasts to have positive alpha, and shorting a roughly equal dollar amount of stocks with negative alpha forecasts.

In practice, portfolios typically hold about 400 names between their long and short positions and use modest leverage (roughly 1.6x–1.8x) to achieve the desired exposure. The portfolio's return is effectively the net of long alpha, short alpha, cash return on short proceeds, and borrowing costs.

Active managers are hired with the expectation of generating alpha (excess return) in addition to the beta (market return), which is available by itself through passive stock management. Our market neutral strategy seeks to minimize beta and generate alpha from both the long and short portfolios through active stock selection.

For investors evaluating portfolio fit, why should they consider a market neutral strategy?

The simple answer is diversification. Adding more strategies to a portfolio doesn't automatically create diversification if the new components end up being highly correlated with what's already there.

Because we aim for low beta and low correlation with major asset classes, we believe this strategy can fit well as a liquid alternative alongside traditional long-only equity and fixed income exposures. Our goal is to provide a durable, all-weather component that offers attractive return potential with reduced sensitivity to broad market swings.

How do you look to generate alpha?

Rather than applying a single factor set to every stock, our alpha engine seeks to identify the unique combination of factors that are most relevant for predicting each individual stock's future performance. Through continued research and machine learning techniques that we began using early on, the process can recognize different company types and attributes that have tended to outperform or underperform over time. That gives us a broader and more diverse set of potential alpha sources to consider across the universe.

How do you manage the various risks that can show up in a long/short strategy?

We use a proprietary risk model that incorporates company volatility and cross-company correlations to help limit unintended exposures. We also apply diversification constraints and explicitly evaluate trading costs — commissions, spreads and market impact — so that proposed trades are considered net of those costs.

There's a perception that market neutral strategies are derivative-driven. Do your portfolios employ derivatives?

Our portfolios invest only in equity positions on both the long and short sides and avoid derivatives. That can make it easier to implement for clients who prefer straightforward long/short equity exposures rather than more exotic hedging tactics.

Is there a "right time" to invest in a market neutral portfolio?

Timing markets is challenging in any environment. Because market volatility is difficult to predict, we believe our portfolios can work well as a permanent holding. A successfully applied market neutral approach has the potential to dampen overall portfolio volatility and improve efficiency over time.

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What are the challenges to managing these portfolios?

Owing to the use of leverage in the construction of the portfolio, risk management is of the utmost importance in this strategy. While we aim for all-weather outcomes in all of our portfolios, there will always be market environments where any actively managed portfolio struggles, and leverage in a portfolio has the tendency to make those difficult environments even worse.

You mentioned earlier that this was largely an internally-generated product based on your research. What was the continued attraction of the team to this investment approach?

We believed that the strategy was, in many ways, the purest expression of the stock-picking prowess of our model. But we also felt that having a strategy with different return drivers and risk characteristics than our other portfolios would help us derive better insights into the model and enhance idea generation that could potentially inform model improvements that would benefit all our strategies.

Risk considerations

Investing in equities is speculative and involves substantial risk.

Diversification does not assure a profit nor protect against loss.

The stocks of small- and medium-sized companies are often associated with higher risk than stocks of larger companies, including higher volatility.

The quantitative models and analysis used by MDT Advisers may perform differently than expected and negatively affect performance.

There is no guarantee that the use of long and short positions will succeed in limiting a Market Neutral portfolio's exposure to domestic stock market movements, capitalization, sector-swings or other risk factors.

The strategies may make short sales of securities, which involves unlimited risk including the possibility that losses may exceed the original amount invested.

Definitions

Alpha measures a portfolio's return in excess of a benchmark (excess return) adjusted for risk (beta).

Beta is a statistical calculation of the market risk of a fund showing how responsive the fund is to market movements. The beta of the market is 1.00. A beta of zero indicates returns independent of market movement.

Correlation measures the similarity between two return series on a scale of -1.0 to +1.0. Assets with a correlation of 1.0 are perfectly correlated, -1.0 demonstrates negative correlation and 0.0 indicates the absence of correlation.

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