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SPRING TRAINING FOR PORTFOLIOS

Michelle Schriver / March 16, 2018

Major League Baseball's spring training is wrapping up. With the exhibition games over, teams are ready to field the rosters they've selected to win in the regular season.

Portfolio managers, too, aim to create winning teams, selecting their investment lineups with a similar mix of scouting rigour and analytical detail.

With a nod to one of baseball's greatest catchers and philosophers, **Yogi Berra**, here's how portfolio managers are approaching the season.

"YOU CAN OBSERVE A LOT BY WATCHING"

Spring training provides a limited sample for evaluating talent. Portfolio managers are also constantly developing new methods for identifying and measuring potential.

"What we're looking for are all-star players that are in a slump," says Talbot Babineau, president and CEO at IBV Capital in Toronto. There must be a 30% difference between the intrinsic value and market value of a potential investment.

Babineau takes a private equity approach to investing in public markets. That means his firm assesses potential picks at an operational level—observing business type and model, management, and financial and operational metrics, he says.

"We do an exceptional amount of due diligence on each name, which is why we only hold between 10 and 20," he says.

His firm's deep dive into due diligence is evident in its holding of Bermuda's electric utility company, BELCO, through parent company Ascendant Group Limited. The firm has been on site, met with management and the board, and consulted with C-suite executives in the utility space to assess the firm's analysis and provide historical context.

"We've gotten fully integrated into the business community and, in some instances, the political community in Bermuda to understand this particular investment—because arguably it's the most important piece of infrastructure on the island," says Babineau.

The firm asked local regulators about the regulatory outlook, which is expected to exhibit greater rigour as

"Slump? I ain't in no slump; I just ain't hitting"

With rigorous analysis undergirding their investment picks, discipline at the plate is a regulation continues to develop in the wake of the island's 2016 electricity act. A sophisticated regulatory environment eliminates uncertainty for utility investment, he says. "There's plenty of room for operational and financial performance improvements."

The thorough assessment resulted in the firm becoming the utility's second-largest shareholder. Because the investment is listed on only the Bermuda stock exchange, "we had to re-create our internal trading infrastructure to accommodate this investment," says Babineau. However, he thinks Ascendant Group can relist onto a different exchange, noting that the TSX owns part of the Bermuda stock exchange.

"We think they can sell non-performing assets and optimize their balance sheet. It's a utility without any debt, which is an anomaly in the utility space," he says.

Rebecca Teltscher, portfolio manager at Leon Frazer & Associates in Toronto, also took a shine to a company whose potential others failed to recognize.

Three years ago, independent power producer Northland Power was largely ignored by the market because two large contracts for wind projects weren't set to come online until 2018. But the name offered good dividend yield (about 6.5%) with potential for increases based on the new projects.

Most of the market is short-term focused, with models and price targets forecasted for the next 12 to 18 months, she says. Taking a longer view "sometimes gives us a competitive advantage."

Patience paid off: Northland increased dividends 11% last year, says Teltscher.

big part of portfolio managers' strategies.

Says Talbot Babineau, president and CEO, IBV Capital in Toronto: "We only swing at pitches we have a high probability of hitting—and hitting well. We're exceptionally selective."

When the count's 3 and 0, he swings harder at the anticipated fastball coming down the pipe: "In specific environments, we increase the size of the investment within our portfolio."

In Q1 2016, for instance, the rate-reset preferred market was volatile and Babineau's firm identified Enbridge's rate-reset preferred shares as undervalued, based on the company's capital structure. With such an "excellent" risk-reward profile, "we took a very meaningful position in a very quick period," he says. The shares were sold in Q2 2017, with a 43% return.

A pitch like that might be thrown once a year, says Babineau. "But during intense market turmoil, we can get a lot of pitches in a row like that."

Filling out the roster

Babineau avoids disruptive models typically found in consumer technology or fashion, preferring companies with attractive business models and valuations. His firm makes picks from around the globe.

Though Teltscher's focus is mostly Canadian, she looks elsewhere for certain sectors. For example, "It's hard to find good consumer names with substantial yield in Canada," she says, and "the Canadian market's a little bit narrow" in large-scale industrials and healthcare.

Michael White, portfolio manager at Picton Mahoney Asset Management in Toronto, also keeps an eye out for picks with a difference. "It's a necessary condition of a portfolio to protect capital, but it's not a sufficient one," he says. "You need to garner a reasonable amount of upside as well."

A growth and momentum investor, White holds Air Canada, which started to pay down debt last year, against expectations. “When you get some element of disbelief associated with positive change, that’s where returns can become very powerful.”

Setting goals and understanding the competition

As with any pre-season, portfolio construction starts with an assessment of goals.

Most clients aren’t trying to beat the TSX, Teltscher says. Rather, they’re trying to reach specific goals, such as funding their lifestyle during retirement.

Dan Hallett, vice-president and principal at HighView Financial Group in Oakville, Ont., says, “We have to quantify those goals so we have something measurable to aim for and to track progress against.”

Knowing the competition is also a must. For Teltscher, that’s inflation.

To beat it, she invests 50% to 70% of her assets under management in mature, dividend-paying companies. Her picks have strong balance sheets and growth potential so they increase dividends over time, in line with or above inflation. They’re “the backbone stocks of the economy,” such as utilities, telcos, banks and pipelines, she says, and they tend to perform through recessions.

“That was evident in 2008 when everyone thought the world was coming to an end. But our utility companies, like Fortis, were still raising their dividends,” she says. Fortis is “as stable as you get, with almost 100% of their cash flows regulated by the jurisdictions they operate in, so there’s not much fluctuation in terms of earnings.”

To make up for an underwhelming bond market in recent years and to diversify beyond traditional markets, Hallett has a private market mandate. “We can spend two-and-a-half years on this process,” he says, starting with identifying what the firm wants to achieve and desired investment characteristics. That way, the firm isn’t distracted by specific products, he says.

Criteria has included direct property exposure. “Directly investing in real estate rather than through the stock market, you wouldn’t pick up the short-term volatility that you would get with a real estate mutual fund,” he says.

Other criteria were cash flow, a solid return on investment and a sensible fee structure.

“IT GETS LATE EARLY OUT HERE”

No matter how solid their lineups are, managers must react to the game on the field. And that game, or market cycle, is in its late stages. “It’s time to start thinking about unintended risks,” says White.

Many investors don’t appreciate interest rate risk, which makes dividend-paying stocks such as REITs, utilities and telcos less attractive, he says. “We’ve paid such a premium for the perceived safety of dividends—that is a very vulnerable aspect of the market.”

Equities in a traditional balanced portfolio geared for income bear the same interest-rate risk as fixed income, White says. The market is now rewarding companies that reinvest cash in the business instead of paying out dividends or buying back shares, he says.

For her part, Teltscher expects interest rates to rise slowly and steadily. As such, stocks sensitive to interest rates will see only “temporary dips,” she says. Utilities, for example, have earnings based on government-set rates, which will eventually be reset as interest rates move. She expects she’ll add to her position when share prices weaken, and eventually adopt a defensive position by adding defensive stocks as the cycle comes to an end.

Plus: "There is a tax advantage when it comes to investing in dividends in Canada that you don't necessarily get when investing globally or in the States. You don't get that dividend tax credit," she says.

To manage volatility risk for retail investors, White manages mutual funds and uses shorting and options strategies.

He describes his position as defensible, not necessarily defensive. "What we're thinking about now is having that protection in place for the eventual market correction or recession," he says. "Continuing to do what you've always been doing because it's continued to work—that poses a risk."

When scouting for a diversifier, Hallett says he wanted "a certain level of transparency and a fee structure that wasn't super high or overly complex." That rules out hedge funds, since their fees "can be very high, the structures are usually not very transparent, and it is difficult to form even a good ballpark expectation of what you're going to get from a return and risk perspective," he says.

Transparency is particularly a problem with fund of funds, he adds. "Even if the overall fund of funds doesn't do well, you could still have performance fees if one or two funds underneath do well."

Further, return expectations for hedge funds rely too much on historical performance, says Hallett. In contrast, a stock's outlook is based on fundamentals, which are forward-looking, he says. Plus, hedge funds are a variation on stock and bonds, so don't offer diversification outside the market.

Hallett notes the lure of equities when the bond market is performing poorly. But if investors allocate funds to dividend payers, for example, at the expense of fixed income, they're increasing their risk by tilting too heavily toward a single asset class.

That said, private equity also poses risks.

"The risks are just not reflected in price volatility; they're elsewhere," he says. "That's why we spend so much time and we're so diligent at making that private market investment decision."

"90% OF THIS GAME IS HALF MENTAL"

White used options strategies to mitigate volatility during Brexit. The day after the vote, he says, "MSCI was down 3% or more, and our protection that we had put in place for the week prior had doubled in value overnight. A lot of people would view that as market timing, but it's not. We were just trying to take that event risk out of the portfolio and replace it with our otherwise long-held view, [which] was constructive."

The strategy also kept clients' capital engaged for the recovery. "When we can mitigate those opportunities where emotion generally takes over for people, that is where the strategy really wins," he says.

With the recent bull run on U.S. equities, White (speaking before the February correction) says he hears anecdotes from advisors of riskier and riskier client behaviour. Investing "boils down to base emotions, like greed and fear," he says. "That greed dynamic is starting to work its way in."

From sovereign debt crises in Europe to geopolitical tensions, clients have become desensitized to risk in this cycle, he says. The record-low volatility until February meant there was "an awful lot of complacency out there."

He says most people's definition of risk is suffering loss. With investors capitalizing on the bull run, "it's probably going to be another one of those cycles where a Sharpe ratio, or risk-adjusted return, is only going to make sense to people after it's too late."

Achieving risk-adjusted returns is a measure of portfolio success, says White: "A dollar of return for 50 cents of risk is an amazing proposition."

Babineau says his firm is "very defensive and selectively offensive." For example, his firm historically carries about 20% cash.

"We see cash as an option on opportunity and a net benefit when the market goes through extreme turmoil. We can deploy that cash very quickly without necessarily having to sell down other positions," he says.

He notes the importance of educating clients on portfolio strategy "during both good times and bad" to keep them grounded.

Hallett says clients must regularly be reminded that markets go in cycles and that many investments that excite them are speculative.

Says Babineau: "We look through what's happening within the markets at the underlying business and operations. That's the critical piece of determining value, and market value just fluctuates around that."

"IT AIN'T THE HEAT, IT'S THE HUMILITY"

Just as the great Yogi Berra pontificated on America's favourite pastime, portfolio managers wax philosophical on their own game.

To describe his management strategy, Talbot Babineau, president and CEO at IBV Capital in Toronto, quotes one of the greatest hitters of all time, Ted Williams: "Hitting is 50% above the shoulders."

"You always have to approach investing as an endless intellectual pursuit to improve technical expertise," says Babineau, adding that that expertise is best employed with mental fortitude.

That's exemplified when he invests most aggressively during market turmoil.

"You have to be able to make decisions based on facts, and remove the emotional elements of the game," says Babineau. "We often make calls that are accurate but unpopular."

Rebecca Teltscher, portfolio manager at Leon Frazer & Associates in Toronto, wins not by swinging for the fences but by advancing incrementally on solid base hits: she chooses companies with increasing dividends. "We don't measure our success based on how well the stock's going to perform for one year," she says. "We want that consistent return year after year."

Throughout the year, she adds value by reinvesting dividends in undervalued names and potentially trimming overvalued ones.

To keep score of the game, Dan Hallett, vice-president and principal at HighView Financial Group in Oakville, Ont., uses two levels of benchmark.

“The primary focus is, are we on track to achieve clients’ goals,” he says, adding that clients’ portfolios are purpose-driven. Being on track means meeting a return target over a period. “Then we look at each component of the portfolio against the market-based benchmark,” which indicates how efficienctly the firm tracked clients’ goals.

Michael White, portfolio manager at Picton Mahoney Asset Management in Toronto, uses hedging strategies to “win by not losing. You don’t have to work as hard to capture upside if you limit your downside.”

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