The Strategy behind a Five-Star Market-Neutral Fund

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by Robert Huebscher

Cognios Capital is an independent employee owned quantitative investment management firm that serves as an investment adviser to a mutual fund, private funds, institutional clients and individuals. Cognios creates investment strategies that follow rigorous quantitative processes. These processes utilize proprietary research based on the fundamental factors that drive investment returns.

Jonathan Angrist is its president and chief investment officer and lead manager of the Cognios Market Neutral Large Cap Fund (COGIX). Prior to co-founding Cognios Capital, Jonathan was a co-owner of and portfolio manager at Helzberg Angrist Capital (HAC), the predecessor firm to Cognios. HAC was an alternative asset investment firm specializing in deep value, long/short equity hedge fund management. Prior to HAC, Jonathan was a portfolio manager for a mutual fund company, The Buffalo Funds, where he launched and managed the Buffalo Micro Cap Fund.

I spoke with Jonathan on June 6.

Your firm was founded in 2008. What is the history of Cognios Capital, and how did you come to manage the Market-Neutral Large Cap Fund?

In a predecessor that I was running in 2005 with another partner, we were doing long-short equity. Over time, I decided the best way to add value for clients was with market-neutral equity. We added a market-neutral equity strategy close to six years ago. That became the primary focus of the firm.

We were a small company. But in 2012, we combined our business with a company called Oxford Creek Capital. It was owned by a man named Jim Stowers. Jim's father founded American Century, the $150 billion asset management company here in Kansas City. Jim was the CEO of that company for quite some time and then retired. He took a break and then started Oxford Creek. Jim and I knew each other and were both doing similar things and considered putting our businesses together. In 2012 we did that.

Today, Cognios is a combination of what was originally my business and Jim's company. Jim is an owner of the business. He's on the advisory board and has been a very important part of helping us get where we are today.

You mentioned that it's a market-neutral fund. Can you explain what that means and how it differs from a traditional long-only fund?

Long-only strategies own stock and are usually highly correlated with whatever index they are trying to track. Long-only funds owning stocks tend to have meaningful relationship with the S&P 500 over time.

There are really two big differences between a long-only strategy and a market-neutral fund like ours. Market-neutral is a subset of long-short equity strategies. Long-short equity means that not only are you long (buying and holding stocks like long-only funds), but you also take short positions. Long positions generally make money as the stock market goes up. Short positions generally make money as those stocks go down.

But there is another way to make money being short, and that is if you are long a stock and short a stock; the short stock doesn't necessarily have to go down to make money. You just have to have the long stock go up a lot more than the short stock goes up. Similarly, if the whole market is going down and the long position is going down and if the short loses less money than your long stock, then you can make money.

When you are just shorting stocks, you are hoping that the stock goes down. But with a long-short portfolio of stocks, the goal often becomes having a portfolio of short positions that underperform your long positions. They don't have to go down; they just have to go up less.

Market-neutral is a special case of long-short, where you take enough short positions to offset all of the market exposure or beta in your long book. Let's say you have a position of 50 stocks and that is your long-only portfolio. Market-neutral means

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you want the long portfolio to behave differently from the overall stock market. If left alone, most stock portfolios of 50 positions have a reasonable correlation to the S&P 500 or whatever index they are tracking. But as you add more and more short positions, the correlation between that portfolio and its index starts to decline. The goal of market neutral is to make money, but in a way that is completely unrelated to what is going on in the overall market.

When you measure the degree to which you succeed at being market-neutral, do you look at the correlation to the S&P 500 or the beta of your fund, or are you looking at some combination of those two things?

The primary measurement is beta. A beta of zero, which is our goal, means that the return on my portfolio is completely independent of the return of the market. One test of the power and meaning of your beta is the R-squared or the correlation to the index. Those are two related measures.

In general, the answer to your question is that we look at all of them combined. But at the end of the day, we want low correlation, low R-squared and a beta near zero. That means we are running a portfolio whose returns don't really have anything to do with the overall return of the stock market.

What have the beta and the correlation of your fund been over the last several years?

The beta to the S&P 500 from the launch of the fund through March 31, 2016 was 0.1. The R-squared is 2.47%. That says the variance of the stock market explained only 2.47% of the variance in returns of the mutual fund.

The fund uses what you callROTA/ROME®, a value-based quantitative investment process that identifies companies whose intrinsic value has diverged significantly from the current market price of its stock. Can you explain in more detail how that works?

Those are the two most important metrics in making our investment decisions. ROTA stands for return on tangible assets. It is the profits that a company makes divided by its tangible assets. That is all the assets on the left-hand side of the balance sheet other than goodwill and other intangibles, but goodwill is the bulk of it. By excluding goodwill, it lets you compare businesses in the same industry and across industries. It lets you compare large, small, foreign and domestic companies.

ROTA tells you universally whether a business is good regardless of where it is, how big it is or if it's public or private. It is the single best metric for telling you if a company is a good or bad business.

ROME tells you if a stock price is cheap or expensive. It is the return on market equity. Market equity is really just the stock price, so it's the return on the stock price or cash-flow yield. It is similar to a yield on a bond; it's the profit yield on a stock price. A higher yield – or a higher ROME – means it's a cheaper stock. We want to own high-ROTA companies that make a lot of money relative to their tangible assets. We want to buy them at the highest ROME – the cheapest price possible.

In our long book, we like stocks that are high ROTA and high ROME. In our short book, we like companies that are essentially the opposite.

You portfolio has approximately 55% of its equity positions in industrials and technology. What has made those sectors attractive?

Our process is purely quantitative, which means we base our stock picking and our portfolio construction on a mathematical model that we built and let run. Obviously we monitor and manage it, but we don't use any portfolio manager gut instinct or discretion to override the model. It is my job to continuously try to make those models better, but the models pick the stocks. Today, the model likes industrial and IT stocks, and it likes consumer staples and healthcare. There are also some sectors that it doesn't like.

But those preferences change over time, so you are right to ask what makes our model choose those things today. In a way, I've already answered that question. Those are high ROTA businesses that are trading at cheap prices, and that's what gets favored in our long book. The short book favors the opposite. We may be long some IT companies and short some IT companies. The net exposure is ultimately a function of what the model likes to put in the long book and what the model doesn't like to put in the short book.

Interestingly, the ROTAs for any particular company or industry – or even for the overall S&P 500 – tend to be fairly stable over time. They can be cyclical, but if you look over a whole cycle, ROTAs tend to be fairly stable over time. What bounces around quite a bit are stock prices, and that is shown in the ROME.

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The sector allocations in our long and short book and on a net basis shift over time. It has more to do with the stock prices of those companies than the underlying economic dynamics of the businesses. In general, the model takes a bit of a contrarian view in that whatever is the cheapest stocks of great businesses go in the long book, and whatever is most expensive of the worst companies go in the short book.

So your fund is rated five-star by Morningstar based on its strong three-year track record. Its three-year return has been 6.97% as of June 3, 2016, which placed it in the top 5% of its peer group. When you look at your performance attribution, what have been the key factors that have led to your outperformance?

I attribute it to ROTA and ROME; that is the core investment philosophy of everything we do. We focus on buying companies that have great businesses, make a lot of money relative to their tangible assets and try to buy the cheapest ones. That comprises our long book, and we go short businesses that don't make a lot of money and are trading at high prices.

It's hard not to make money over time. It is a very simple strategy. That's the number one thing that has been driving our returns, our ROTA-ROME investment philosophy.

Second, it's a very simple portfolio. We are long and short stocks that are constituents in the S&P 500. There are no stock options, futures, forwards or total-return swaps. There are no derivatives in the portfolio. That simplicity lowers the overall cost of the portfolio and it just makes it a more efficient way to manage money.

The last thing is that we run the portfolio on a beta-neutral basis. We are not just short one dollar of stocks for every dollar that we are long. We adjust the portfolio based on how sensitive the long and short books are to overall movements in the stock market. That is calculated and reflected in its beta.

The fund's administrative expenses are capped at 1.95% for COGMX and 1.7% for the COGIX. The fund has a relatively high turnover, which is ranged from 155% to 491% over the last three years. I'm sure you've been asked about those numbers by advisors. What has been your response?

You are correct; those are the expenses directly related to managing and running the operations of the fund. Different third parties, like Morningstar, may show slightly different expense ratios, depending on what they include in their calculations.

The turnover in the portfolio is going to be higher than in a long-only portfolio because we use a little bit of leverage. In our long book, for every $100 we invest in the mutual fund, we are going to long $120; we are borrowing $20.

Plus, in order to be beta-neutral, we need about 70% in the short book. For the 120% long, we have to have almost 70% short, so that's another 80% of the equity. If you invest $100, we are going to be long $120, short $80; in total that is $200. Our gross exposure is two-times that of a typical unlevered long-only portfolio. Everything else being equal, our turnover would be twice that of an unlevered long-only mutual fund.

Relative to other funds with our strategy, our turnover is not particularly high. Early in the life of the fund there were some large movements in and out. As a very small, new fund, those can drive turnover to rates that are not comparable to when it is running at size. Today we are running at $115 million. I wouldn't expect turnover numbers that high. That is not consistent with the strategy.

I understand that one of the goals of the fund is to provide diversification outside of traditional stocks and bonds. Can you talk about how that works and, more generally, how advisors have been using this fund within their typical client asset allocations?

One of the number-one complaints that we have been hearing from investment advisors around the country is that asset classes that they were told or used to think were diversifying end up not diversifying at all when markets get choppy. Take MLPs, REITs, utilities, commodity funds or other nontraditional asset classes. When markets are stable or growing, those asset classes for whatever reason tend to have a low correlation to the S&P 500. Advisors expect diversification if they add it to their portfolios, and they go ahead and do that. But when the market goes down, all those things go down together.

Some people say that when the market goes down everything correlates to one. Another way of saying that is those correlations are bimodal; there is a certain correlation when the markets are flat to up, and there is a different correlation when the markets are going down. Right when advisors need the diversification the most they don't get it. That's the number one complaint we've been hearing.

But market-neutral equity is fundamentally different from those supposedly diversifying asset classes. Take utilities, MLPs

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or REITs for example. There is no reason why they have to behave differently when the market when the market is going up versus down. There is no reason why the correlation has to be low. They are just stocks that other people happen to own. Market-neutral equity and, in particular, a beta-neutral market equity portfolio like ours is designed from the inside out to be uncorrelated to the market. There is no reason to believe that it will be correlated to the market when the market is going up, and there's no reason to believe it's going to be correlated with the market when the market goes down.

In fact, that is what we've seen.

The related advantage is that it can replace either the traditional equity or the fixed-income part of a portfolio. It's been easy for advisors to see how they can take a piece of their traditional equity portfolio and allocate to market-neutral equity because it feels equity-like to them.

But interestingly, what we have been hearing more and more is that advisors are also comfortable using the market-neutral equity portfolio to replace a piece of their fixed-income portfolio. The reason for this is that even though we are long and short stocks, we hedge out and remove the beta and end up with a return stream that looks very different from stocks. In fact, it feels a little bit more like a fixed income portfolio.

Advisors have said it's very hard to make money in fixed income. They don't want to go out any further than a year or two in terms of duration risk. If they are worried about interest rates rising over time, they feel like they are more likely to lose than make money in fixed income, and they are certainly not likely to make a lot. They've been allocating to market-neutral equity as a replacement for their traditional fixed income portfolio. That is the most creative use of the product these days.

What feedback have you had from advisors about your performance?

Many market-neutral equity strategies generate very low – zero to 2% – returns. What advisors needed was a market-neutral equity strategy that generated equity-like returns. They're willing to settle for something below equity-like returns, but it needs to be better than the zero to 2% that the market-neutral equity indices have been providing.

We've been generating mid- to high-single-digit returns in the strategy with a lower standard deviation than equity markets, a very low beta and a very low R-squared. So while past performance doesn't guarantee future performance, for many advisors it has fit the bill and is exactly what they were looking for – returns that, at the end of the day, they can live with, that can make money when the market is going up and, in particular, that can provide protection when the market is going down. Advisors want a solution that is designed from the inside out to be independent of the market. It's not just low correlation when the sun is shining, but no diversification when the market is declining.

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