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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Tilting Portfolios Toward Market Outperformers

GEOFFREY GERBER is Founder, President and Chief Investment Officer of TWIN Capital Management, Inc. He is responsible for overseeing the management of the firm and the investment process. Recognized as a specialist in institutional quantitative investment management, he has been quoted in the financial press and his opinions are often sought by his peers in the industry. Mr. Gerber is also a faculty member for the Aresty Institute's Wharton Executive Education Program on Investment Strategies and Portfolio Management. He serves as Chair of the Pittsburgh UJF Foundation Investment Committee, Chair of the Burroughs Wellcome Foundation Investment Committee, a member of the Burroughs Wellcome Board of Directors, and is a member of the Editorial Advisory Board of the *Journal of Investment Consulting*. Mr. Gerber also serves on the Investment Advisory Committee of the New York State Teachers' Retirement System (NYSTRS). He earned a B.S. degree in economics from the University of Buffalo and a Ph.D. in economics and finance from the University of Pennsylvania.

SECTOR — GENERAL INVESTING

TWST: Please introduce TWIN Capital Management to readers with some history and an overview of the firm today.

Mr. Gerber: TWIN Capital was founded in 1990, and our first product was a long/short equity market-neutral strategy. In 1995, we began successfully managing long-only portfolios. We currently manage six long-only strategies, and we continue to manage a long/short equity market-neutral product. All of our current strategies employ large- and mid-cap domestic stocks. In the fourth quarter we plan to launch our newest strategy, a small-cap core active product that's designed to outperform the Russell 2000. Our client base is institutional, including public and corporate pension plans, foundations and endowments, Taft-Hartley plans, mutual funds and other pooled vehicles. A major advantage to clients is the longevity of the TWIN investment team. We've worked together since 1999, and not only has TWIN been fortunate with the steadiness of our investment team, but we've also been fortunate to have the opportunity to enjoy some of our client relationships over a long period of time. Some of our clients have even been with TWIN since 1995. TWIN's goal is to remain a boutique investment management firm, focusing on research and improving the investment performance for our clients. That's an overview of TWIN and who we are.

TWST: Tell us about your approach to investment management, including your "Fundamental Tilt."

Mr. Gerber: In terms of investing, we seek to systematically identify measurable indicators of investor behavior as they relate to equity returns. We've created our own proprietary research database, plus the back-testing portfolio management and trading systems that drive our investment process. Our investment process consists of a stock selection model and Fundamental Tilt, which you mentioned. The stock selection process is based on models of valuation, growth and quality, and together these models are combined to produce relative rankings of expected returns for stocks. Stocks with higher expected returns become potential purchase candidates, while stocks with negative expected relative returns are potential sale candidates.

After we run our model, we look to apply TWIN's proprietary Fundamental Tilt. You can think of Fundamental Tilt as TWIN's trademark method of tilting our portfolios towards certain market factors and risk levels. We implement Fundamental Tilt by targeting exposures to certain capitalization and style segments, while at the same time targeting risk for our client portfolios.

There are three main components to TWIN's Fundamental Tilt. They relate to the capitalization, style and risk posture of our portfolio. We first ask the question, will megacap stocks perform better or worse than midcap stocks or smaller-cap stocks? Secondly, we ask if the value side of the market will win over the growth side of the market. And we're also going to ask the question, are there other market style segments that we should be focusing on? Once we've answered those questions, we begin to tilt our portfolio towards those segments of the market that we think are going to outperform, whether they be capitalization, style or other attributes that are having an impact on the stock market. For example, in March 2009, we started focusing on the abundance of low price stocks in the Market. And in April of 2011 we started focusing on companies that consistently have grown their dividends. Our Fundamental Tilt is going to allow us to tilt our portfolio towards those stocks that our model ranked highly, but we also believe we have the right characteristics for the market going forward.

The final element of Fundamental Tilt is to target the appropriate level of risk that we want to take in a portfolio based on the current market environment, whether the market outlook is more or less favorable for our kind of investment process and how it's expected to work in the future. It's important to know that at TWIN Capital we're humble; we recognize that nothing works all the time, so the idea behind Fundamental Tilt is to take the appropriate level of risk. At times we would like to take more risk for our clients, when the markets are favorable, but if the market environment is not favorable, we have to be taking less risk for our clients.

Highlights

Geoffrey Gerber of TWIN Capital Management discusses his firm's investment strategies. He says they manage seven strategies, with one on the way, a small-cap strategy. Mr. Gerber emphasizes the long-only strategy, TWIN Prime, and he says the portfolios hold some exposure to every sector so long as it is represented in the benchmark. Underweight sectors include consumer discretionary and financials, and overweight are technology, industrials and health care. He also touches on the macroeconomy and what it means for the markets going forward.

TWST: Of your various products and strategies, is there one in particular you'd like to discuss in more detail today?

Mr. Gerber: We manage seven strategies currently. We're about to manage an eighth with our small-cap strategy. In terms of our current strategies, the one that would be the most interesting to emphasize is the most active long-only strategy relative to our enhanced index strategies, and that's TWIN Prime. TWIN Prime is a strategy that we've been managing since January of 2004, so we have a little over nine-and-a-half years of track record in that strategy. Its benchmark is the Russell 1000 and its goal is to outperform the Russell 1000 over time. We certainly don't outperform every day and we don't outperform every quarter, but we have outperformed most of the quarters and, in fact, most of the years. If you look at the nine calendar years through 2012, this strategy has outperformed its benchmark, the Russell 1000, seven out of nine times. Although the year is not over yet, year-to-date this strategy is ahead of its Russell 1000 benchmark.

The reason it's worth highlighting is that TWIN Prime is an active strategy that has seen a lot of interest of late from our clients. Obviously, as the markets have performed quite well over the last several years, all one really needed to have done is just buy in to the market. Going forward it could become more difficult. If you believe that it's going to become more difficult as the stock market becomes more choppy, having a strategy like TWIN Prime, which makes the maximum use of our Fundamental Tilt and allows us to apply it to the broadest universe of stocks, really gives us the best chance to add value consistently.

One other comment to make about the Prime strategy is that, in addition to trying to beat the market, the goal of the strategy is that when we do lose, we don't lose by a lot relative to the market. The reason it's called TWIN Prime is because it makes maximum use of the information set available to us, and at the same time it makes prime use of our Fundamental Tilt. If we think the market environment is not going to be favorable, we will certainly cut down on the risk in this active strategy.

TWST: Based on your modeling in the current market, what are you seeing as the best opportunities?

Mr. Gerber: The way we think about the best opportunities is starting with themes with our Fundamental Tilt. I would tell you that within the U.S. domestic equity market, we tend to favor slightly more defensive, value-oriented stocks. We also tend to favor smaller stocks rather than the megacap stocks. And we also slightly favor some stocks that have shown some consistent dividend growth, because we do think that over a period when volatility rises — it hasn't yet in 2013, but we do believe that volatility will spike up again — it's important to have companies that have exhibited consistent long-term growth. The best way to get that is to find companies that have consistently paid back to their shareholders with growing dividends.

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Sitting here today, I would tell you that we are concerned about the overall level of the market. If the month were over today, the S&P would have advanced 13 of the past 16 months, including the month of September. The market has been up tremendously since its March 9, 2009, trough. I believe that the market will take a breather. The market's volatility was very high in 2008 and 2009, still elevated in 2010. While volatility declined in 2011, there were still some spikes. In 2012 and 2013 volatility has been very, very low and in fact declined — but I do think that these low levels are likely behind us.

Within the theme of best opportunities, from a sector basis we are slightly overweighted to technology stocks. We think that technology stocks do provide some good potential for better than market returns, in particular companies related to the cloud. Obviously, disaster recovery is something that's prevalent to many, many investment managers, as well as many organizations outside of the investment management field. So we think that technology stocks may outperform the market going forward.

TWST: Would you name a couple of specific examples of stocks that you like?

Mr. Gerber: As a matter of policy, we prefer not to mention individual client stock holdings. We certainly are comfortable talking about the themes we have in the portfolio, but not individual stock positions.

TWST: In addition to technology, are there any other sectors to point out that you are overweight? Or particular sectors that you are underweight?

Mr. Gerber: Let me first say that all our portfolios are diversified across all sectors. We're always looking to hold some exposure in every sector as long as that sector is represented in the benchmark. However, we may choose to hold slightly more or slightly less weight in a sector compared to the strategy's benchmark. Currently, we are underweight consumer discretionary stocks. Now, that's an underweight today; two years ago we were overweight consumer discretionary. As I already mentioned, we are overweight technology; we are also overweighted a little bit at the margin to industrials, and a little bit towards health care. In addition to our underweight to consumer discretionary stocks, we are also slightly underweight financials.

TWST: What's your typical turnover, and what are the key components of your exit strategy?

Mr. Gerber: The turnover of our Prime strategy has averaged between 50% and 60% per year for the last three years, so that on average we are holding a stock for a little under two years. The exit strategy is primarily based upon our stock-selection model's ranking for a stock. If a stock moves from a positive expected return stock to a negative expected return stock, it certainly would be considered as a sale candidate. A negative expected return would be considered a potential trigger for an exit. But we will also evaluate the characteristics of that stock and whether that stock has other characteristics that are valuable to the portfolio relative to the Fundamental Tilt we want in place in our portfolio, and that might cause us to scale back on the stock rather than exiting the stock completely. When we evaluate a position in a stock, it's not a binomial decision — either you are in or you are out at full weight. A stock may enter the portfolio and we may be adding to its weight over time, or a stock may be in the portfolio and we may be subtracting from its weight over time, based on the model's ranking of the expected return for the stock, and based on the characteristics that stock provides to the portfolio. That said, if a stock has very negative expected returns, it likely will be sold from the portfolio at some point. So our exit strategy is really going to be based on our model and our expectation of stock returns. And those stocks that are expected to produce the most negative returns will be the ones that are triggered for a potential exit, or at least a scale back, meaning we cut the position down.

TWST: What macro issues concern you the most in today's market environment?

Mr. Gerber: I would say we have several macro concerns. Certainly, potential trouble spots include the geopolitical crisis with Syria and/or Iran, and a possible disorderly breakup of the eurozone. In addition to that, we are concerned about the potential fiscal gridlock in the United States. We're also concerned about the dysfunction between Congress and the president over the budget and, in particular, Obamacare. And lastly, what is the Fed policy? As you may know, the Fed came out today, and while everyone was expecting the tapering of the easing, we're continuing the easing, as was announced today. So I think that the Fed policy is certainly a question mark, and obviously with Lawrence Summers stepping down earlier this week, it's also a question of who will be running the Fed and what policy changes might be implicit from Bernanke to the new Fed chairman once they are selected and take over.

I hate to be a pessimist, but we've enjoyed a significant market rebound. If you look at it from March 9, 2009, the Russell 1000 is up 184%. The S&P 500 is up 178% since its low on March 9, 2009. So obviously, they've more than doubled, almost tripled from their lows. We are sitting here, year to date through yesterday, with the S&P 500 and the Russell 1000 both over 21%. I would have to say that any potential bad news — if, for example, there is an airstrike against Syria, I can't imagine the market wouldn't take some kind of shock or hit from that. Obviously, with all of these macroeconomic events, we are very concerned that there could be market declines. Furthermore, we are concerned by the fact that volatility has been so low and so quiet for the last year and a half, and on top of that the market is going up so much. So I have to say that, yes, we are very much concerned about several macro issues, along with the fact that the market is very elevated with very low levels of risk today. That's a recipe for potential volatility shocks. Unfortunately, when volatility skyrockets, it's usually in a negative market environment.

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TWST: What about the Fed's announcement today? Would you expand your thoughts on the Fed not yet tapering the bond purchases?

Mr. Gerber: It looks like the Fed is going to wait to see the level of unemployment drop more. They're looking for more growth. Given the Fed's announcement about the future direction of monetary policy on May 19, and what happened to the bond market following the announcement, it's not a surprise that they decided here in September to continue easing and not taper off yet. It's certainly the case that when they made the announcement in May, 10-year

Treasury yields shot up, prices of bonds declined, and perhaps there was more reaction than I think Chairman Bernanke was expecting. Given that there has been some economic progress, but not nearly enough, I'm not surprised that the easing will continue. Certainly, the market in its reaction to the announcement this afternoon is positive, at least in the short term. I would tell you that I'm not 100% surprised. I think that, if you talked to many bond managers, they would have told you that they felt that interest rates might go down before the year is out, and obviously if the Fed is going to continue its easing policy and continue buying the bonds, then the possibility of interest rates not going up for the remainder of the year gets better.

TWST: Is there anything else you'd like to add?

Mr. Gerber: Given the strength of the stock market over the past four-and-a-half years from the market bottom in March of 2009 and the current low level of market volatility, we really think that having strategies that actively manage volatility make sense. Going forward for the next year or two, I think it's probably important for investors to be thinking about volatility in terms of their strategies, rather than just focusing on trying to capture returns.

TWST: Thank you. (MN)

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