Investment Insights

Active Management: The View From External Managers

Peter Langas
Chief Portfolio Strategist

Lisa Corcoran
Director of Private Markets

Gerry Santy
Portfolio Manager, Hedge Funds

Nancy Sheft
Head of External Managers

Highlights

- Bessemer teams have been in close contact with external managers to understand how the COVID-19 shock is impacting their strategies, both from an investment and operational perspective.
- Across asset classes, from publicly traded securities to hedge funds and private assets, we have not identified areas of concern to date.
- Structural trends that have accelerated due to the pandemic, and that managers are pursuing, include the move to cloud computing, growth in renewable energy, telemedicine, cellular therapies, and artificial intelligence.

Overview

Chief Portfolio Strategist Peter Langas recently hosted a roundtable discussion with senior Bessemer investment professionals who oversee external managers that invest in different asset classes, from publicly traded securities to private assets and hedge funds. Similar to our recent roundtable with internal equity portfolio managers (see *"Active Equity Management Amid Turbulence"*), Peter posed a number of questions to them, including how managers are navigating the current environment, recent performance, new opportunities created by dislocations, and emerging themes and trends as we move forward beyond the immediate shock of COVID-19 on the world. This *Investment Insights* provides a summary of their conversation.

We continue to offer our deepest sympathies to everyone affected by the virus.

Peter Langas, Chief Portfolio Strategist (PL)

Before we delve into questions for our team, I'd like to take a step back to review the philosophy of our investment platform. We believe combining internal and external managers creates a much stronger platform than if we only utilized internal strategies or only external managers. Having in-house investment professionals who are researching companies and industries all around the world every single day provides valuable firsthand information on the investment landscape that helps to inform our macroeconomic views.

That said, a key tenet of our platform is diversification. We believe there are many different types of strategies and asset classes that can generate long-term value for our clients. The teams represented herein perform in-depth due diligence on external managers, with whom they form strong partnerships, and we utilize these managers to complement our internal strategies. This combination is a key strength of our investment platform. With that as a backdrop, we will turn to questions for the team.

PL: Year-to-date returns in equity markets are still negative, but we saw a sharp rebound in April. Could you please provide a brief summary of your philosophy and process, and share your thoughts on performance so far this year?

Gerry Santy, Portfolio Manager – Hedge Funds

Philosophically, we believe hedge funds can complement a client's broader asset allocation through strategies with risk diversification and return enhancement objectives. Risk diversification strategies aim for low to no correlation to other asset classes, a modest level of volatility, and relatively modest net returns over a full market cycle. Return enhancement strategies are more correlated to the market comparatively, and expected volatility is higher; the objective is a higher return profile over the cycle. These strategies aim for return asymmetry, with more equity market upside than downside capture.

In terms of performance, elements of protection were demonstrated in February, March, and the first quarter as a whole. Generally speaking, over the last several years, risk diversification strategies have outperformed global equities in months where equity markets were negative. Return enhancement strategies that have more market sensitivity, or beta, definitely experienced a bit more pain relative to strategies focused on diversification during the recent downturn, and this is not surprising. That said, these strategies generally met their return asymmetry objectives in the last two quarters.

Nancy Sheft, Head of External Managers

When choosing external long-only managers, the credibility of the management team is very important to us; we look for strong partners. Also critical is a repeatable investment strategy, low turnover, attractive performance over time, available capacity, and reasonable fees. Managers must meet our strict operational due diligence criteria.

In terms of performance, most external managers within our mandates outperformed their benchmarks in the first quarter, some by significant margins. One dynamic at play here is the acceleration of structural trends that benefitted growth-focused managers. Some of these trends include online shopping, streaming television, and online trading. The strength of these trends allowed growth oriented strategies to hold up best through the tumultuous markets.

Managed volatility strategies outperformed in the downturn but not by as much as we expected in the large cap space. We have spent a lot of time in discussions with the large cap managed volatility manager we invest with. According to their analysis, when the market sells off indiscriminately, stocks don’t always behave as their betas would suggest. Sometimes low beta stocks underperform what their betas would imply; this is called beta compression. They, and we, would expect this to even out over time.

Gerry Santy, Portfolio Manager – Hedge Funds

In the broader hedge fund landscape, there were reports of certain volatility control/systematic strategies also experiencing trouble with their beta forecasting models with markets moving as fast as they did. That said, some did outperform their relative equity indices, just not to the degree they expected.

PL: For private equity, it’s difficult to look at the very short-term performance given the long-term, illiquid nature of these investments — but could you share some perspectives on how managers are navigating the current environment, and any expectations for performance?

Lisa Corcoran, Director of Private Markets

To start, our diligence process is rigorous and should help our private markets programs to weather the storm to some degree. In terms of managers, we spend a lot of time focused on the team, their investment process, and the historical track record. Do they have the right investment and operating expertise on the team to execute their strategy? Are they prudent in their use of leverage? How much value do they add to their portfolio companies? This process gives us comfort that we've invested with managers who can really roll up their sleeves and work closely with portfolio companies to guide them through this challenging time.

In terms of performance, our clients will start to see some of the impact when values are updated for first-quarter 2020 marks, which will be on July month-end statements. But the Q1 change is unlikely to be meaningful for private equity; it should be more noticeable for real assets. Second-quarter marks, which will show up on October month-end statements, are likely to show more of the impact.

Cash flows for the industry will certainly be impacted, compared to what we were expecting at the start of the year. If an owner does not have to sell a business, he is unlikely to — which means managers will have fewer exits. At the same time, new investments will slow down; managers are not traveling around and meeting new companies. What this generally means for investors is distributions and capital calls will slow down.

PL: It's been a very tumultuous time, and we'd like to hear what type of analysis each of you are doing in the midst of this downturn with external managers.

Lisa Corcoran, Director of Private Markets

We are always in close contact with managers, but over the last six weeks, that has reached a new level. We're discussing what sort of runway portfolio companies have to weather through this, so we can be prepared for the potential impact. The work our operational due diligence team has done is critical; this team has communicated with managers to understand if they are seeing any impacts to their operations from having to work remotely, and thankfully this is not an issue.

Another area we have focused on is leverage and understanding where there might be issues. Generally speaking, we prefer strategies that avoid using a lot of leverage. However, there are likely to be companies with debt issues — particularly companies where revenues have cratered. In those cases, managers are working very closely with the companies and their lenders.

Nancy Sheft, Head of External Managers

We are also in constant contact with managers, asking a lot about the people. Is everyone on the team healthy? Are they sticking to their process and not deviating from what they do? The operational due diligence team is focused on any issues with their day-to-day operations, trading, or remote working — as well as their financial stability. Thankfully, to date, we have not run across any issues from the operational or investment side.

It's interesting that in this new form of contact, we feel we are getting to know the managers even better — more on a personal level. It is heartening to see one manager donate a significant amount of supplies to both U.K. and U.S. healthcare workers through their contacts. They also provided the use of their cafeteria for meals for the homeless and needy children.

Gerry Santy, Portfolio Manager – Hedge Funds

In all respects, March was a whirlwind of conversations with managers, and that's the nature of what happens during times of market stress. We are talking about how they are being impacted, how trading is going, how hedges are working, what changes they are making in portfolios, and what opportunities they are finding. For the most part, the conversations are within what we would have expected with most managers.

On the operational side, the analysis is similar to other teams; we are focused on how things are going with working remotely. Are they having any operating challenges of any kind? What is happening with those managers that employed leverage? Has there been any stress in that regard? Are they having liquidity issues? To date, we have not identified any major areas of concern. But certainly transaction costs are going up, depending on the particular area — on the equity side to some degree and perhaps a larger degree on the credit side.

We also want to understand any issues around redemptions — how that's looking, are they feeling any stress in this regard? So far, there do not seem to be any significant issues, but this is an area our team will continue to stay on top of and keep having conversations. There were lessons learned from the 2008 crisis, and it appears managers are largely benefitting from a more disciplined approach to asset-liability matching.

PL: I'd like to next ask about the energy sector. Clearly, energy has been under a lot of pressure in a lot of different ways. Lisa, can you share some perspectives on the issues and opportunities here?

Lisa Corcoran, Director of Private Markets

This has obviously been a key area of focus for our real assets team. We are spending a lot of time analyzing exposures, as different parts of the sector are going to be impacted differently. Upstream and midstream are likely to be the most impacted given the sensitivity to oil prices. It is important to note that the prudent use of leverage is critical in this space. Many companies have employed hedges through the balance of the year, which should be helpful. Managers are working closely with portfolio companies to help them through these significant challenges. I would note that power generation is a meaningful part of our energy exposures, and those positions are doing relatively well.

It is important to remember that in private markets, capital is invested over time. So recent vintages have a lot of dry powder where they can take advantage of some of the dislocations. Within the energy space, we believe there are interesting opportunities away from more traditional oil and gas in the renewables area; for example, managers that focus on solar energy. We are also spending time on infrastructure, like communications infrastructure, as well as technology within the real assets space.

PL: Nancy, could you discuss some portfolio themes and positioning? One question we sometimes hear is with regard to our large cap and small and mid cap funds, with their very large numbers of stock holdings. Are they too diversified?

Nancy Sheft, Head of External Managers

When we think about putting together a portfolio, what we're trying to do is balance and diversify it while keeping it active at the same time. We focus intently on managers that think about stock selection. When we think about small and mid cap, which appears to be the most diversified, it is important to look at the active share of the portfolio — in the case of our overall strategy, this number is 85%, which is very high relative to other funds. The high security count is a function of holding quantitative strategies; one manager in particular holds about 75% of the total number of holdings, but only about 5% of the overall assets managed in the mandate. Our internally managed small and mid cap strategy, on the other hand, holds only about 30 companies, and it is about 20% of the overall mandate. This drives our active share number.

PL: One point I want to make here is we believe in active management, and we also recognize that to outperform, portfolios have to look different from the benchmark. We use a lot of quantitative tools to monitor how different the pieces of our portfolios are from their benchmarks. When we look at our All Equity model portfolio, we want to make sure it does look different enough to be able to outperform over time.

Nancy Sheft, Head of External Managers

Turning back to themes we are seeing, a small cap manager has talked a lot about the acceleration to cloud computing, and they own a lot of software names that fit this theme. They also believe that the strong companies will get stronger. They have a theory that — restaurants, for instance —the ones that can survive will get stronger, and the little mom and pop coffee shops are just not going to make it. Another theme managers are investing in is telemedicine. Managers have different philosophies and approaches; some are more sensitive to valuation, and some are more long term with their investing horizon. One manager we invest with has a very long-term horizon, so they are not selling out of names that will see a significant short-term impact from the pandemic.

PL: Gerry, could you share with us a few interesting strategies or themes that you're seeing within the hedge fund program?

Gerry Santy, Portfolio Manager – Hedge Funds

Managers are finding interesting opportunities in the credit space. Distressed debt is one such opportunity, but this is a less liquid strategy that requires a longer capital lockup period, in the range of four to eight years. Managers have seen some equity dislocation opportunities, but they are less interesting now that we've seen a bit of a snapback in markets. There are also certain areas of mortgage-backed securities that look interesting.

Peter Langas, Chief Portfolio Strategist

I would offer some thoughts here as well. As we look across our investment platform, we see opportunities brewing in credit, and there are a number of different ways we may be able to take advantage of them. Overall, though, it's fairly early right now in the cycle; we don't yet have a sense of how severe the economic damage will be and the extent of potential credit losses. When the time is right, we will adjust our portfolios accordingly to make sure we are taking advantage of the opportunities in this space.

Gerry Santy, Portfolio Manager – Hedge Funds

In terms of other opportunities we are seeing, one of these is quantitative fixed income, which is actually a relatively nascent area. There are numerous quantitative strategies in equities, but there's not as much being done in fixed income. These strategies take a market neutral approach to U.S. and European credit, and generally perform well in times of heightened volatility and dispersion in markets.

Another attractive area is in global equity options, looking for over- and undervalued volatility across regions and between countries. March offered some very attractive opportunities for them, and they performed quite well.

PL: Lisa, in private equity and venture capital, can you talk about our exposure to areas that are benefiting from the current environment, like cellular therapies, personalized medicine, artificial intelligence? Are there any other major themes you are seeing?

Lisa Corcoran, Director of Private Markets

The pandemic has certainly accelerated certain themes that were already underway, like the digital transformation of enterprises. If you think about all of us working remotely, the need for solutions like cloud data management and cybersecurity accelerates the pace of adoption of these technologies. Artificial intelligence touches a lot of different areas. For example, many of us use Alexa in our homes. The amount of computing power that goes into natural language processing is very high. We think companies developing semiconductor chips that take advantage of this trend represent an exciting opportunity. Personalized medicine is an area that is leveraging artificial intelligence to process large datasets and develop personalized therapies, like in oncology. In the life sciences area, we are seeing a number of companies tackle the COVID-19 crisis more head-on, developing treatments and vaccines. Some technology companies are working on tracking tools and digital health tools that could help.

Peter Langas, Chief Portfolio Strategist

Thanks to each of you for all of your very thoughtful perspectives. It is very clear that external managers play a key and differentiated role in making our investment platform very deep and robust, and are integral in helping us to achieve our clients' investment objectives.

Recent Insights

Changing Energy Market Dynamics — A Closer Look (May 2020)

Active Equity Management Amid Turbulence — Investment Insights (April 27, 2020)

Beyond the Headlines: Your Investments and Wealth Plan — Webcast (April 23, 2020)

Stabilization in the Municipal Bond Market — Investment Insights (April 8, 2020)

Navigating an Evolving Crisis — Quarterly Investment Perspective (Second Quarter 2020)

Adjusting Exposures While Maintaining Similar Risk Profile — Investment Insights (March 25, 2020)

Addressing Municipal Market Volatility — Investment Insights (March 23, 2020)

Navigating an Evolving Crisis — Webcast (March 16, 2020)

Market Sell-Off Continues Despite Fed Actions — Investment Insights (March 12, 2020)

Latest Thoughts on Market Turmoil – Investment Insights (March 9, 2020)

Taking a Long-Term View During Volatile Times — Webcast (March 3, 2020)

Taking a Long-Term View During Volatile Times — Investment Insights (February 28, 2020)

Portfolio Positioning Amid Recent Market Moves — Investment Insights (February 25, 2020)

Turning Trends in 2020 — Quarterly Investment Perspective (First Quarter 2020)

To view these and other recent insights, please visit www.bessemer.com.

About Bessemer Trust

Privately owned and independent, Bessemer Trust is a multifamily office that has served individuals and families of substantial wealth for more than 110 years. Through comprehensive investment management, wealth planning, and family office services, we help clients achieve peace of mind for generations.

ATLANTA • BOSTON • CHICAGO • DALLAS • DENVER • GRAND CAYMAN • GREENWICH
HOUSTON • LOS ANGELES • MIAMI • NAPLES • NEW YORK • PALM BEACH • SAN FRANCISCO
SEATTLE • STUART • WASHINGTON, D.C. • WILMINGTON • WOODBRIDGE

Visit us at bessemer.com