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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Identifying Reliable and Predictable Sources of Return

GEOFFREY GERBER is President and Chief Investment Officer of TWIN Capital Management, Inc. Having founded TWIN in 1990, Dr. Gerber oversees the entire quantitative investment process and general management of the firm. Recognized as a specialist in institutional quantitative investment management, he has been quoted in the financial press and authored numerous articles in books and journals. Outside of TWIN, Dr. Gerber is a faculty member for the Aresty Institute's Wharton Executive Education Program on Investment Strategies and Portfolio Management. He participates in a number of foundations' investment committees and boards, including the Burroughs Wellcome Foundation, the Jewish Federation of Greater Pittsburgh and the Jewish Healthcare Foundation. Dr. Gerber is also a member of the Editorial Advisory Board of the *Journal of Investment Consulting*. He holds a Ph.D. in economics and finance, University of Pennsylvania, and a B.S. in economics from the University of Buffalo.

SECTOR — GENERAL INVESTING

TWST: Could you tell me a little bit about the firm?

Dr. Gerber: TWIN Capital was founded in 1990 as an institutional domestic equity manager, focused on delivering consistent value-added for our client accounts and overall service exceeding their expectations. Our client base is institutional, including public and corporate pension plans, foundations and endowments, health plans, family offices and wealth management firms. A major advantage to clients is the longevity of the TWIN investment team. The six-member investment team has over 130 years of investment experience, with most of those years working at TWIN.

We've been fortunate to experience consistent growth in clients and assets over time. As of September 30, 2018, TWIN manages $2.2 billion in assets. The heart of our investment philosophy is that systematic application of in-house quantitative research coupled with rigorous risk control in portfolio construction affords the best chance of achieving excess return over a benchmark or market index on a risk-managed basis. Our job is to identify and capture the reliable and predictable sources of returns while minimizing any impact for more arbitrary sources of risk. TWIN differentiates itself from the mainstream investment community with the application of our proprietary Fundamental Tilt, which provides the top-down thematic perspective that complements our bottom-up model.

We currently manage five U.S. equity strategies covering the spectrum across market capitalization. The largest of these five strategies is Prime, with $1.1 billion in assets under management as of September 30, 2018, and it's about to complete its 15th year since its inception in January 2004. Over these 15 years, Prime's performance has been very consistent as it has outperformed on a gross of fee basis its Russell 1000 benchmark index in every one of the 48 12-quarter or three-year rolling periods since its inception through September of 2018.

TWST: Did you want to get into a little more detail about the strategy that you use with Prime and why it is successful?

Dr. 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 as well as the backtesting portfolio management and trading systems that drive our investment process.

Our investment process consists of a stock selection model called the TWIN Equity Model and our proprietary Fundamental Tilt. The stock selection process is based on models that incorporate components of valuation, growth and quality, and together, these models are combined to produce relative rankings of expected returns for stocks. Stocks with higher expected future returns become potential purchase candidates, while stocks with negative expected future relative returns are potential sell candidates.

After we run our model, we look to apply TWIN's proprietary Fundamental Tilt. You could think of Fundamental Tilt as TWIN's trademark method of tilting our portfolios toward certain market factors, themes and risk postures. We implement Fundamental Tilt by targeting exposures to certain capitalization and style segments, while at the same time managing the appropriate risk level for our client portfolios via dynamically varying the tracking error. For example, we would ask the question: Will megacap stocks perform better or worse than midcap stocks or smaller-cap stocks? Will the value side of the market finally win over the growth side of the market given that the growth side of the market has won over the trailing 10-year period?

In addition, we're also going to ask the question about risk — the basic tenet of Fundamental Tilt is to target the appropriate level of risk we want to take in a portfolio based on the current market environment. Will the market environment become more risky, more volatile or less

volatile? Whether the market outlook is more or less favorable for our kind of investment process will lead to determine how much risk we want to take actively in our clients' portfolios.

It's important to remember that we're humble at TWIN Capital. We recognize that nothing works all the time. At times, we'd like to take more risk for our clients when markets are more favorable. But if the market environment is not as favorable, we want to take less risk for our clients.

TWST: Right now, given what's been going on in the stock market, risk is an issue, volatility is an issue, especially, I would think, for institutional investors who are dealing with things like pension plans and endowments? Do you want to talk about that a little bit?

Dr. Gerber: So let's talk about risk. The first thing I'll say about risk is that, unfortunately, risk in terms of volatility doesn't seem to be average. Often, it seems to be high or low. There are many ways to measure risk. One way to measure risk, we like to look at the percentage of days that the S&P 500 goes up or down by more than 1%. Historically, dating back to 1962, the S&P 500 goes up or down by more than 1% once a week, on average, or about a little more than 20% of the trading days.

In 2017, there were a total of eight days that the S&P 500 moved up or down by more than 1%. Eight days as compared to 41 already in 2018 — through October 18, 2018 — where the market moved up or down by more than 1%, which totals to 20% of the days so far in 2018. Last year, it was less than 3% of the days. And to put that in further perspective, in the third quarter, the S&P generated its best quarterly return since the third quarter of 2013 and did so with zero days during the quarter where the S&P moved up or down by more than 1%.

Highlights

Geoffrey Gerber discusses TWIN Capital Management, Inc. The firm has an institutional client base, and Dr. Gerber notes that the longevity of the TWIN investment team is a major advantage to its clients. When constructing portfolios, Dr. Gerber uses in-house quantitative research and rigorous risk control. He believes this philosophy provides the best chance of achieving returns in excess of the benchmark. In looking to identify reliable and predictable sources of return, Dr. Gerber's stock selection process looks at components of valuation, growth and quality. While the firm's strategies are sector-diversified, Dr. Gerber says, currently, he is slightly underweight technology and consumer discretionary and slightly overweight consumer staples and utilities.

Dr. Gerber: That's very correct. The way I would put it is that we are sector-diversified so that our portfolios hold stocks in all sectors. As a reminder, the goal of our strategies is to beat market indices that are also invested in all of those sectors. Our objective is to purchase stocks within those sectors that outperform their peers within the same sector, thereby having the portfolio in aggregate outperform the market. So yes, we believe in sector-diversified portfolios.

That said, there are sectors that we do have a slight preference for or we're willing to slightly overweight, and conversely, there are certain sectors that we would be willing to slightly underweight. The important point is that we're still holding exposure to all sectors. It's just a question of whether we are slightly overweighted or underweighted to those sectors.

TWST: Did you want to give an example maybe of one or two things that you're overweighted in now?

Dr. Gerber: This is more of a recent shift, but we have shifted our portfolio in terms of sector overweights and underweights. We've shifted to slight underweighting the technology and consumer discretionary sectors, while slightly overweighting more defensive sectors such as consumer staples and utilities.

TWST: Is that in response to some very recent things in the market in October, or is it more in response to things that have been developing over a longer period?

Dr. Gerber: The themes that we've been talking about — investing in and increasing our emphasis toward more value and defensive-oriented stocks— is something we started focusing on in the third quarter, prior to October. And the reason for that is the extreme markets we've seen.

"I would tell you that volatility is likely going to be higher going forward, not lower. What some of our institutional clients have done to respond to this higher volatility level is to look at strategies that are more defensive and have less volatility. So for example, our Dividend Select strategy is a strategy that is designed to provide market-like returns over the long term but take less risk than the market."

Then, move forward to October, we've already had a down 2% day, we've had a down 3% day and a lot more volatility.

I would tell you that volatility is likely going to be higher going forward, not lower. What some of our institutional clients have done to respond to this higher volatility level is to look at strategies that are more defensive and have less volatility. So for example, our Dividend Select strategy is a strategy that is designed to provide market-like returns over the long term but take less risk than the market, or aide in reducing the overall equity risk of our pension clients' portfolios.

TWST: Given that you have different sectors represented in these funds, it's a more holistic approach to finding ways to control risk. Is that right?

To put growth versus value in perspective, for the 10 years ending September, the Russell 1000 Growth Index has outperformed the Russell 1000 Value Index by 4.5% per year annualized. That is the highest differential in favor of growth since August of 2000.

Secondly, the third quarter of 2018 marked the seventh consecutive quarter that the Russell 1000 Growth Index beat the Russell 1000 Value Index. That has never happened in history since Russell has been calculating this data back to 1979. Never had there been seven consecutive quarters where growth beat value until the seven quarters starting in January of 2017 and through the third quarter of 2018. And so yes, we do think there will be a shift from growth to value, and obviously, we were a little bit early.

TWST: Changing direction, when you talk with your institutional clients, especially those that work on things like pension plans and endowments, where there's a lot of pressure to make sure there's enough money so that an organization can do its mission, what are some of their concerns as they look at the market this year and maybe even looking ahead to next year?

Dr. Gerber: Obviously, the biggest difficulty faced by pension plans, foundations and endowments that have a target rate of return — that's in the range of 7% to 8% — is that it becomes more difficult to achieve that return following the strength of the market's return and the financial market's return in the last many years. Certainly, the last 10 years with quantitative easing has really helped propel the equity market returns. Institutions are now faced with the issue of, should they be lowering their long-term expected target rate of return below 7.5% or 8% to more like 7% or 7.25%?

And of course, that has a dramatic impact on the cost of running the pension plan, and it also, for foundations and endowments, has significant impact on their ability to make grants and grant payments. I think the biggest issue for all of these institutional investors is whether their target rate of return should be lowered. Certainly, capital market assumptions at the end of September of 2018 certainly are going to be viewed as lower than they were five years ago or six years ago. So I think that is an issue for them.

Secondly, on top of the fact that it will be harder to earn their rate of return, volatility is likely going to be higher in the coming year, two years as compared to almost nonexistent volatility in 2017. And higher volatility also makes it more difficult for institutional investors that have to spend continuously through time and have constant draws, whether it's benefit payments or grant payments.

TWST: What do you think are some benefits with your approach at TWIN Capital versus maybe some other approaches that are out there, in terms of benefits to institutional investors, especially in the climate that we've described?

Dr. Gerber: The other issue that institutional managers have faced in the last several years is the difficulty faced by active managers to outperform the index. As an example, in the 12 months ending September, only 40% of the S&P 500 stocks beat the market's return for the 12 months ending September. That is the lowest percentage on any 12-month basis back to June of 2012. And to put it in further historical perspective, 40% is the third lowest percentage of the number of stocks to beat the market over a span of 217 prior 12-month periods. So it has been very difficult for active managers to beat their benchmarks when few stocks are beating the market and when breadth is narrow.

The advantage that TWIN provides can be seen by our Prime strategy. Our Prime strategy has outperformed the market on average in up months, in down months and in sideways months, and that is a fairly unique opportunity for institutional investors. Typically, managers outperform the market on the upside because they're growth-oriented or they outperform the market on the downside because they're defensive or value-oriented. Our TWIN Prime strategy, which is our largest strategy, has generated over almost a 15-year period outperformance in up and down markets. So having the ability to have positive upside capture — meaning outperform the market on average in up markets — as well as outperform in down markets is a feature that our institutional clients really value.

TWST: Does it make it easier for them to communicate information to a board of a nonprofit than maybe with some other approaches — the boards would feel more comfortable planning, knowing that?

Dr. Gerber: That's correct. The advantage of these kinds of risk-control strategies is that the board can appreciate that they are invested in an asset class and that the manager managing that segment of the asset class for them is going to be relatively close to the market index. There's not going to be press risk or major event risk, because whatever the market delivers, our strategy is going to deliver on average a little but not a lot more.

We're going to focus on hitting singles and doubles; we're not going to focus on hitting home runs. We're also not going to strikeout often either. And to your point, what they're really trying to reduce is the number of strikeouts or huge misses. And so while we do not win all the time, we typically win more often than we lose, meaning we beat the market more often than we don't beat the market. And when we lose, we keep it very, very close.

And that is a feature that makes it easier to report to boards or makes it easier for boards because their choice really is active management or passive management. If they've used passive management, they know that they're going to equal the market index minus the fees. If they go to active management, the hope is that they outperform the market, net of fees. But to do so, they tend to take more risk. Our approach allows them to try and beat the market by a little bit without taking more risk, and in some cases, by taking less risk than the market.

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TWST: Finally, is there anything we didn't bring up that you care to mention, either about the firm or some trends out there?

Dr. Gerber: I would say the other trend worth mentioning is the significant run in positive monthly returns for the market. The S&P 500 Index was up for the sixth consecutive month in September. It has generated a positive total return in 28 of the last 31 months, since March of 2016. During this period — during this recent 31-month period — the S&P 500 generated monthly gains during 15 consecutive months and was up every month during the calendar year of 2017, both of which were also unprecedented. Never before has the S&P generated a positive return 28 times in any 31-month period back to 1962.

Another comment I would make is that we are definitely at an extreme period in the market, in terms of the run of positive returns. Historically, the S&P 500 is up five out of eight months, or 62% of the time, since 1962. So the 90%-plus rate we've seen for the 31 months ending September of 2018 is unprecedented.

TWST: What would you say that means to investors? Should they be cautious, or is it too hard to tell what it might mean?

Dr. Gerber: I could tell you that it means they should be much more cautious going forward because things will, over the long-term, revert back to the long-term average — meaning that whether it's five out of eight months or two out of every three months, historically, the market's going to be down 30%-plus of the time, say 35% of the time. And if it's only been down less than 10% of the time in this period, it's

going to make up for it somewhere. So it's more likely the case that you'll have more negative months going forward. That's not to say that the market will soon have a large drawdown, but the growth of the market, it will be less.

To put it explicitly, in the last two and a half years, the S&P 500 has generated over 20% annualized return, which is more than double its 10% long-term return back to the 1920s. And it has generated that double return with less than half the risk. It's generated over 20% return with about 7.5% risk, whereas in the long term, the S&P generates maybe a 10% return with a 15% risk. It is really difficult to believe that the market environment of producing double the return at one-half the risk, or put another way, the S&P generating four times its typical return to risk ratio, can continue. It is likely going to break.

TWST: Thank you. (ES)

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