

A Seat at the Table

Epoch Investment Partners stressed traditional, fundamental investment approaches when it was launched six years ago. But in seeking out a head of risk management, the founders went in a decidedly quantitative direction.

BY JEFFREY KUTLER

Boasting an impressive, 30-year portfolio management track record, William Priest wasn't ready to retire at 60, as the policy of Credit Suisse required him to do. He had co-founded and run BEA Associates since 1972, then served as chairman and CEO of Credit Suisse Asset Management Americas (CSAM), which had grown to 800 employees and more than \$100 billion in assets under management, after the Swiss financial giant's 1997 acquisition of BEA. Moving on, in 2002, Priest joined up with Michael Steinberg in Steinberg Priest Asset Management. The investment team he assembled there became the core of Epoch Investment Partners, which at its June 2004 inception had an asset base of \$630 million.

Today, New York-based Epoch manages \$12.6 billion with a leadership team that includes CEO and co-chief investment officer Priest, president and COO Timothy Taussig, executive vice president and head of client relations J. Philip Clark and executive vice president and co-CIO David Pearl. All are co-

Chief risk officer Michael Welhoelter (left) is a peer of portfolio managers including CEO William Priest (right).



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founders and all had been at BEA except Clark, who had spent 17 years with Sanford C. Bernstein & Co.

For risk management they turned to Michael Welhoelter, whose extensive quantitative investing background contrasted with the principals' more fundamental, long-only direction. Priest knew Welhoelter from BEA/CSAM, which he had joined from Chancellor/LGT Asset Management in 1997 to oversee long/short market neutral and large-cap core products in the structured equity group.

Welhoelter, who has a bachelor's degree in computer and information science from Colgate University, left for Columbia Management Group in 2001, where he managed over \$5 billion in quantitative strategies. Priest and Epoch came calling in 2004, and Welhoelter recalls finding it "a little unusual" to be going "from the purely quantitative arena – building alpha models, risk models, and optimized portfolios – to being part of a team that reflected fundamental, traditional management practices. But Bill had the insight to think about how I could contribute to a traditional investment firm by incorporating the risk management practices characteristic of a quant investor."

Welhoelter, whose current title is managing director, portfolio manager – quantitative research and risk management, sat together with Priest recently in Epoch's offices for a joint interview that reveals the acceptance and importance of risk management in the culture of the firm and provides a glimpse into the strategic and day-to-day dialogues among the portfolio managers. Priest – who graduated from Duke University and the University of Pennsylvania's Wharton School and whose 2007 book *Free Cash Flow and Shareholder Yield* (with Lindsay McClelland) spells out Epoch's approach

– points out that Welhoelter's designation as "co-portfolio manager of every strategy" underscores the working partnership between risk and portfolio management.

Was there a hurdle or disconnect between fundamental and quantitative, and how did you manage through it?

Welhoelter: Bill has made a career of tackling risk management and right-sizing positions in a more intuitive sense. Although he won't admit it, he was once a closet quant.

Priest: When I came out of business school in the 1960s, part of my training was as a quantitative analyst, although I didn't really know what it meant at the time. What it boils down to is this: When you manage a portfolio of securities, you are dealing with two problems: security selection and portfolio construction. Security selection is about what to buy; portfolio construction is about how much of it to buy. Traditional analysts generally focus on what to buy. Quant analysts like Mike figure out how to combine them in a way that manages risk. Using models, he puts these securities together with suggested weights so we can begin the process of building a portfolio that either maximizes return per unit of risk or minimizes dispersion per unit of return sought. You can achieve one or the other, but not both at the same time.

In our organization, a portfolio manager might say to Mike, "Your model suggests we buy 2% of Boeing, but Boeing is my favorite stock. I'd like to make it 3% or 4%." The PM can override Mike's optimization report's suggested weight, but he must weigh that with his quantitative insight. It also works the other way. Mike might say, "This may be your favorite stock, but it is four times the optimum weight. Do you really like it that

much?" That interaction is where risk management comes into play in portfolio construction.

How do the quantitative disciplines contribute to portfolio management?

Priest: Mike's quant background greatly enhances our ability to measure and manage risk. If you don't have these skills, you are just managing money in the dark. Portfolio managers love picking stocks, but they can be clueless as to how to assemble them into efficient portfolios. You need somebody like Mike who knows how to bring a perspective and a set of tools for insight into how to do that and to measure it.

Welhoelter: Building portfolios is about taking risk. You have to understand the risks you are taking and whether or not you are being rewarded for them. If you are taking risks that are unintended, make sure they are mitigated or change the expectations about them. When we are hired as an equity long-only manager, some risk is already expected: that of the market as a whole. The next question is, "Are we taking risks in the portfolio to exceed the returns attached to that market risk?" When we measure that, we find that we do have very efficient portfolios with relatively low risk, low tracking error and relatively high active returns.

How natural was your progression from quantitative investment management to the chief risk officer role?

Welhoelter: I was quite comfortable with operating and managing a portfolio in a quantitative way, having done it for many years. At Columbia Management Group, we began to combine fundamental and quantitative insights in the investment process. I became comfortable with

the notion of a fundamental source of alpha: quantitatively supported research with in-depth [fundamental] analysis. It might be said that quants look at a universe of securities a mile wide and an inch deep, while fundamental analysts take it an inch wide and go a mile deep. Combining these two approaches can give you a very robust data set.

What specifically in the quant background is applicable to the risk process?

Welhoelter: I distinguish between two components of risk in managing portfolios. One is the implementation risk. That is, delivering the returns that clients expect based on the strategies they are invested in, and making sure you deliver that within their guidelines and expectations. From a quantitative standpoint, I could manage hundreds of portfolios for one strategy in a very efficient way using tools to look at portfolios relative to a model. As long as our model portfolio is optimal, we can apply that model to all other portfolios within the strategy and according to general guidelines. If a client wants large-cap value but no tobacco stocks, it's easy for us in a quantitative sense to create a portfolio with that exclusion. At Epoch, we have a portfolio implementation team that talks to the managers about what to do with the capital that is excluded – how to allocate it to other consumer stocks, for example.

Then there is what people traditionally think of as risk management: the risk of individual securities, how that contributes to overall portfolio risk, and whether the risks are consistent with the overall expected returns. On a daily basis, we run all the portfolios through the Northfield Information Services risk models. We know exactly what the risks are and can tell managers when their portfolios start

to vary from expected risk parameters, or when they start to take on systematic risks that the managers may or may not be aware of. For a pure quant, that is all done in an optimizer in the morning. We do it by reporting to a number of people who evaluate the data – portfolio managers, traders, implementation team, chief compliance officer.

Was over-dependence on models or too much faith in the modelers to blame for the financial crisis?

Welhoelter: In my view, models are simply guidelines to help evaluate risks in the portfolio. You can blindly follow these guidelines – or not. We need to interpret the information that comes out of risk models and understand what it means when there are unexpected changes in the models. At Epoch, when a portfolio tracking error goes above a certain number, we have a dialogue in the investment policy group meeting to decide whether or not anything within the portfolio has fundamentally changed. This is where insight and intuition – and not just models – are critical in the risk management process.

Priest: With respect to risk and the recent crisis, it's important to understand the link between behavior and compensation. If you tell me how people get paid, I will tell you how they will behave. Investment bankers and hedge fund managers were paid handsomely to take risks in the form of leverage and exotic derivatives. So, in a sense, it's hard to blame them for trying to develop new products they believed would succeed and doing what they could to have them rated triple-A. But embedded in that process were the conflicts between an employee's near-term compensation and the clients' long-term benefit. [Editor's note: Priest's "Whodunit Perspective" on the financial

crisis and its causes is available in a white paper at the www.eipny.com Web site.]

Welhoelter: In the financial modeling world, there were innovations that supported people's desires to measure risk associated with these derivative products. We know now that these models didn't account for illiquidity and discontinuities, and virtually every quant model failed under these circumstances. At Epoch, our approach is very different. Not only do we question the thesis for an investment, but if something comes out of a risk report that doesn't seem right, we don't just go down to the manager and say, "You have to change the portfolio." We have a dialogue about what's happening with the model and why. Then we consider what steps to take. We certainly don't go to sleep at night thinking that everything is fine and the models will take care of everything.

Priest: Most of our strategies are benchmarked. How do you beat a benchmark? You have to un-diversify, if you will, which gets at the excess risk or tracking error. In selecting securities to outperform an index by 2% or 3%, there is a band of tolerance, a reasonable amount of risk to be taken in order to obtain that return, which might be in the 6% to 8% range. So you could be 8% under a benchmark and not be in violation of your risk targets for a short period of time. If that's the case for a long period, of course, you'll be out of the game. What it comes down to is knowing where your exposures are. Realistically, you will make mistakes in this business. But if you can be right 60% of the time, you will have a phenomenal record over the long run.

Have there been improvements in the risk technology tools that you see or use?

Welhoelter: It's hard to say if they have gotten better. Each of the vendors would show you some revamping of their models and show you that the r-squared measure is a little better. I find it hard to distinguish between small, incremental increases in r-squared in a risk model. Different models are constructed differently, and any construction process has its benefits. Ultimately, as a firm, we have to pick one model. The point is not that it's the best – you don't want to be over-confident in it – but rather that you can understand how it's built, how it's updated and what its weaknesses are. I can't say the quality has increased dramatically from five years ago, but I do feel more comfortable going with my understanding of the strengths and weaknesses of the models.

Here is an example of how risk models can miss emerging systematic factors and how we dealt with it at BEA/CSAM. In the late 1990s there seemed to be many risk models out there that were unable to capture the then-emerging Internet factor. Optimized portfolios didn't account for it. Every month there would be some unexplained return that was associated with the Internet stocks. To address this problem, we took the S&P 500 and Russell 3000 and built a taxonomy of Internet companies and set limits on the risk we would take, thus creating a customized system independent of a Northfield or a Barra risk model.

Are there other innovations in the software? Sure. It's faster, and there are better reports and disaggregation of the risks so you can dive a little deeper. But when I want to dive deeper, I do a lot of the analysis myself and try to understand what's happening in the risk model, which includes talking to the risk model manufacturers.

Priest: We like to blend insights of quant approaches with the fundamental analysis. It's all about perspective. The future is never like the past, but in a lot of models, the future is defined as a replication of the past. That is where judgment and interpretation have to come into play. To make wise investment choices, we want the best of both worlds: the power of automation and the power of human judgment derived from experience.

What factors helped you attract new mandates last year, which contributed to the 16% increase in assets under management (to \$11.4 billion at year-end)?

Priest: In the last two years, there were certain large firms whose philosophies didn't work. These philosophies were based on price-to-book, price-to-earnings and the concept of reversion to the mean. That type of methodology showed that Bear Stearns, which had a \$60 book value one day and \$0 the next, was cheap. There is a fundamental flaw in the design of a strategy that misrepresents value so thoroughly. Because Epoch's strategy is not based on accounting terms, we were able to insulate ourselves from much of the recent financial fallout. Conversely, there were some firms who were hit hard and lost mandates. Those mandates had to go somewhere, and we were one of the beneficiaries.

We have written about these accounting/finance issues for years now and have demonstrated thought leadership on several other subjects. We've deliberately built this firm with a certain caliber of intellectual rigor in mind. When you're facing complex uncertainties, you have to be smart enough to frame the problem accordingly. You may not have the answer, but you can approach the

problem the right way – with humility. Insight into uncertainty is what a good risk officer provides.

How are you staffed, in terms of numbers, and how has that changed?

Welhoelter: We have not increased the risk team dramatically despite our recent growth. One reason is that the firm invested in technology early on to support its growth – risk systems, client reporting, the Charles River Development order management system, FactSet for data and tools. Everything we do is designed to be systematically applied to all the strategies, so it is not a great burden to the firm to introduce a new strategy. Bill's observation about insight and experience says something about the culture of the firm. I am not a policeman. I come in as colleague and peer of the portfolio manager. We are all working together toward the same goal. We did hire a chief compliance officer whose role spans corporate risks as well as portfolio risks. He brings SEC experience and a different way of looking at risks that adds a valuable perspective.

Priest: In addition to being chief risk officer, Mike is designated co-portfolio manager of every strategy. That is significant. There are four managers – myself, Emily Baker, David Pearl and Eric Sappenfield. Each of us "owns" our portfolios, but Mike is our partner. And he is a chosen partner. We don't have the problem of people complaining that they're "saddled with this risk guy." All of our people understand the issue of security selection and portfolio construction and welcome his assistance. Mike has a seat at the table, and it is a powerful seat. He is widely respected throughout the organization as an insightful and user-friendly chief risk officer.



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