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Boston Habor Brings Rules-Based Fundamentals To Quant Strategy

Boston Harbor Investment Management has launched a quantitative rules-based fundamental equity strategy.

The SELECT 40 Large-Cap Low Volatility Investment strategy was launched on April 1 and is based on 22 years of back-testing.

The strategy was developed by CIO Dennis Caulfield, who worked with Denmark-based HUGIN EXPERT A/S, a mathematical analysis firm which specializes in complex statistical models, to quantify and validate the proprietary strategy.

"This is a strategy that tells us whether or not a company is a well-managed, healthy company that has a high probability of sustainable earnings," CEO David Page said.

To accomplish this, the strategy utilizes less than 12 variables to analyze 10-K filings of companies in the S&P 500 Index. Companies that fail to meet all of the criteria are eliminated from the portfolio. Page cited the requirement that return on equity must be greater than the cost of equity capital as one of the variables the strategy examines.

"What we are doing is systematically applying forensic accounting and fundamental financial analysis to the 10-Ks of large-cap companies in a designated investment universe. The strategy looks closely at the relationship between the income statement and the balance sheet. They have to be in alignment without any red flags for us to select a company," Page said.

Typically, about 85 companies pass the no red flags test and make it into the portfolio. Those companies are then sorted by a proprietary beta, with the 40 lowest beta companies making up the equally-weighted portfolio.

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David Page
CEO
Boston Harbor Investment Management"

The portfolio is currently reviewed on an annual basis.

"We don't have an active portfolio manager coming in every day that has a specific style and picks stocks based on qualitative judgments. The strategy is systematic and rules-based and if you don't fit the rules, you are not in the portfolio, plain and simple," said Jack Cunningham, executive v.p. of business development at the Boston-based firm.

According to Page, the strategy is designed to keep up in momentum markets and, most importantly, outperform in down markets resulting in high return per unit of risk.

In its back-testing, the SELECT 40 was able to produce an annualized return net of fees and transaction costs of 10.38% as compared to 1.51% for the S&P 500 from the market peak of April 2000 through Dec. 31, 2012, with risk-adjusted returns of 15.31%.

"When you look at our performance, we play incredibly strong defense. We play good offense, but we have an incredibly strong defense because we are eliminating companies that have performance risk from the portfolio," Page said.

How the firm identifies low beta companies is important to the strategy as well. "When we are selecting for low beta, we've first identified the companies whose low beta is due to their fundamental performance. That is why we talk about no red flags and sustainable earnings," Page said. "If a company has strong sustainable earnings that result in a low beta, that company can be expected to survive market declines with a stock price decline that is materially less than the average stock and keep pace with the market when the market turns around. The ability to systematically select companies that are well managed and healthy and have low betas is the cornerstone of the strategy."

In developing a new strategy, the firm uses the scientific method, first building a hypothesis based on causal relationships and then rigorous back-testing to prove the theory. "This is a rules-based strategy…that was developed with an initial hypothesis, the strategy was then mathematically defined, it was then back-tested producing the returns that we have. The development occurred in that sequence, there was no data mining or fitting (the strategy) to the data. It is what it is," Page said, pointing out that from a transaction standpoint there were no special prices selected because the portfolio is only reconstituted annually using March ending closing prices.

Prior to the strategy's launch, Boston Harbor has had approximately $2 million in assets under management from investors who have invested during the past two-year evaluation period with live portfolios.

The firm is initially targeting the emerging manager space. "Scale is important. We definitely want to focus on managers-of-managers, but the strategy is well suited for both institutional and high-net-worth investors. The high quality portfolio and sizable market cap will allow for significant growth in AUM while providing a high degree of liquidity," Cunningham said.

Cunningham also mentioned the firm's board of advisors as another critical aspect of the firm's strength. The board consists of Stephen Penman, chair of the accounting division at Columbia University Graduate School of Business; Steffen Lauritzen, founder and chairman of HUGIN EXPERT A/S; Robert Ploder, president of Ploder Capital Management and retired senior financial advisor for equities at IBM Retirement Funds; James Hansel, former director and senior fund manager for UBS Funds; Anders Madsen, ceo of HUGIN EXPERT A/S; and Adolfo Garcia, a corporate partner at the international law firm Brown Rudnick LLP.

"Each of our advisors is an authority in his field and that expertise ties into our plans to extend the strategy into the global large-cap market. Each individual addresses a need that we have," he said.

See Boston Harbor's Website for additional information: http://www.bostonharborim.com.