NATIXIS INVESTMENT MANAGERS | SOLUTIONS

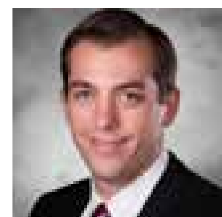
MULTI-ASSET PORTFOLIOS

Strategy Selection: Looking past performance

By Brian Kmetz

Strategy selection is never easy. The disclosure "Past performance does not guarantee future results" is displayed on every factsheet for good reason. By definition, a strategy will look its absolute best immediately preceding periods of underperformance. How many of us have fallen into the past performance trap?

Figure 1 shows the rolling three-year excess returns for an active strategy vs. its benchmark. Typical manager searches require at least three years of history, and a strategy at peak performance will often float to the top. So how does a practitioner select a strategy that offers the best chance at long-term performance without picking an intermediate top?



Brian Kmetz, CFA®, CIPM®
Vice President and Portfolio Manager, Natixis Investment Managers Solutions

FIGURE 1: Active manager vs. S&P 500® Index
Rolling three-year excess annualized return (9/28/12–5/31/22)

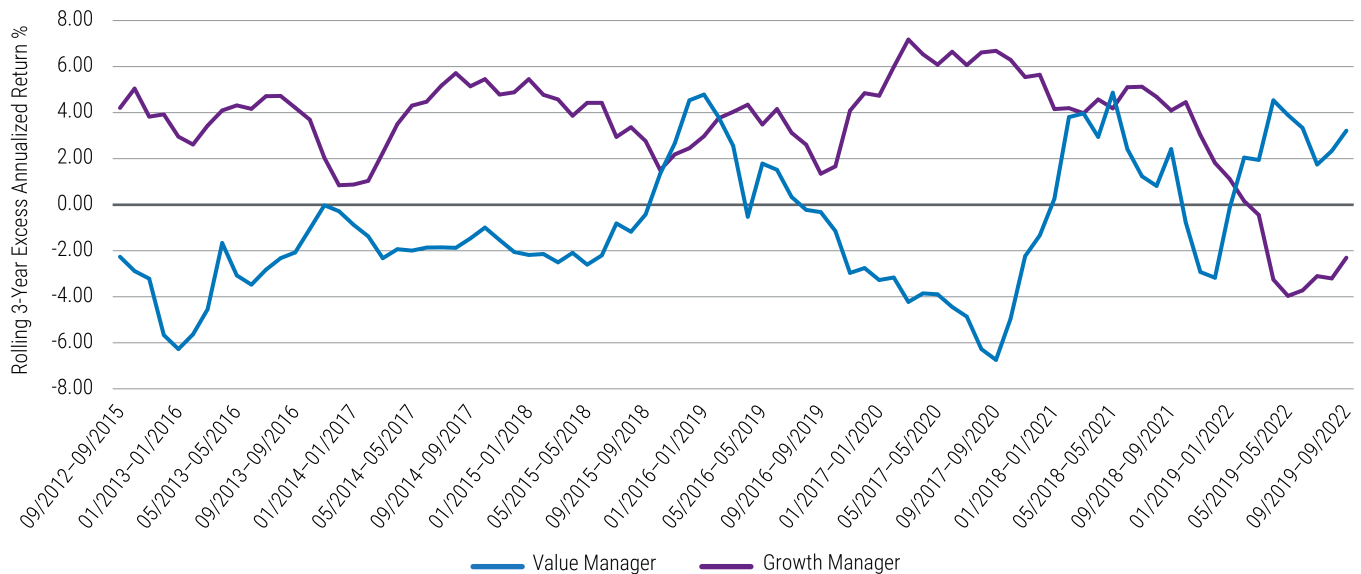
Source: Factset. For Illustrative Purposes Only. Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of, future results.

No magic bullet...

Unfortunately, the answer here is disappointing: There is no magic bullet. The reason for this is the randomness of performance patterns; it is nearly impossible to tell which strategy will outperform over the next 12 to 24 months. We can do our best to pick a solid manager with a good entry point, but fate could have other ideas. Only with hindsight is it obvious which strategy worked and which didn't.

Despite the knowledge that strategy selection is impossible to time, there is a way to mitigate the effects of random performance. Selecting complementary strategies that provide diversification helps temper performance cycles. The classic example of this is the style pairing of growth and value. Figure 2 is the same chart as above but using the performance of a large cap growth strategy and large cap value strategy vs. the broad market. Here the pattern becomes immediately clear. While one strategy is in favor, the other is out, mitigating the timing effect of strategy selection. Expand this to each asset class in the portfolio, and the timing aspect is largely mitigated.

FIGURE 2: Large Cap Growth and Large Cap Value vs. S&P 500® Index / Rolling three-year excess annualized return (9/28/12–5/31/22)

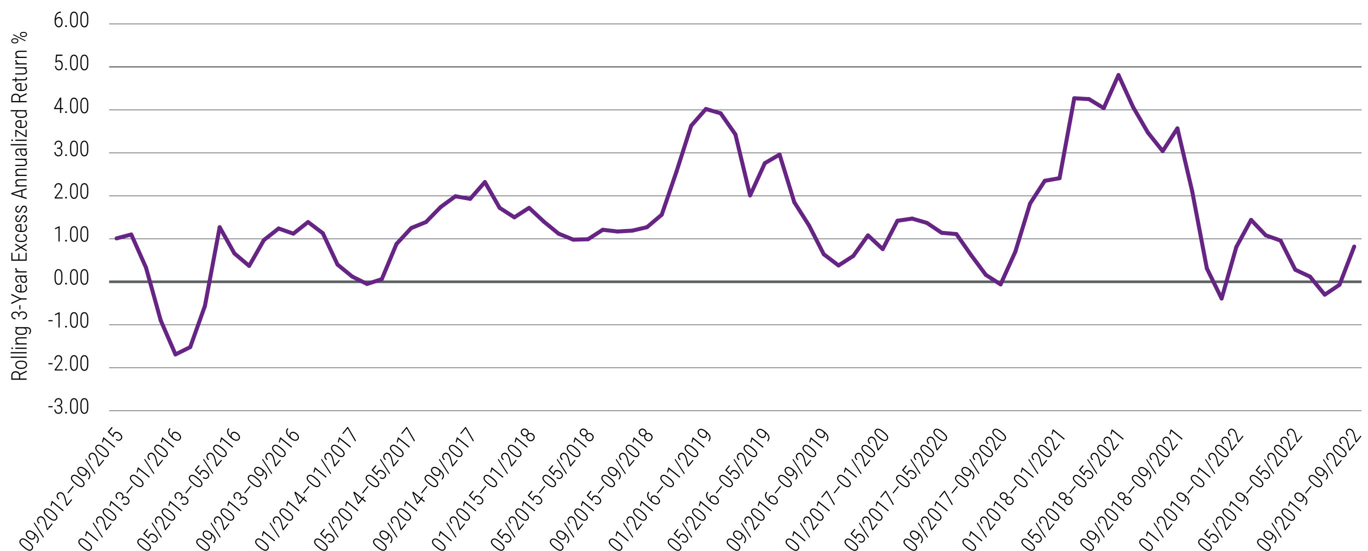


Source: Factset. For Illustrative Purposes Only. Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of, future results.

What about a 50/50 mix?

In Figure 3 we examine a 50/50 portfolio of the large cap growth and large cap value strategy. Combined, their performance pattern becomes much more stable and excess returns against the benchmark become more reliable.

FIGURE 3: Large Cap Growth and Large Cap Value vs. S&P 500® Index / Rolling three-year excess annualized return (9/28/12–5/31/22)



Source: Factset. For Illustrative Purposes Only. Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of, future results.

Depending on the practitioner's investment philosophy, this process can be applied across asset classes, sectors, and style factors. No matter what the pairing, two important considerations are the stability of the relationship over time and the theoretical grounding behind the relationship. This helps answer the question: "Will this relationship persist in the future as expected?"

Focusing on each strategy's fit within the total portfolio lessens the emphasis on individual performance and tempers emotional decisions when a strategy underperforms. However, this does not remove the need for individual evaluation. Track record is important, even with its flaws, and should be long enough to experience a full performance cycle. This means at least five to ten years of returns; three years of solid performance can still be considered luck.

Applying additional screening criteria

A manager search applied to an investible universe should rank and weight criteria the practitioner finds meaningful. This often includes risk-adjusted performance, risk measures such as maximum drawdown, and other rankable data points such as fees. What criteria to include in the ranking and their weights depends largely on investment philosophy. For example, more defensively oriented portfolio managers may weight downside risk statistics more heavily. Figure 4 shows an example of typical screens.

FIGURE 4: Sample manager ranking criteria

Weight	20.0%	15.0%	20.0%	10.0%	10.0%	15.0%	10.0%	100.0%	
	Annual Report Net Expense Ratio Percentile Rank	Manager Tenure (Longest) %'ile Rank	Alpha %'ile Rank 5 Yr	Batting Average %'ile Rank 5 Yr	Up Capture Ratio %'ile Rank 5 Yr	Sharpe Ratio %'ile Rank 5 Yr	Down Capture Ratio %'ile Rank 5 Yr	**Weighted Average Rank**	**Numerical Rank**
Manager A	21	30	4	2	12	5	24	**14**	**1**
Manager B	17	21	9	4	19	19	28	**17**	**2**
Manager C	16	62	5	2	14	3	29	**19**	**3**
Manager D	13	32	7	22	25	9	26	**19**	**4**
Manager E	5	37	9	17	56	5	13	**20**	**5**
Manager F	37	22	6	22	38	6	12	**20**	**6**
Manager G	17	46	15	2	4	15	52	**22**	**7**
Manager H	26	60	10	5	5	15	40	**23**	**8**
Manager I	24	8	7	30	92	4	3	**24**	**9**
Manager J	43	38	16	5	8	19	42	**24**	**10**
Manager K	44	46	1	17	65	1	3	**25**	**11**
Manager L	31	58	10	22	20	11	34	**27**	**12**
Manager M	26	35	15	12	71	13	15	**27**	**13**
Manager N	35	44	4	36	54	13	14	**29**	**14**
Manager O	35	15	13	36	83	13	10	**29**	**15**
Manager P	7	68	11	36	53	13	20	**30**	**16**
Manager Q	42	49	2	17	97	2	1	**30**	**17**
Manager R	20	34	44	12	18	45	65	**34**	**18**

Source: Factset. For Illustrative Purposes Only.

In addition to quantifiable data points, the strategy should exhibit return and risk characteristics that reflect its stated investment process. Performance cycles should align with this process as well. For example, a more aggressive and value-driven process should outperform in strong cyclical uptrends. Since each strategy is a piece within a total portfolio, style drift is an important aspect to monitor. Two strategies that drift together stylistically over time can double up exposures. Finally, if it is an active strategy, it should exhibit outperformance against its benchmark over a full market cycle.

Complementing existing portfolio strategies

With the individual strategy selection criteria out of the way, let's look at a typical short list and how to find a suitable complement for the portfolio's existing strategies. The four shortlisted funds in **Figure 5** are intended to complement a defensive growth equity strategy. They rank at the top of the large cap value universe and have strong risk-adjusted statistics. The table shows seven-year statistics for the shortlisted value managers and the growth strategy against the S&P 500® Index. We can see strong alpha and Sharpe ratio statistics for Value Strategy B and Value Strategy D. While both strategies have strong risk-adjusted returns, Value Strategy B is the more aggressive of the two, with a higher standard deviation and tracking error.

FIGURE 5: Multi-statistic review of value funds as complement for defensive growth strategy (9/30/15–9/30/22)

	Annualized Return (%)	Annualized Standard Deviation	Beta	Jensen Alpha	Sharpe Ratio	Maximum Drawdown	Annualized (All Periods) Tracking Error
Value Strategy A	11.57	22.37	1.12	-0.32	0.48	-40.82	7.92
Value Strategy B	12.77	20.20	0.90	3.23	0.59	-38.89	10.64
Value Strategy C	9.84	18.28	0.90	0.11	0.49	-36.89	6.14
Value Strategy D	10.77	17.27	0.87	0.17	0.57	-32.74	5.03
Growth Strategy	11.20	20.44		0.58	0.50	-34.08	6.53

Source: Factset. For Illustrative Purposes Only. Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of, future results.

Looking at excess return correlation in **Figure 6**, we see that all four strategies are good complements to our Growth Strategy with a negative correlation. Value Strategy C shows the lowest excess return correlation with the Growth Strategy, at -0.67.

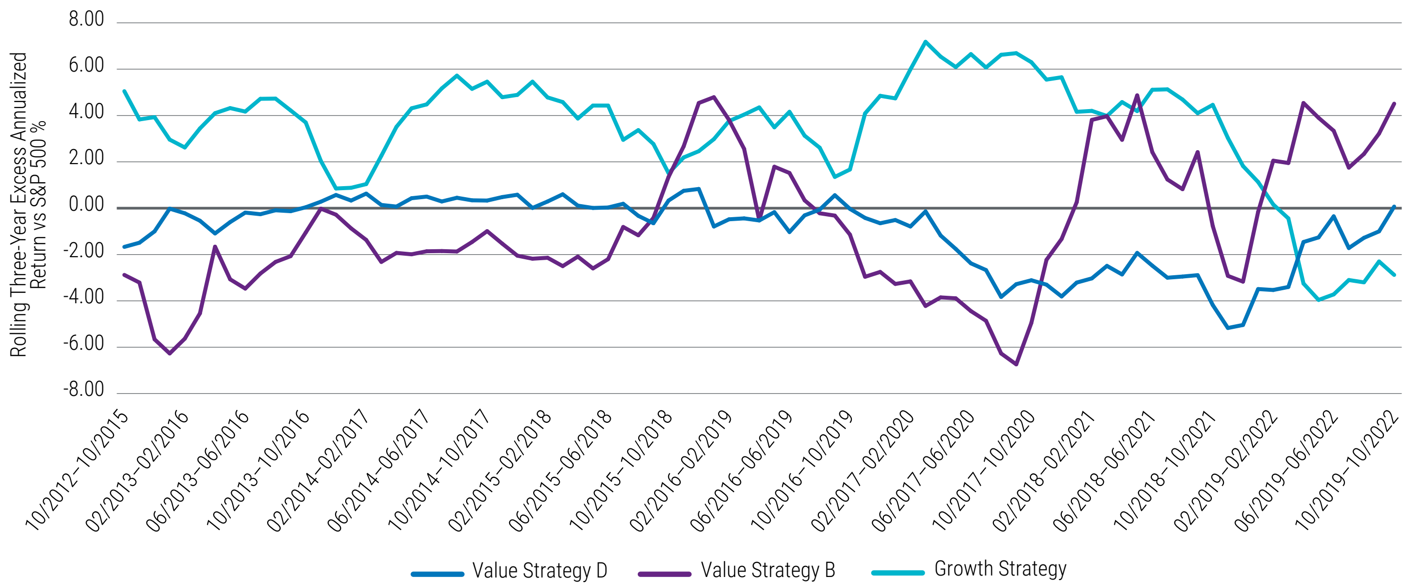
FIGURE 6: Correlation of excess returns with defensive growth strategy (9/30/15–9/30/22)

	Correlation (Excess)				
	1	2	3	4	5
Value Strategy A	1.00	0.17	0.46	0.55	-0.41
Value Strategy B	0.17	1.00	0.84	0.49	-0.57
Value Strategy C	0.46	0.84	1.00	0.72	-0.67
Value Strategy D	0.55	0.49	0.72	1.00	-0.50
Growth Strategy	-0.41	-0.57	-0.67	-0.50	1.00

Source: Factset. For Illustrative Purposes Only. Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of, future results.

Charting rolling three-year excess returns vs. the S&P 500® Index, we see that both strategies act as a complement to the Growth Strategy (**Figure 7**). Value Strategy B has more extreme peaks and troughs than Value Strategy D, but directionally both have similar performance profiles. In the recent time periods Value Strategy D has underperformed, while its longer-term history shows more stability. This type of quantitative analysis combined with qualitative assessments helps align past performance with future expectations.

FIGURE 7: Value Strategy B and D returns vs. defensive growth strategy
Rolling three-year excess annualized return vs. S&P 500® (10/31/12–6/30/22)



Source: Factset. For Illustrative Purposes Only. Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of, future results.

Making the final decision

Finally let's look at a 50/50 combination of the Growth Strategy with Value Strategy B and Value Strategy D. In **Figure 8** both combinations look strong: higher returns, lower volatility and positive alpha compared to the S&P 500®. While Value Strategy B has higher absolute returns, it is higher risk, sporting larger maximum drawdowns and a higher tracking error. While Value Strategy D has struggled recently, it has shown more consistency in the past. Depending on objective and risk tolerance, both strategies are solid complements.

FIGURE 8: Pairing growth strategy with Value Strategy B or D
Rolling three-year excess annualized return vs. S&P 500® (10/31/12–10/31/22)

Source: Factset. For Illustrative Purposes Only. Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of, future results.

FIGURE 8: Multi-statistic analysis (10/31/12–10/31/22) – Continued

Portfolio	Annualized Return (%)	Annualized Standard Deviation	Beta	Jensen Alpha	Sharpe Ratio	Maximum Drawdown	Annualized (All Periods) Tracking Error
50% Growth Strategy 50% Value Strategy B	12.23	18.52	0.95	1.39	0.61	-32.28	4.67
50% Growth Strategy 50% Value Strategy D	11.08	17.88	0.94	0.40	0.57	-29.47	2.77
S&P 500 – Net Return	10.74	19.21	1.00	–	0.51	-33.83	–

For Illustrative Purposes Only. Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of, future results.

The final decision comes down to a matter of preference: a more defensive, lower tracking error strategy vs. a more aggressive and higher tracking error strategy. Like any tough decision there is no easy answer, and each combination provides tradeoffs. No matter what the preference, instilling a process around strategy selection and sticking to it will ensure the best chances of building a resilient portfolio. Pairing complementary strategies together reduces timing risk and the probability of a bad entry point. While it is impossible to predict the future, we can reduce uncertainty through thoughtful strategy selection.

FOR FINANCIAL PROFESSIONALS ONLY

SOLUTIONS

To learn more about our Multi-Asset Portfolio & Mandate capabilities, please contact your Natixis Investment Managers sales representative.

Visit: im.natixis.com
Call: 800-862-4863

NATIXIS INVESTMENT MANAGERS SOLUTIONS – Multi-Asset Portfolios

Natixis Investment Managers Solutions provides design, development and execution of portfolio strategies tailored to specific investment objectives and unique portfolio constraints. Our Multi-Asset Portfolios include core, completion and thematic model portfolios, multi-asset mandate capabilities, and target date funds.

This content is provided for informational purposes only and should not be construed as investment advice. Any opinions or forecasts contained herein reflect the subjective judgments and assumptions of the author only and do not necessarily reflect the views of Natixis Investment Managers, or any of its affiliates. There can be no assurance that developments will transpire as forecasted and actual results will be different. Data and analysis do not represent the actual or expected future performance of any investment product. We believe the information, including that obtained from outside resources, to be correct, but we cannot guarantee its accuracy. The information is subject to change at any time without notice.

The data contained herein is the result of analysis conducted by Natixis Investment Managers Solutions' consulting team on model portfolios submitted by Investment Professionals.

Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of, future results. under the graphs showing past performance data.

Natixis Investment Managers Solutions collects portfolio data and aggregates that data in accordance with the peer group portfolio category that is assigned to an individual portfolio by the Investment Professionals. At such time that a Professional requests a report, the Professional will categorize the portfolios as a portfolio belonging to one of the following categories: Aggressive, Moderately Aggressive, Moderate, Moderately Conservative, or Conservative.

The categorization of individual portfolios is not determined by Natixis Investment Managers Solutions, as its role is solely as an aggregator of the pre-risk attributes of the Moderate Peer Group and will change over time due to movements in the capital markets.

Portfolio allocations provided to Natixis Investment Managers Solutions are static in nature and subsequent changes in a Professional's portfolio allocations may not be reflected in the current Moderate Peer Group data. Investing involves risk, including the risk of loss. Investment risk exists with equity, fixed income, international and emerging markets. Additionally, alternative investments, including managed futures, can involve a higher degree of risk and may not be suitable for all investors. There is no assurance that any investment will meet its performance objectives or that losses will be avoided.

Before investing, consider the fund's investment objectives, risks, charges, and expenses. Visit im.natixis.com or call 800-862-4863 for a prospectus or a summary prospectus containing this and other information. Read it carefully.

CFA® and Chartered Financial Analyst® are registered trademarks owned by the CFA Institute.

Natixis Advisors, LLC provides advisory services through its division Natixis Investment Managers Solutions. Advisory services are generally provided with the assistance of model portfolio providers, some of which are affiliates of Natixis Investment Managers, LLC. Natixis Advisors, LLC does not provide tax or legal advice. Please consult with a tax or legal professional prior to making any investment decision.

Natixis Distribution, LLC is a limited purpose broker-dealer and the distributor of various registered investment companies for which advisory services are provided by affiliates of Natixis Investment Managers. • Natixis Advisors, LLC and Natixis Distribution, LLC are located at 888 Boylston Street, Boston, MA 02199. • 800-862-4863

5189000.2.1
PAC14C-2023