The Integration of the Investment Processes of Golden Capital Management and the Wells Capital Global Strategic Products Group

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Background

In late 2011, as we worked toward the integration of the Golden Capital Management (GCM) and former Global Strategic Products group (GSP) investment teams, we undertook a comprehensive review of the research platforms and investment processes used by each team. From a surface level review, it was clear that GCM and GSP shared a similar dedication to fundamental research. A deeper comparison shows remarkably similar philosophical underpinnings, as well.

Since the beginning of the integration, it has been our desire to gain a detailed understanding of the people, philosophies, research, and investment processes used by both teams in order to leverage the unique strengths offered by each team. We found that the similarities vastly outweigh the differences. GCM and GSP have extremely capable investment teams that have a dedication to their work and a high level of trust among team members. The research produced by each group has been of exceptional quality, and both teams place a significant emphasis on achieving a diverse and optimal combination of the sources of alpha and risk within portfolios.

Below, we provide a summary of the GCM and GSP investment processes. We then highlight each team's approach to harvesting market inefficiencies and controlling risk. Finally, we conclude with a description of the research and investment process that the combined GCM investment team has determined to use going forward.

The GCM Research and Investment Processes

In the early 1990's, Greg Golden and Jeff Moser, the founders of GCM, began working together to establish the framework of what would become the GCM investment philosophy. Their research demonstrated that companies which possessed attractive valuations as well as those that were likely to exceed earnings expectations should have better than peer stock price appreciation. Their work led to the development of quantitative models which were built to find companies exhibiting these characteristics. The investment process was built to leverage

GCM's Total Composite Model is comprised of a combination of the following sub-composites:

- *Traditional Valuation*
- *GARP Valuation*
- *Earnings Growth*
- *Earnings and Sales Momentum*
- *Earnings Quality*
- *Trading Momentum*

the new research platform and included strong risk controls. In 2005, Fred Karimian was hired as Director of Research and the research platform has evolved since that time to reflect more advanced techniques and to achieve a deeper, more comprehensive evaluation. The focus remains on building risk-controlled portfolios of relatively undervalued companies with strong and improving earnings fundamentals.

The GSP *Portfolio Signature* Approach

The GSP group also has a rich history of quantitative investment decision-making. Its investment process is designed around a concept that it calls *Portfolio Signature*. At its most fundamental understanding, *Portfolio Signature* refers to the aggregate exposures within a portfolio to each alpha and risk factor. The alpha factors used by the GSP group have been selected to exploit three types of inefficiencies in the market: 1) inefficiencies caused by emotional investor behavior, 2) inefficiencies caused by imperfect information dissemination, and 3) inefficiencies caused by signaling/agency issues relating to corporate insiders. A fourth inefficiency, geographic constraints on the flow of capital, labor and information, exists in the context of international investing.

The GSP Alpha Model focuses on:

- *Valuation*
- *Sentiment*
- *Quality*

While a quantitative alpha model produces opinions on individual stocks, the *Portfolio Signature* provides an integrated view of the total portfolio. The *Portfolio Signature* concept focuses the team's attention on the aggregate exposures to each alpha and risk factor. The idea behind *Portfolio Signature* is to achieve a balanced portfolio that can generate alpha through diversified potential sources while tightly managing risks. The approach identifies optimum ranges for each alpha and risk factor to ensure that the portfolio avoids unintended risks, while positioning it for consistent performance during a variety of market conditions. During the portfolio management process, any outliers from the determined optimum ranges are identified, and optimization rules are implemented to select the best securities to trade in order to achieve the optimum *portfolio signature* - that is, the optimum aggregate exposures to the alpha and risk factors.

Emphasis on "Best Alpha"

There are similarities and differences between the specific approaches taken by GCM and the GSP group to identifying what we call "best alpha." For GCM, the idea of best alpha" has been built into the structure of our quantitative ranking methodology. To maintain a consistently strong alpha signal, we incorporate a diversity of factors into our models. Also, we employ a proprietary categorization methodology[1] that groups companies into four distinct groups. This process allows us to optimize, for each category, the weightings assigned to each of our sub-composite models as they are rolled up into a single Total Composite ("TC") score. The idea behind our categorization methodology is that certain alpha factors are more predictive for some types of companies than others, so optimizing TC scores by using this approach allows us to select from the best companies within each category.

For GSP, the idea of "best alpha" is tied to the concept of *Portfolio Signature*. The group similarly incorporates a diversity of alpha sources into its process, but its approach to determining the proper emphasis on each factor differs. Prior to rebalancing a portfolio, the GSP group identifies the aggregate portfolio characteristics relative to research informed optimum ranges for each factor. Then, portfolio trades are determined with the goal of bringing the aggregate exposure to each alpha factor within that optimum range.

[1] The initial step in GCM's quantitative ranking process is to divide companies into four categories. Companies within a given category share certain financial characteristics and operate within a similar phase of their business cycle.

Strong Risk Controls

Risk management is integral to the investment processes for both teams. Sector and security weighting constraints are a common control, but the two groups have employed different approaches to the more detail-oriented aspects of risk management. GCM has long utilized the Barra Aegis risk model to evaluate and manage risk. Barra has identified 13 risk factors that are common to all equity securities, and it quantifies portfolio exposures to those risks. We can monitor portfolios using the Barra system to identify and take steps to correct any undesired exposures.

For GSP, risk management is also tied to the portfolio signature concept. The steps taken are similar in practice as the pursuit of "best alpha," as noted earlier. That is, the GSP research process determines optimum ranges for each risk factor that it uses and acts to bring aggregate exposures to each factor within those ranges when rebalancing a portfolio.

These processes are very similar in nature.

The Way Forward

The GCM and GSP (now GCM-Boston) investment teams have come together as one integrated team. Amit Chandra, Ph.D. has joined the leadership team as the new Chief Investment Officer for GCM. As the new GCM looks to the future, it is important that the entire firm work within a common research and investing framework. As we have shown, our evaluation of the two groups' investment approaches showed many similarities. Given these similarities, we have determined to use the Total Composite Model construct as the research platform for all of GCM's domestic strategies. The Barra Aegis system will be utilized to monitor and manage risk.

Additionally, we have determined to continue with the *portfolio signature* approach in managing the Disciplined International Core Equity (DICE) strategy. We came to this conclusion based on its similar philosophical emphasis and the manner in which the *portfolio signature* concept and the legacy GSP international alpha model are integrated.

As we move forward, in order to demonstrate our commitment to the investment philosophy now shared by the investment team for domestic strategies, and to enhance the signal and efficiency of our international research, our research team has begun the process of studying the feasibility of a Total Composite Model for use in international markets.

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