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Conversations With...

Fred Ingham, Portfolio Manager

Neuberger Berman Uncorrelated Strategies Fund

At a time of heightened market turbulence, investors are increasingly looking for ways to reduce portfolio volatility and enhance diversification. The Neuberger Berman Uncorrelated Strategies Fund aims to serve that role, focusing on hedge fund strategies whose performance bears little or no relationship to that of traditional indices. We spoke with Fred Ingham, Co-Portfolio Manager of the fund, about the uncorrelated strategy universe, the growing opportunity of these types of strategies in the current market environment, and how the fund seeks to capture this potential opportunity in an efficient fund solution that uses managed accounts instead of a fund of funds.

What is an uncorrelated strategy?

At a high level, the hedge fund universe can be bifurcated into two camps. Traditional approaches seek alpha but may be correlated to traditional equity, credit or other market risk premia. Uncorrelated strategies seek alpha but have not historically demonstrated any meaningful correlation to traditional asset markets.

More, precisely, we define uncorrelated hedge fund strategies as those that demonstrate a correlation of no more than +/- 0.20 to equity or fixed income markets over a full business cycle. Unlike long-biased equity or credit long/short strategies, for example, they tend to derive virtually all their returns from market-agnostic trading strategies (e.g., market-neutral positions, short-term trading or relative-value strategies).

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In simple terms, a manager with 50% in longs and 50% in shorts does not care whether the broad market is going up or down; a short-term futures trader can jump on market moves regardless of whether a GDP print is good or bad, or rates are going up or down; and economic news means little to an investor collecting premia for re-insuring hurricane risk.

Can you provide some examples?

We would categorise the following as leading uncorrelated strategies: equity market-neutral, statistical arbitrage, trend-following, short-term trading, systematic and discretionary global macro, and certain more niche strategies such as volatility arbitrage.

Broadly speaking, what's the appeal of the group?

This group has a number of attractive qualities in addition to their genuine differentiation from equity and fixed income markets.

First, the cross-correlation between these strategies tends to be low, due to the wide range of styles and markets traded. This means that a portfolio of uncorrelated strategies can have a high level of diversification and a relatively low level of common factor risk versus a portfolio of more market-sensitive strategies.

Second, the strategies are often derivatives-based, which means that if built in the right way, they can be funded with particularly efficient cash usage and a carefully constructed risk allocation. It is relatively easy to scale risk up or down to meet portfolio goals.

Third, each strategy tends to have an explicable economic rationale. For example, a statistical arbitrage strategy may provide long and short liquidity against daily flows in stocks, or a trend follower may exploit behavioural biases in the market such as the persistence of momentum. Each strategy has a clear *raison d'être* that can be readily understood.

Finally, these strategies generally have a high level of liquidity, so they lend themselves well to a flexible and dynamic portfolio.

Why is now a good time for uncorrelated strategies?

In general, we do not recommend trying to time entries into and exits from uncorrelated strategies. Rather, they should be strategic allocations. Having said that, certain market conditions suit some of them better, and we believe those conditions may be coming into play at the moment. Increased dispersion of monetary policy, higher equity volatility and rising interest rates are all contributing to new uncertainty in markets. In our view, this sort of environment should prove more difficult for traditional strategies and more beneficial to uncorrelated approaches.

For example, fixed income and FX-focused global macro strategies are likely to see an expanded opportunity given volatility in the forward path of interest rates, and as US policy diverges from the rest of the world. Statistical arbitrage strategies have generally done better when equity volatility picks up because there is a higher level of ongoing movement between stocks. Similarly, options arbitrage has a great opportunity to feed off of a higher-volatility environment with greater trading ranges. Finally, higher rates are generally beneficial for strategies that depend upon derivatives, such as CTA trend-following, which maintain large unencumbered cash balances.

Why should investors consider the Neuberger Berman Uncorrelated Strategies Fund?

The fund provides the potential to capture a diverse set of absolute returns that are uncorrelated to equity and bond markets in an easy-to-access, transparent and cost-efficient investment vehicle. Our team is stable and seasoned—our core group has worked together for 13 years and has an average of 18 years' experience — and we leverage that experience to carefully select subadvisors for the fund across a range of specialties.

Part of our appeal is structural: We employ managed accounts instead of pooled funds for a more effective capital allocation and better control of underlying assets, and set the risk levels at which each managed account is run. And the fund is highly fee-efficient, limiting fixed costs by focusing on performance-based compensation at the subadvisor level. As a UCITS portfolio, the fund is liquid and fully transparent. The use of managed accounts also allows for full transparency on the portfolio.

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Tell us more about the portfolio construction process.

We select a mix of strategy types to create a diversified and risk-efficient portfolio, typically of five to 10 differentiated strategies.

The first step is to identify the universe of uncorrelated strategies as distinct from those viewed as having any persistent exposure to equities or fixed income. Once identified, these strategies are then bucketed into six broad categories, each of which is expected to be distinct from the others.

The next step is to screen within each category for managers who have exhibited both competitive risk-adjusted returns and minimal correlations to traditional asset classes over at least five years, but preferably significantly longer. These managers then undergo thorough due diligence so that we can understand the sources of their return generation and lack of correlation. This step also includes a review of all aspects of the strategy, the risk management, the team and the organisation.

Final candidates are then further assessed based on their diversification potential for the overall portfolio, taking into account the other candidate managers in each strategy. The goal is to have a disparate set of trading strategies with limited overlap in time horizon, investment style, trade selection process or underlying markets traded.

Final selections are allocated a risk budget and individual risk limits in order to fit the overall portfolio goals. The strategies are initially allocated an equal risk weight and then the portfolio exposures are reviewed to ensure consistency with the goals. Weightings may then be tweaked in order to take into account risk and exposure considerations.

Overall, we seek to maximise return with an expected volatility of 7 – 10%, while maintaining a zero correlation target over the medium term to the global equity, credit and interest rate markets. To manage risk, we will allocate no more than 25% of the fund to any one manager and no more than 35% to any particular strategy, and we have risk and exposure guidelines at both the manager and portfolio manager levels.

Any final thoughts on the uncorrelated universe?

We believe that a properly structured portfolio of uncorrelated strategies can function both as an effective portfolio diversifier and as a genuine source of absolute return. This is particularly the case as the effects of extraordinary monetary policy begin to recede on a global basis and as markets return to more normal volatility levels. As the search for return becomes more problematic, their benefits are likely to become more apparent to investors.

AT A GLANCE

Neuberger Berman Uncorrelated Strategies Fund

- Allocates across a carefully selected range of alternative investment advisors, each with a specialisation in an uncorrelated strategy
- Uses managed accounts for a more efficient capital allocation and full control over assets
- Aims to minimise correlation to equity and bond markets while seeking attractive absolute returns
- Transparent, liquid and cost-effective UCITS solution
- Stable and experienced portfolio management team

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