Profiles

AT INNOVEST, ATTENTION TO RISK YIELDS REWARDS FOR CLIENTS

BY NICK LIOUDIS | APRIL 21, 2016

In an investment environment where volatility can take on many different forms, quantifying downside risk takes on a whole new level of importance for clients, says Managing Principal and CEO Richard Todd of Denver-based investment consultant Innovest Portfolio Solutions.

"The difficultly in today's environment, with low interest rates and slow growth, is how do you get to your spending needs when you're trying to stay within risk parameters and spending goals that are hard to make," he said of one of the main issues being addressed by the firm, which was co-founded in 1996 by Todd and President Wendy Dominguez.

For nonprofits, the tug-of-war between balancing risk and liquidity for spending needs is ongoing, but getting to a point where an organization can clearly define its downside risks—even if it is in the form of pressures related to development or fundraising—can have a significantly positive impact on performance.

Richard Todd

"Portfolio strategies can vary from fund to fund and while more illiquid strategies have offered better returns, you get that premium through taking on more illiquidity," which may be too large a price to pay for some institutions, he said.

Understanding Sources of Return

Before recommending an asset allocation for a new client, Innovest first goes through a traditional capital markets assumption process, which goes back to the firm's focus on better quantifying an organization's downside risk parameters from the start of the relationship.

"We quantify a one-in-20 chance of loss in the portfolio," Todd said.

After determining an asset allocation that best encompasses those needs, Innovest looks to strategies that offer the lowest correlations, and the firm is unafraid to move to managers that may be currently out of favor.

"Some areas that have been battered are perhaps more interesting to us today. Our investment committee has to lean against the wind sometimes and make allocations to those areas," Todd said, citing the energy and non-U.S. equity sectors as examples. "The U.S. dollar has been a huge headwind and that environment with a stimulus abroad could be changing with such a strong dollar and could favor investments outside of the U.S."

One way in which Innovest differentiates itself in assessing the equity markets is by taking a deeper dive into currency risk that may not be accounted for in valuations over the coming years.

"In the end, valuation matters, but only in the long run. In the short run, you can buy cheapness and performance can be lousy and you can buy expensiveness and performance can be good, but we employ pretty aggressive rebalancing techniques to address those risks," he said.

Looking forward, Innovest also sees allocations to energy, including Master Limited Partnerships, as areas of long-term value, with attractive entry points considering their current distressed conditions.

"This year we've been positioning MLPs in the portfolio for the long-run, which includes firms that have long contracts with little counterparty risk," Todd said.

In the alternatives space, Innovest believes that there are quality hedge fund managers, understanding that fees, lockups and leverage are a headwind and less liquidity can be difficult for a fund to take.

"We want to understand why—why were returns so good in that month? Maybe those managers made sizable bets in a factor, or maybe they were in an area they're not normally in."

When asked if Innovest viewed hedge funds as more of a risk-reducer or alpha-generator, Todd said that it would lean closer to the former, citing the firm's long/short managers' abilities to ease some of the recent pain in the long-only space.

"This last year we've been really happy with how our long/short equity managers performed in a pretty difficult year for long-only equities," he said.

Innovest has also been a proponent of using private debt strategies, working with firms that have been able to provide consistent earnings in lieu of slumping traditional fixed-income markets.

"[Private debt managers] have been able to provide capital to places where banks have been historically able to meet needs, which creates opportunities for clients to take advantage," he said.

On Assessing Managers

Innovest has an open door policy with investment managers and finds that one of the ways to distinguish skill from luck is by conducting a monthly returns analysis on traditional and alternative strategies. That analysis seeks to identify reasons why outliers emerge outside of typical benchmark comparisons, whether those returns are sound and how they relate to the balance of the firm's overall portfolio.

"We want to understand why—why were returns so good in that month? Maybe those managers made sizable bets in a factor, or maybe they were in an area they're not normally in. In essence, we may be uncomfortable with this manager," he said.

Even with a process that begins with screening outperformers, Innovest has historically sought relationships with firms that provide consistent returns.

"I think we like managers who hit singles and doubles," he said.

The firm's research staff takes a generalist approach in the long-only equity and fixed-income sectors, with a specialized team approach on the alternatives side of the due diligence process, Todd said.

As managers make their way through the latter stages of the due diligence process, Innovest's 15-member investment committee, supported by 12 investment analysts, is responsible for final approval.

Further information on Innovest's investment committee, staff and manager research is available on its website (http://www.innovestinc.com).

Across the alternatives spectrum, Innovest's due diligence process pays a great deal of attention to firms that take on significant amounts of leverage to gain returns, which can lead to trouble in distressed market environments, Todd noted.

"When we look back at funds that blew up, it was leverage more than anything else. People are worried about fraud, and you need to make sure you're doing due diligence when looking at the operational side of funds," he said.

What Innovest will not do is approve managers with strategies that are simply difficult to understand, whether it is from a lack of transparency or clarity on their sources of returns.

"Based on our experience…what's gotten [consulting] firms into trouble is recommending strategies they didn't understand. Sometimes I think advisors recommend things they truly don't understand. If we're going to recommend a strategy, we need to fully understand it," Todd said.

However, he went on to explain that complicated strategies by no means preclude firms from being recommended by Innovest.

“Sometimes the strategies are complicated and that is what creates an advantage,” he said.

A Progressive Take on Impact

A growing area of interest among Innovest’s client base, which accounts for approximately $14 billion in assets under advisement, is in the area of impact investing.

The evolution of impact investing has the firm looking at unique ways to achieve both programmatic and financial returns.

“We have clients with social screens and we’re looking at this more in terms of ways a fund can maybe help an organization within their mission and have it effectively be an investment,” Todd said.

Even with interest in socially responsible investment strategies currently gaining the most attention from investors, Todd said that there are a growing number of ways to gain strong risk-adjusted returns through financing.

“A foundation may have part of their mission be in supporting mental health, so if they’re helping a mental health organization with a mortgage on their building, it may be a sound impact investment instead of making a grant. You can lower the interest rate for the organization and still get a solid return,” he said.