

Nicole Schnuderl is the Australian representative of Invesco's Global Quantitative Equity (GQE) team, which manages more than A\$20 billion worldwide.

In this article Sam Sorace, National Retail Sales Manager at Invesco, talks to Nicole Schnuderl about global equity investing, global equity markets, and managing the Global Matrix Funds to deliver strong returns for investors.

About the Invesco Global Quantitative Equity team and how it manages global equity portfolios

Sam Sorace: Nicole, can you tell me how Invesco's Global Quantitative Equity team is broadly structured, and how it goes about managing global equity portfolios?

Nicole Schnuderl: Our team is based in various locations across the globe, in New York, Boston, Frankfurt, Melbourne and Tokyo. The team comprises more than 40 investment professionals, and we're proud to have attracted such a diversified group of talented and smart investment professionals. Not only are they diversified in terms of their investment backgrounds, they also have diverse personal backgrounds. One member of the team, for example, is a former Grandmaster of chess!

The GQE team's management style is quantitative-driven. Our researchers, which make up about half the team, are responsible for the quantitative models used in the management of our funds. They design the investment process, test new ideas and produce the stock return forecasts on a daily basis. The portfolio managers are responsible for the optimisation and implementation of all funds. Every member of the team, whether they're in research or portfolio management, is involved in idea generation. Moreover, all transactions are initiated by this team; they are also accountable for transaction cost management and risk control.

SS: What do you look for when investing in a stock?

NS: We observe stocks from different angles, assessing a stock's investment case across a number of key areas. Our stock analysis and stock forecasts are based on four basic investment concepts. They are: price trend, earnings momentum, management action and relative value. Each concept is supported by underlying investment ideas.

How do these concepts work in practice? Well, taking price trend first, we prefer companies that show a stable upward price movement and have comparably low volatility compared to their peers.

In looking at earnings momentum, the price of a stock will only continue to be sustainable if it is supported by continuous earnings growth, which has to be considered over a short as well as a longer period. The more analysts increase the earnings expectations, the better view of that stock.

We also assess the soundness of a company's management and we want to avoid risky stocks. We prefer companies that refrain from 'empire building', that buy back shares rather than issue stock and debt, and that are able to pay their debt back in a timely manner.

In terms of looking at relative value, we prefer companies that are comparatively cheap. That means companies which have fallen out of favour and which are attractively valued against their peers. Markets typically have low expectations of these companies, they tend to deliver better than anticipated performance resulting in an above-average price performance.

Nonetheless, we constantly review the models used and research for characteristics which make a stock more attractive compared to its peers. Also, you have to be aware of the differences in weightings of the characteristics. For example, a dividend yield will give you a fair amount of information in Germany rather than the US. In the US market, companies tend to buy back shares, and many do not even pay a dividend. Long term price momentum works strongly in Australia compared to Japan, where shorter signals add value. It is important that the team compares 'apples to apples' and that we are industry-neutral, which means we compare banks to banks, for instance.

SS: What is the philosophy that the team's process is based on and what are the benefits?

NS: The basis of GQE's investment philosophy is that we believe markets are inefficient and offer exploitable opportunities for returns. One example of an inefficiency is when investors tend to sell their 'winners' keep hold of their 'losers' because they don't want to crystallise their losses.

SS: More specifically, what is the team's approach to managing risk in GQE portfolios?

NS: Risk management is incorporated throughout the process in two key ways.

First, we ensure that investment risk is well diversified, through the different investment ideas that capture the attractiveness of a stock. For example, choosing a stock with attractive valuations, a sound balance sheet and low volatility gives us the opportunity to look at it from different angles.

Second, risk is also assessed at both the stock and portfolio level. At the stock level, not only is its attractiveness that counts, it's also the risk associated with the stock position taken. We aim to have well diversified portfolios at all times and not 'bet' on just one theme, which would have risky consequences if that theme did not pan out as expected. We control stock risk with different active risk targets relative to the benchmark.

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Also, we do not take any positions that have large over or underweights to sector or country. As mentioned, we manage global equity portfolios on a 'style neutral' basis and do not operate a 'value' or 'growth' strategy.

About the environment for global equities

SS: Nicole, what are the dynamics at play in global equity markets at present?

NS: Broadly, a weak Europe is trying to combat the credibility of the euro and the Eurozone. The US government has increased its debt ceiling but has failed to present a long term solution to the debt problem, as evidenced by S&P's recent rating downgrade on US sovereign debt from AAA to AA+. Also the markets now fear a slowdown in Asia, particularly China and India.

Global economic growth is under pressure and this is weighing on consumer confidence. We think that politicians have to present credible long term solutions to make the investment environment less uncertain.

SS: The debt situation in Europe and the US is approaching critical levels. Indeed, many people are saying that the decision to raise the US debt ceiling is simply deferring the inevitable. What are your views on that?

The other key driver is the strengthening of corporate and household balance sheets. How do you see that playing out?

NS: On your first question Sam, markets are nervous about the debt and economic problems in Europe and the US and there is disbelief that problems are not being tackled soon enough. The consequences of failing to reach a compromise in time, and the immediate consequences of that, might actually spur politicians into finding a sensible way forward, which would positively surprise markets.



Nicole Schnuderl
Senior Portfolio Manager

Nicole Schnuderl, based in Melbourne, has investment responsibilities for Invesco's Global Matrix Funds, as well as for Invesco's quantitative Australian equity portfolio. Nicole has extensive experience working with the GQE team in Frankfurt, Germany, with Invesco's Institutional Sales team in London, and with the Austrian Central Bank. Nicole has a degree in Business Administration and Economics from Vienna University, Austria and the University of Richmond, Virginia USA.



Sam Sorace
National Retail Sales Manager

Sam Sorace is responsible for Invesco Australia's retail sales team and for managing Invesco's retail advisory networks in Victoria, South Australia and Tasmania. Sam has 20 years experience in financial services in retail sales and distribution at Invesco, Zurich, NAB and Westpac.

We apply our philosophy by translating fundamental and behavioural finance insights into our stock selection model. While our model is implemented using a structured and systematic process that's quantitative in nature, we select stocks on a 'bottom-up' basis based on fundamental analysis and valuation framed by our investment concepts. The process is style-neutral, and along with strict risk control measures, we can provide investment portfolios for clients that offer attractive return characteristics.

Because we pick stocks using a 'quant' methodology, we can analyse our investment universe, comprising more than 3,000 stocks daily, rather than research and analyse a much smaller stock universe using a pure fundamental method. Our approach creates opportunities for returns and greater portfolio diversification. Typically 120-160 stocks enter our portfolio. Another advantage is that, inherently in our quant approach, we do not have 'key man risk'.

On your second question, we have seen a de-leveraging process in the household as well as in the corporate sector. That has led to a build-up in the savings rates of private households, while companies have rested on their piles of cash. Since the GFC crash, cash has been 'king'. But for consumers to start spending they need to be confident in their jobs and the economy.

Company de-leveraging will be followed by re-leveraging. The latter means companies starting to buy back shares, paying dividends and investing in mergers & acquisitions. Corporate activity gives you a lot of information to distinguish between attractive and unattractive stocks. We see potential here as corporate activity picks up.

SS: What has changed about equity market investing in the period immediately since the GFC compared to now? Given the uncertainties and complexities of global equity markets, is it still possible to invest successfully in global equities rather than aiming to time markets?

NS: We have come a long way since the outbreak of the GFC. Markets were beaten down in 2008 due to a shortage of liquidity and de-leveraging pressures. In 2009 we saw another difficult year in markets with higher quality stocks beaten up and lower quality stocks favoured as investors sought to regain the losses from the previous year.

While this market was adverse to our way of managing money (i.e. long term-focused and seeking high quality, well valued stocks), our investment discipline paid off and was the right thing to do. In 2010 the market again started to distinguish between low and good quality stocks and in this environment our process has generated improved performance.

Investors moved a lot of their money into passive or indexed investment strategies in 2008-09, which are mostly market capitalisation-based, in the hope of timing markets to generate strong returns. As a result, the more liquid companies' index weights rose and they could increase their capitalisation and liquidity further. The selection based on market capitalisation lacks efficiency, whereas we seek to invest in quality companies, particularly as we invest for the long term rather than to time markets.

Let's compare a passive investment with an active investment in terms of some numbers. Say a passive or indexed investment returns 6% per annum. By comparison, over 40 years, an active manager outperforming this passive return by just 0.5% per annum would result in an outperformance of 20% above the passive investment. Or looking at it another way, that's 12 times the initial investment. If the yearly outperformance of the active manager were 2%, it would result in a doubling of the amount of money compared to a passive investor over the same 40 years.

And it's also interesting to compare the performance, since the GFC ended in March 2009, of global equities to Australian equities. As illustrated in the chart, a \$100K investment in global equities at this time produced a much stronger return than the same value investment in Australian shares, i.e. a difference of about \$27K in favour of global shares. Active manager outperformance on top of that would yield an ever higher result.

About the performance of the Invesco Global Matrix Funds

SS: The performance of the Global Matrix Fund has picked up over the last 12 months. What has the GQE team done right over the last year that it was not doing say two or three years ago?

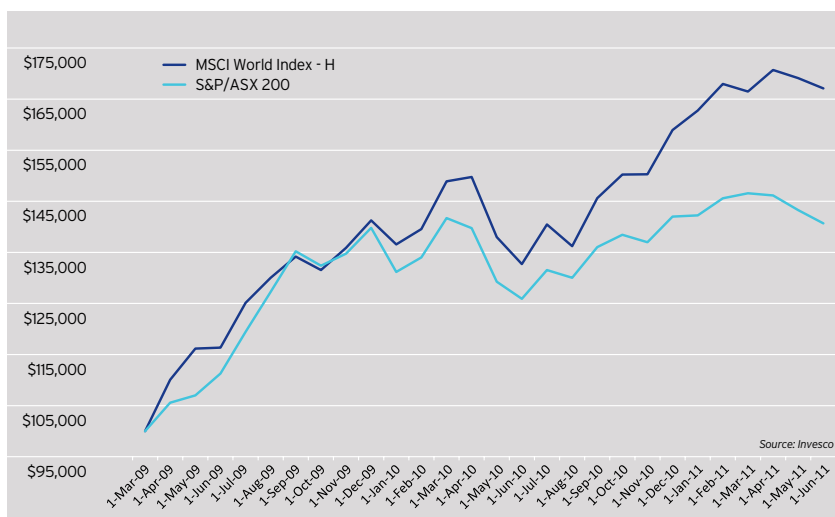
NS: As I mentioned, one reason for the Fund's prior underperformance was the 'junk rally' in 2009, where many quality stocks in the portfolio were not favoured by investors. In the US this effect continued into 2010. We also saw, at the beginning of last year, high correlations of stock returns, which simply meant that both 'good' and 'bad' stocks moved in the same direction. This dynamic was mainly due to macroeconomic views, which pushed markets into a situation of investors either taking on more risk or taking it off the table.

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As we've seen these pressures ease, our most attractive stocks have been outperforming while our least liked stocks have underperformed over the last 12 months.

The rebound in Fund performance has come predominantly from our stock selection capabilities. Clearly, this is what we strive to achieve. Our model's return signals have been positive for the last 18 months, which underscores the quality and consistency of our process, where our best-ranked stocks perform in line with expectations while our poorly-performing stocks continue to underperform.



SS: What are the largest active stock positions in the Global Matrix Fund? Why are those stocks ranked highly by the team according to its investment process?

NS: To give some examples, one of our overweights includes BHP. This company has a strong balance sheet and has recently started to buy back shares, something we clearly favour. We view BHP as attractive on a valuation basis compared to its peers. Among the telecommunications services stocks, we have identified BT Group in the UK as attractive, based on strong price performance and upward earnings expectations.

We also have an overweight position in US software giant IBM, which has showed stable price performance. Its earnings revisions have been supported by upward sales expectations, which show that earnings are expected to be supported by sales rather than by cost cutting.¹

SS: Do you think we're seeing a long term return to form for quantitative global equity portfolios?

NS: As a consequence of the GFC, companies have cleaned up their balance sheets, and are returning to profit and sitting on large cash piles. The latter fact provides us, as a 'quant' manager and given our investment philosophy, with many opportunities to capitalise on market movements, i.e. when companies start paying dividends, buying back shares and entering acquisitions again. We have seen this commence already. As mentioned earlier, we see potential here as corporate activity picks up, which enables the market to differentiate on the quality of stocks.

Furthermore, the interest rate environment in major developed markets is favourable for equities, with rates expected to stay at low periods for some time.

Conclusion

SS: Thanks Nicole. Further to your comments, I would also add that, since the rebound in equity markets in early 2009, quant managers have been in a good position to capture excess returns compared to fundamental managers who may have had a value, growth or thematic approach to portfolios.

By combining a quant fund into a global equities allocation, we believe that advisers can diversify manager investment styles and help mitigate portfolio risk by providing their investors with the opportunity to capture returns in different market cycles when other investment styles may be out of favour.

¹As at the end of June 2011.

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