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SPECIAL REPORT

TOP-PERFORMING MANAGERS

Small-cap growth, ultrashort strategies reign

In separate accounts, familiar equity funds dominate; intermediate-term strategies follow top bond account

By TRILBE WYNNE

Small-cap growth dominated the list of top-performing equity strategies for the year ended Dec. 31 in Morningstar Inc.'s separate account database, while an ultrashort bond strategy held the top spot among one-year fixed-income returns, with five intermediate-term bond managers in the top 10.

Small-cap growth strategies claimed eight of the top 10 spots on the domestic equity list for the one-year period, with four returning from the list of top strategies for the year ended Sept. 30.

"I was intrigued to see how many of the names stayed on there," said Tony Thomas, manager research analyst at Morningstar in Chicago.

"Those growth stocks and tech stocks have done so well over those trailing one- and five-year periods. But a number of tech stocks took a beating in the fourth quarter. Volatility had an impact. Major indexes ended down. Oil prices dropped dramatically in the fourth quarter, making energy one of the worst-performing sectors. Some of the momentum trades that had done well went down sharply in the fourth quarter. But many managers say that presented them with opportunities," Mr. Thomas said.

The FAANG stocks — Facebook Inc., Amazon.com Inc., Apple Inc., Netflix Inc. and Google (Alphabet Inc.) — and large-cap technology growth stocks generally performed well during the five-year period, he said.

"It's interesting to see Microsoft back in the leaders. Tech has been an area for people who are interested in innovation and change without some of the risks to the downside facing biotechs, for example. Amazon, for example, continues to grow. They are engaging in a lot of different things. All of that could be attractive to an investor," he said.

Ryan Jehangir

MEASURED UP: Drew Beja said Granahan uses a 'rigorous valuation discipline' in its selection process.

A gross return of 25.6% put Waltham, Mass.-based Granahan Investment Management Inc.'s Small Cap Focused Growth strategy at the top of Morningstar's domestic equity list for the year ended Dec. 31.

The Granahan strategy moved up from second place on the list for the year ended Sept. 30.

"We like to invest in companies that can sustain 15-, 20-, 25% growth for several years," said Drew Beja, senior vice president and managing director at Granahan.

"We have a rigorous valuation discipline that we apply to the stocks of those companies ... there are a few sectors that are rich with sustainable growers, such as mobile computing, marketplaces, certain business service companies. And there are many sectors where there are very few sustainable growers — commodities, banks, energy, industrials, for example," Mr. Beja said.

He cited **SodaStream International Ltd.**, which was acquired by **PepsiCo Inc.** in 2018, **LivePerson Inc.**, which is developing a "conversational commerce" approach for brands to engage with consumers, and software provider **Paycom**, as notable contributors to the Focused Growth strategy's outperformance for the year.

But he noted "it was pretty broad-based. It really wasn't a single stock."

Small-cap growth strategies also occupied the next four spots on Morningstar's list of top-performing equity strategies.

Kayne Anderson Rudnick Investment Management LLC's Small-Cap Quality Select was in second place with a gross return of 25.24%; Kopp Investment Advisors LLC's Emerging Growth strategy followed in third place at 24.18%; fourth on the list was Next Century Growth Investors LLC's Micro Cap Growth strategy at 18.22%; and Crow Point Partners LLC's Small Cap Concentrated strategy was in fifth place, with a gross 16.32% return for the 12 months ended Dec. 31.

The median return for domestic growth equity strategies in Morningstar's universe was -3.47% for the one-year period, while the median return for Morningstar's overall domestic equity universe was -6.86%, with strategies in the domestic value and blend categories returning a median -9.86% and -11.86%, respectively.

The S&P 500 index had a total return of -4.38% and the Russell 2000 Growth index returned -9.31% for the year.

Fixed-income opportunities

In fixed income, investment-grade corporate credit was under pressure for the first three quarters of 2018 and high-yield fared better, said Emory Zink, senior fund analyst, fixed-income strategies, at Morningstar in Chicago. But high-yield credit hit a period of volatility in the fourth quarter, she added.

"With the lengthening of the credit cycle, mangers have been asking, 'When is the end of the credit cycle? Are we already there or are we still getting to the end of it?' If a fund was more conservatively positioned in corporate credit and bracing for the end of the credit cycle early in 2018, it might have missed some opportunities in high yield," Ms. Zink said.

Alaina Bompiedi, fund analyst at Morningstar, said investment-grade corporates and high-yield corporates were negative for the year, and investment-grade underperformed high yield.

"There was a double whammy of volatility in credit and volatility of interest rates, and high yield is more insulated from interest rates," Ms. Bompiedi said.

Ms. Zink said: "Four interest-rate hikes in a year is quite a bit." However, she said events such as the U.S. government shutdown, the falling price of oil, tight credit spreads and slower economic growth were more significant drivers of volatility than interest rates during the fourth quarter.

The median return for Morningstar's entire domestic fixed-income universe was 0.36% for the year ended Dec. 31, the Bloomberg Barclays U.S. Aggregate Bond index returned 0.01%, and the Bloomberg Barclays Global Aggregate Total Return Bond index returned -1.2% for the one-year period.

Federated Investors Inc.'s Trade Finance Fixed Income composite — a strategy in Morningstar's ultrashort bond category — debuted on Morningstar's one-year list in first place with a gross 4.43% return.

Federated's Christopher McGinley, London-based head of the trade finance team and portfolio manager, said the trade finance portfolio has a weighted average life of 24 months. In the last year, it has been in the 12- to 16-month range.

"Trade finance can best be thought of as a subset of the loan market. Relatively short-term loans to finance the physical flow of goods — to use those goods as a primary source of security. The transactions are self-liquidating. As each trade flow is sent and paid for, it pays down the loan," Mr. McGinley said.

"It's very, very low-vol. We have a very well-risk-adjusted return, mainly through diversification and really good credit work. Sectors, regions and geographies, it does make a strong diversifier on a number of bases. There's no real macro influence that affects it and you also have really low correlation, or no correlation, to all major asset classes — emerging markets, high-yield bank loans, TIPS. ... With primary goods as an underlying source of collateral, there's a deep, liquid market for it," he said.

Brandywine Global Investment Management LLC's U.S. Fixed Income strategy was in second place with a gross return of 4.11%; TCW Group Inc.'s Opportunistic Mortgage-Backed Securities strategy followed in third place at 3.78%; fourth on the list was Diamond Hill Capital Management Inc.'s Short Duration Total Return strategy, 3.77%; and Fidelity Institutional Asset Management's High Yield Commercial Mortgage-Backed Securities composite was in fifth place among one-year fixed-income returns with a gross 3.68%.

Tracking five years

In equities, Columbia Threadneedle Investments' Global Technology Growth strategy joined Morningstar's list of top-performing domestic equity strategies in first place for the five years ended Dec. 31 with a gross annualized return of 16.94%. All multiyear returns are annualized.

The S&P Global 1200 Information Technology index returned 11.68% for the five-year period.

Rahul Narang, San Francisco-based senior portfolio manager at Columbia Threadneedle, said the process-oriented approach of the Global Technology Growth strategy is driven by three key themes: first, "moats" that can sustain long-term competitive advantages, including Microsoft, Apple, Amazon, Alphabet, and **Alibaba Group Holding Ltd.**; second, an all-cap focus on companies that offer forward-looking secular growth opportunities in areas such as cloud computing, artificial intelligence, autonomous vehicles, factory automation, mobile payments and 5G; and third, value-oriented stocks that balance the strategy's growth focus, including **Sysco Corp.**, **Samsung Electronics Co. Ltd.**, **Lam Research Corp.**, and **Avago Technologies Ltd.** during the five-year period ended Dec. 31.

"We use the data set to construct a balanced approach, which is empirically proven to add the most value and that's what we've demonstrated in up markets and in down markets," Mr. Narang said.

"Risk management is crucial" for the portfolio, he said, especially in risk-off years like 2016 and 2018 when the balance between value and growth offered downside protection.

"Volume, momentum, size, growth, paying attention to those factors, being cognizant of different factor exposures, gives you a different lens," said Mr. Narang.

Two small-cap growth strategies from Kayne Anderson Rudnick followed Columbia Threadneedle on the five-year list. The Small-Cap Sustainable Growth strategy was in second place with a gross return of 16.2% and the firm's Small Cap Quality Select strategy was in third place with 15.46% for the five-year period.

Euclid Investment Advisory LLC's Large Cap Growth strategy was in fourth place with a 15.18% return and Allianz Global Investors GmbH's Global Technology Equity strategy rounded out the top five with a gross annualized return of 15.03%.

The S&P 500 index returned 8.49% for the period. The five-year median return for domestic growth equity strategies in Morningstar's universe was 7.75%, and the median return for Morningstar's overall domestic equity universe was 6.58%.

The Russell 2000 growth index returned 5.13%. for the period.

5-year fixed income

For the five-year period in fixed income, NISA Investment Advisors LLC's 15+ STRIPS Fixed Income composite, which invests in zero-coupon securities with a maturity date of 15 years or more, topped the list of domestic fixed-income strategies with a gross return of 8.9%.

"We hold only Treasury securities — for the most part, all STRIPS — in these mandates, that to a large extent line up with the client's chosen benchmark," said Joseph Murphy, director, portfolio management at NISA in St. Louis. "The inherent strategic purpose of these mandates is to hedge pension liabilities, so the credit should go to our clients and their consultants for choosing (liability-driven investments), for making the decision to hedge the interest-rate risk embedded in these liabilities."

Mr. Murphy said over the five-year period, between year-end 2013 and year-end 2018, "Long-term interest rates were lower, and these STRIPS strategies performed well. The 30-year U.S. Treasury yield was approximately 95 basis points lower. That's a fairly significant, fairly substantial drop in rates."

Thomas J. Herzfeld Advisors Inc.'s Fixed Income composite was in second place on the fixed-income list with a gross annualized return of 8.39% for the five-year period; Camden Asset Management LP's Long Duration (Government/Credit) composite followed in third place at 7.15%; fourth on the list was Hoisington Investment Management Co.'s Macroeconomic Fixed Income composite, 7.08%; and Hillswick Asset Management LLC's Long Duration Government strategy was in fifth place with a 6.82% return.

The Bloomberg Barclays U.S. STRIPS 15+ index returned 8.79% for the period, the Bloomberg Barclays U.S. Long Government/Credit index was up 5.37% and the five-year median return for long-duration fixed-income strategies in Morningstar's universe was 5.53%. The median return for Morningstar's overall domestic fixed-income universe was 2.65%, and the Bloomberg Barclays U.S. Aggregate Bond index returned 2.52% for the five years ended Dec. 31.

All data for *Pensions & Investments*' top-performing managers report are provided from Morningstar's global separate account/collective investment trust database. The data for the rankings on which this story is based were pulled Feb. 4.