IN CONVERSATION

Harvard’s Stephen Blyth on the Endowment’s Long-Term Investment Approach

Stephen Blyth is head of internal investments at the Harvard Management Company and professor of statistics at Harvard University. He tells Bloomberg’s Nicholas Dunbar about his investment approach.

Q: You spent 13 years working as a trader at investment banks. How does working at an endowment compare?
A: Unlike an investment bank, here we have a single investor, a single client and a single goal to support—the activities of the University—by providing a portion of its operating budget and also maintaining the purchasing power of future generations. An endowment has a very long term time horizon but also must meet current liabilities. One great advantage for a long-term investor with a long-term capital base is that we can choose when and how much to invest. Not having to execute opportunities that are not attractive is a big advantage that sets us apart from short-term investors.

Q: How did your experiences in academia affect your work as a trader, and how did your trading experiences change your view of finance theory?
A: The skills I learned as an undergraduate, from my PhD and as a lecturer have served me well. One needs quantitative ability to understand financial markets. However, as I spent longer on Wall St, I realised that models were not enough. Ultimately, one has to respect the complexity of financial markets and interactions and how they impact prices. There was a lot of work in the late 1990s and early 2000s on building more complicated derivative models. There was good mathematics, and these features had some benefit, but people were not spending enough time thinking about judgment, about interpretation of the model. There were many good trading opportunities for people who had market savvy and a broad understanding of the failings of standard models.

Q: You teach quantitative finance at Harvard. How has that field evolved since the crisis?
A: It has changed in interesting ways. The products one trades are still there: for example, swaptions, caps and other derivatives still trade. However, assumptions that people had about the value of these products no longer hold under periods of extreme stress. This changes investing: when we assess the attractiveness of particular trades and their risk profile, our ranking system looks very different. We now ask, why would we do this trade if under certain conditions this arbitrage bound is violated? The challenge is to understand the drivers for particular dislocations and the likelihood of them happening again. This makes the teaching of quantitative finance really enjoyable.

Q: As a long-term investor, how do derivatives fit into your strategy?
A: Derivatives have for a long-time allowed people to access dislocated or mispriced risk, especially when driven by market segmentation, where different sub-sections of the market, whether corporates, pension funds or mortgage accounts, drive related products out of line. That can provide attractive opportunities for investors in the derivatives space. My view is that if one has the expertise and analytical capability to operate in derivatives, it would be detrimental not to, especially given that our goal as portfolio managers is to generate alpha on top of our policy portfolio—and a lot of that alpha sits in the derivatives space.

Q: Some investors don’t understand the mark-to-market nature of derivatives, and the liquidity aspects.
A: Collateral agreements, where most counterparties are posting collateral against mark to market movement in their derivative portfolio, are beneficial from a credit standpoint. However, they present increased liquidity risk because counterparties have to post additional collateral when facing mark-to-market losses, or unwind the trade. Some participants might not have appreciated that, especially when we’ve seen price dislocations where the mark to market value of a derivative has breached previously watertight bounds.

Q: How do you see the European crisis evolving?
A: Even though there is a lot of uncertainty in Europe, financial markets themselves - investors, banks, hedge funds, even regulators to some degree - are in general better prepared to ride out a storm than they were four years ago. When the pessimism reached a height in December I felt that people were better prepared to deal with the uncertainty. The 3-year LTRO from the ECB has had a significant effect, to me an analogous effect to the responses the U.S. government made in late 2008-09. In particular there was QE, and also the Temporary Liquidity Guarantee Program, whereby the FDIC guaranteed bank debt. Similarly, with the LTRO banks can now finance their holdings of debt, government bond yields are coming down and people are getting the confidence back to do other things. Ultimately we will need to see growth, but we need confidence first.

Q: How should long-term investors view sovereign risk?
A: On sovereign risk, my view is that investors should make sure they know why they’re invested in government bonds. What role does U.S., Japanese and even sterling debt play going forward, with yields so low and when up to now it has played a flight to quality role? Treasurers have played that role far more than anyone predicted. It was only two years ago when people were saying it was a no-brainer to short treasury bonds. I think they’ve rallied by over 175 bps since then.

Q: How has the new landscape of regulation and limits on investment banks affected the investment environment?
A: One question is whether the alpha opportunity set is increasing or decreasing. In this new environment, with both the shrinking of investment banking and increasing regulation, it is not clear if there’s an alpha dividend or a deprivation. On the plus side there are fewer competitors chasing the same opportunities. Against that, the ability to trade products has decreased - the dimensionality and liquidity of some markets has shrunk. As things play out we will determine whether on balance the impact is positive or negative for our investing.