REVERSAL FOR MOMENTUM; QUALITY AND LOW VOLATILITY OUTPERFORM

It was a roller coaster start to 2016. The year started off very much in “risk-off” mode with markets concerned about the sustainability of global growth and the effectiveness of unconventional central bank policies, only to rally in early February and finish the quarter up 1.4%. In general, active large cap equity managers had a difficult time navigating this environment.

Anecdotally, we’ve observed that the managers who performed the best in 2015 tended to struggle the most in Q1. One factor contributing to this dynamic was a notable reversal in equity style factor performance during the quarter. In 2015 markets generally rewarded stocks with positive price momentum and high expected growth rates. Higher quality, lower volatility, and “cheap” value stocks struggled. Coming in to the year, in our Investment Strategy Outlook, we noted that:

- We believed that volatility would be elevated in 2016 and quality oriented strategies, which seem reasonably valued, could be a hedge against market volatility.
- We were concerned about elevated downside risk for momentum strategies given that valuations looked stretched relative to history.
- It wasn’t the time to throw in the towel on value oriented strategies. While not cheap, value strategies had become more attractively priced after significant underperformance in 2015, and could benefit if earnings stabilize.

Indeed we did see a reversal during Q1. Momentum and growth sold off early in the quarter, while high quality and lower volatility stocks outperformed. Value-oriented stocks started to outperform later in the period, finishing slightly up for the quarter.

WHERE DO WE GO FROM HERE?

We continue to see elevated risk for momentum strategies. Even with recent underperformance, momentum doesn’t look cheap. High quality stocks, in terms of companies with stable earnings, low debt, and high returns on capital, still look reasonably valued and could do well in a low return, elevated volatility environment. We are cautious, however, on strategies that emphasize low price volatility (low volatility “smart beta” ETFs for example) as valuations look elevated relative to history. Finally, we believe that deeper value strategies have some upside potential as they look cheap relative to history and can benefit if earnings stabilize as we expect.
STRATEGIC INVESTMENT RESEARCH GROUP

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Morningstar Large Value Category: funds that invest primarily in big U.S. companies that are less expensive or growing more slowly than other large-cap stocks. Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large cap. Value is defined based on low valuations (low price ratios and high dividend yields) and slow growth (low growth rates for earnings, sales, book value, and cash flow).

Morningstar Large Blend Category: funds are fairly representative of the overall U.S. stock market in size, growth rates, and price. Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large cap. The blend style is assigned to portfolios where neither growth nor value characteristics predominate.

Morningstar Large Growth Category: funds invest primarily in big U.S. companies that are projected to grow faster than other large-cap stocks. Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large cap. Growth is defined based on fast growth (high growth rates for earnings, sales, book value, and cash flow) and high valuations (high price ratios and low dividend yields).

Equity Style Factors are derived using the largest 1000 stocks by market cap. The universe was then segmented into quintiles of stocks that meet certain characteristics. Factor performance is the return differential between quintile 1 and quintile 5 within each sector.

Value Factor: contains stocks with the highest earnings to price, book value to price, sales to price, and cash flow to price multiples.

Price Momentum Factor – contains stocks with the highest returns over the preceding 12 months, lagged one month.

EPS Growth Factor: captures stocks with the highest expected earnings growth over the next year.

Quality Factor: Captures stocks with the highest levels of return on equity and return on invested capital over the last 3 years, stocks with the lowest ratio of total debt to equity, and stocks with the highest levels of earnings stability over the last five years, as measured by net income divided by the volatility of earnings.

Dividend Yield Factor: contains stocks with the highest current dividend yield.

Low Price Volatility Factor: measures stocks with the lowest standard deviation of returns over the preceding 3 year time period.

Smart beta defines a set of investment strategies that emphasize the use of alternative index construction rules to traditional market capitalization based indices.

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