Beacon Trust

MarketMonitor

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Actively Managing Factor Exposures

By Alan Segars, Chief Investment Officer

During last year's fourth quarter, we introduced the powerful attributes of factor investing. (Please see the Beacon Trust Market Monitor dated November 2013 in the Research section of the Beacon Trust website.) We explained that a factor is a force that explains or drives equity returns. We gave examples of factors including quality, valuation, size and momentum. Importantly, the report included three examples of excess return achievements utilizing quality (high), valuation (low), and size (small capitalization): 1) 25-year performance record of UK portfolio manager Neil Woodford; 2) 24-year performance study by BlackRock titled, "Global Return Premiums on Earnings Quality, Value, and Size"; and 3) back tested excess return results obtained from our Factor Information Return Model (FIRM) from January 2012 to November 2013. Since its funded inception in January 2014, FIRM has delivered an excess return ranging between 2% and 4% versus the S&P 500. This was achieved utilizing three separate quantitative screens (quality, valuation, and size) with no reliance on fundamental judgments, emotion, or biases.

In this commentary, we explore supplementing quant screen decisions with a small dose of active management to extend excess return opportunities. The valuation factor has had a prominent position in our factor mix largely based on our expectation for economic growth and interest rates. In FIRM, valuation is represented by low trailing price/earnings (P/E) ratio. At this stage of the economic and market cycle, two significant things occur. First, stock correlations decline, meaning stock prices diverge more. In other words, metaphorically, the tide does not lift all boats. Consequently, stock picking becomes more critical to achieving superior performance. In our view, this condition applies to both fundamental stock picking (based on differentiated company fundamentals) and quantitative stock picking (based on screening or other models). We are concerned with the latter instance, which brings us to the second significant point. Based on history, the valuation factor produces superior returns during periods of declining correlations. The accompanying charts show the extent to which sector correlations have broken down during this late phase of the market cycle. Research by BMO Capital Markets indicates that, based on intra-stock correlations and historical performance trends, valuation is a good guide to outperformance for the following sectors: financials, health care, industrials, materials, and utilities. BMO also showed that the telecom sector was positively influenced by the quality factor.

How have the valuation and quality factors performed on a sector basis during this recent period of low stock correlations? The answer was provided by valuation and quality screens we ran for the six sectors identified above. The screen produced 15 stocks from the financials, health care, industrials, and telecom sectors. The screen was initiated in July, and stock performance was calculated from July through September. The 15 stocks produced an average return of 2.4% versus 1.1% for the S&P 500. We consider this a decent margin of excess return given the low price volatility environment that characterized this period. Going forward, we look to supplement FIRM's screening process with a sector tilt based on valuation and, to a lesser extent, quality.

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Market Facts

1) Factors explain equity returns.
2) Stock correlations decline during late stages of economic and market cycles.
3) Valuation is a good guide to outperformance in 5 sectors based on declining correlations

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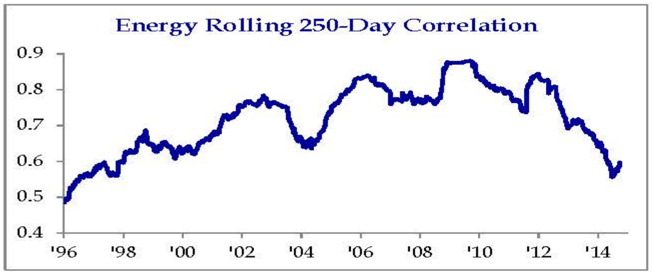

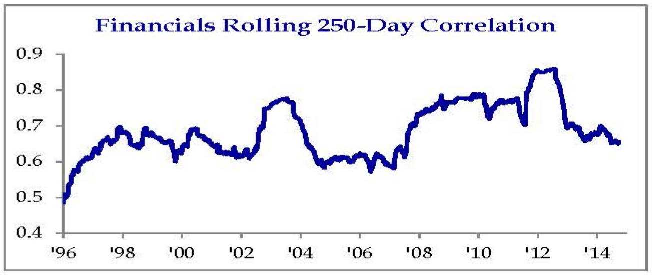

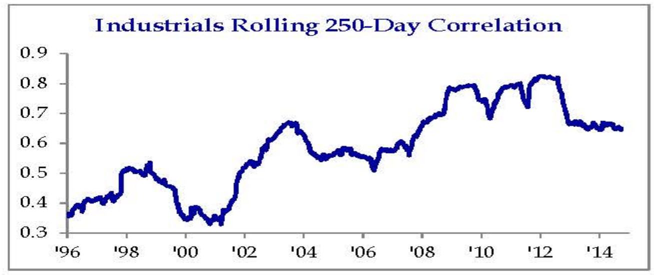

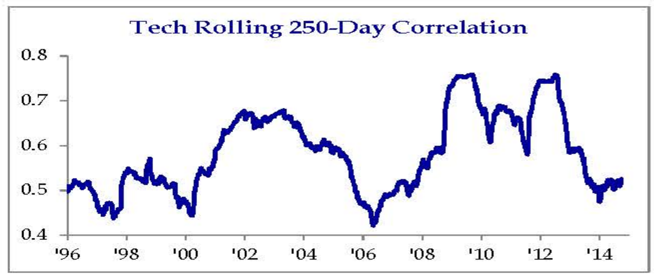

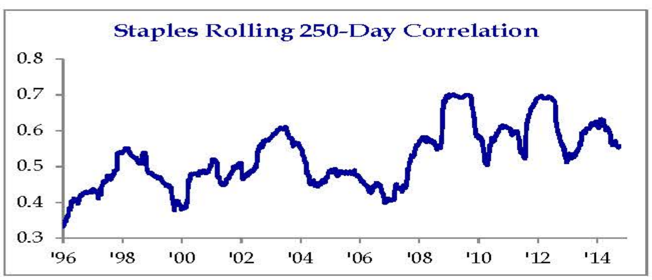

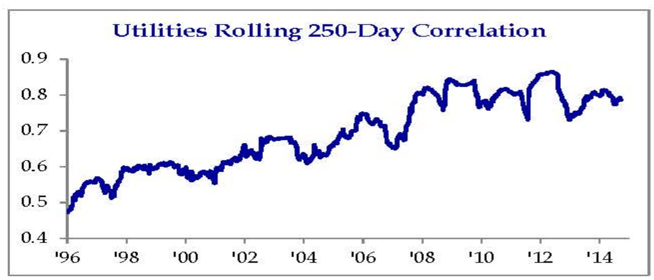

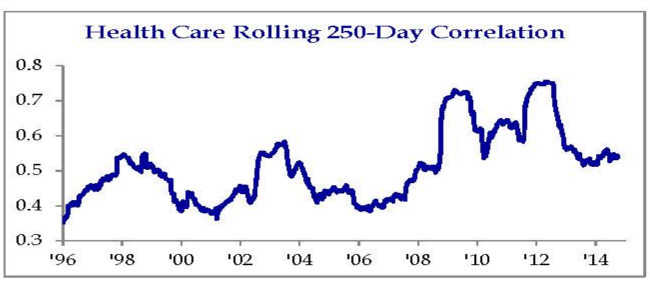

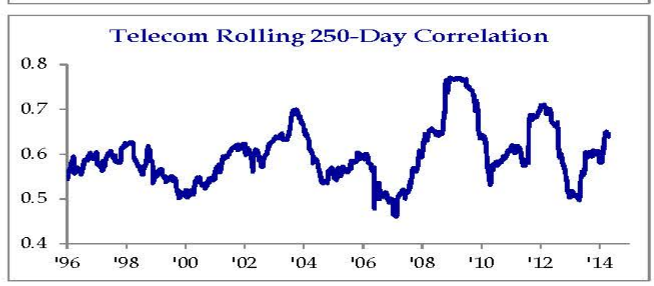

Source: Bureau of Economic Analysis; Beacon Trust

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