JUNE 2018 NEWSLETTER

Select the Best Factors – Manage Them!!

As portfolio managers we have been selecting stocks for many years. The selection process has numerous inputs, and big picture implications can at times overshadow even the best characteristics that make a selection successful. But over the long term studies by Research Affiliates Inc., as well as other academicians, indicate greater success using certain selection factors that have historically outperformed and done so with a lower level of risk.

Over fifteen years ago Robert Arnott and Research Affiliates Inc. examined the factors driving security performance in the long run, identifying the five leading factors: Momentum, Value, Quality, Size and Low Volatility. These factors have shown relevancy in both domestic and international stock markets. While our industry seems to be promoting an unlimited amount of factors only these few survive test of time.

So what exactly is factor investing? Factor investing is a rules-based, quantitative strategy that aims to deliver better risk-adjusted returns than traditional market indexes by focusing on characteristics that drive investment performance. Traditional asset management is really all about factors. Value funds, growth funds and small capitalization funds are all trying to tap into the inherent benefits of factors. However, the profession has a fairly poor track record in delivering these benefits. In our opinion the lack of success comes down to the prevalence of trying to cherry pick stocks to build a portfolio. Due to the law of large numbers there will always be a hot fund in a category, but as history has shown it is impossible to maintain significant outperformance over the long term. In fact, most high flying funds eventually come crashing down. A rules-based, quantitative strategy avoids this shortcoming by being able to own hundreds of securities in a very cost effective manner. We use factor ETFs alongside individual stocks in our portfolios. In fact we believe in the approach so much we've developed a strategy that invests exclusively in factor ETFs.

Currently investors are flocking to strategies that have outperformed recently –traditional index investing and momentum investing best represented by the FANG stocks. Every investment strategy has its challenges, and all go through slumps. Traditional index funds are driven by the size or market capitalization of companies within the index. For example, the S&P 500 index is a selection of around 500 companies with the individual holdings weighted by size giving the largest companies the most impact on the performance of that index. This can be very beneficial in a market where the largest and most popular companies are tops in performance. The downside is that these leading companies can often be greatly overvalued and at risk as was evident during both the tech bubble around the turn of the century and real estate bubble ten years ago. Recently, Facebook, Amazon, Netflix and Google (among others) have benefited from a meteoric rise as their own price action attracted even more investors. Like any other investment criteria too much popularity can be momentum's downfall as stock prices surge far above the intrinsic value of the underlying companies.

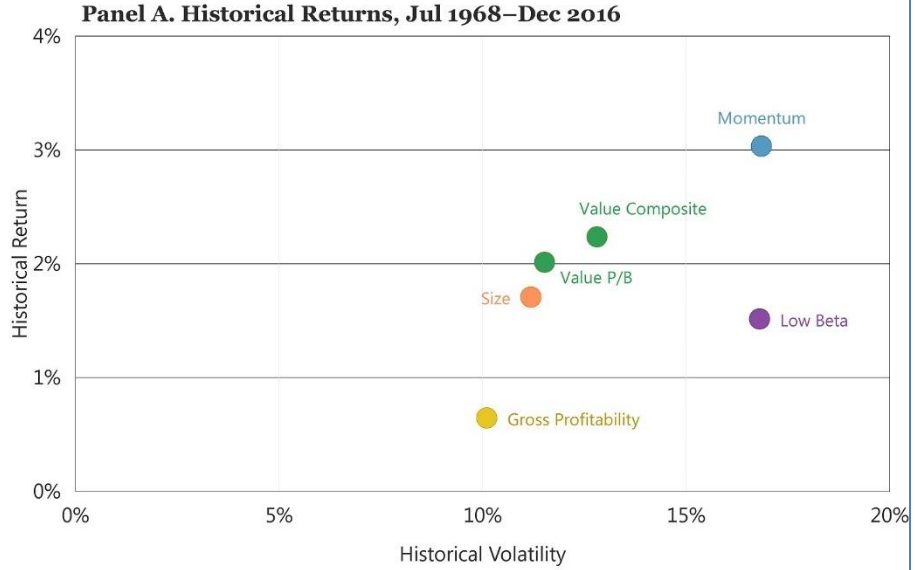
We believe factor investing should be in the repertoire of most investors beyond the current love affair with momentum and can provide diversification benefits even to investors who stick mainly to index funds. Like individual stocks, factors can themselves be undervalued, overvalued or at fair value. Momentum has dominated the last few years, but all factors tend to go in and out of favor. Recently both value and small have shown signs of renewal. Our belief is that this recent trend change is more than just a head fake.

Best of all, through the introduction of low-cost ETFs (Exchange Traded Funds) advisors and investors can now take advantage of direct investment in the factors of their choice. While many traditional mutual funds carry expenses often nearing 1%, a large selection of factor ETFs are available at a fraction of the cost.

Jim Tillar, CFA and

Steve Wenstrup

Figure 2. Risk and Return Characteristics for US Factors
Panel A. Historical Returns, Jul 1968–Dec 2016



February 2017 · *Arnott, Beck, and Kalesnik Forecasting Factor and Smart Beta Returns*

Source: Research Affiliates, LLC, using CRSP/Compustat and Worldscope/Datastream data.