Stock Pickers

Shared by one of QOF's Members yesterday:

Investing: Hard times for stock pickers

“Beating the market has always been hard for the pros. Lately it has been even harder,” said **Justin Lahart** in *The Wall Street Journal*. Over the decade that ended in 2015, an average of just 37 percent of large-cap, actively managed mutual funds outperformed the Russell 1000 index of the U.S.’s largest companies in any given year. And in the first seven months of 2016, only 14 percent outpaced the benchmark. Unsettled global markets and weak corporate earnings have made it more difficult for fund managers to pick winners, but so has the steady exodus of investors into index funds with lower fees and more consistent performance. For stock pickers at mutual funds, that means “fewer patsies at the poker table to take chips away from.”

“The lion’s share of retirement dollars is going into passive funds these days—and investors are better off for it,” said **Mark Miller** in *Reuters.com*. Even the best-performing actively managed funds seldom succeed in staying on top for long. Only 7.33 percent of U.S. equity funds that were in the top quartile of high-performing mutual funds in March 2014 were still there two years later. And a measly 3.7 percent of large-cap funds stayed in the top half of performers over five consecutive years. In theory, an astute investor could hop in and out of hot funds at just the right moment, but most people don’t have the time or the energy for that kind of tinkering. For the average investor, passive investments are the way to go.

But blindly pumping your money into an index fund won’t “guarantee investing success,” said **Walter Updegrave** in *Time.com*. While many offer rock-bottom annual fees of 0.1 percent or less, some indexes charge 10 times that amount or more, putting them on par with many actively managed funds. A growing number of investment firms have also started offering increasingly niche indexes that track “everything from wind power and cybersecurity to obesity and organic foods.” Remember, the idea behind index investing is to put together a broadly diversified portfolio that will match the market’s return, not to gamble on an industry that’s hot right now.

The experts could be due for a comeback, said **Stan Choe** in the **Associated Press**. In recent years, stocks have largely moved up and down in unison, blunting the advantage of picking the best company in an industry. That’s at least partly due to the Federal Reserve, which has kept stocks high through a massive stimulus in the form of low interest rates. The Fed’s next move, though, will likely be to raise rates, not lower them. When that happens, it could be time to make “the most contrarian move in investing today: Trust a stock picker.”

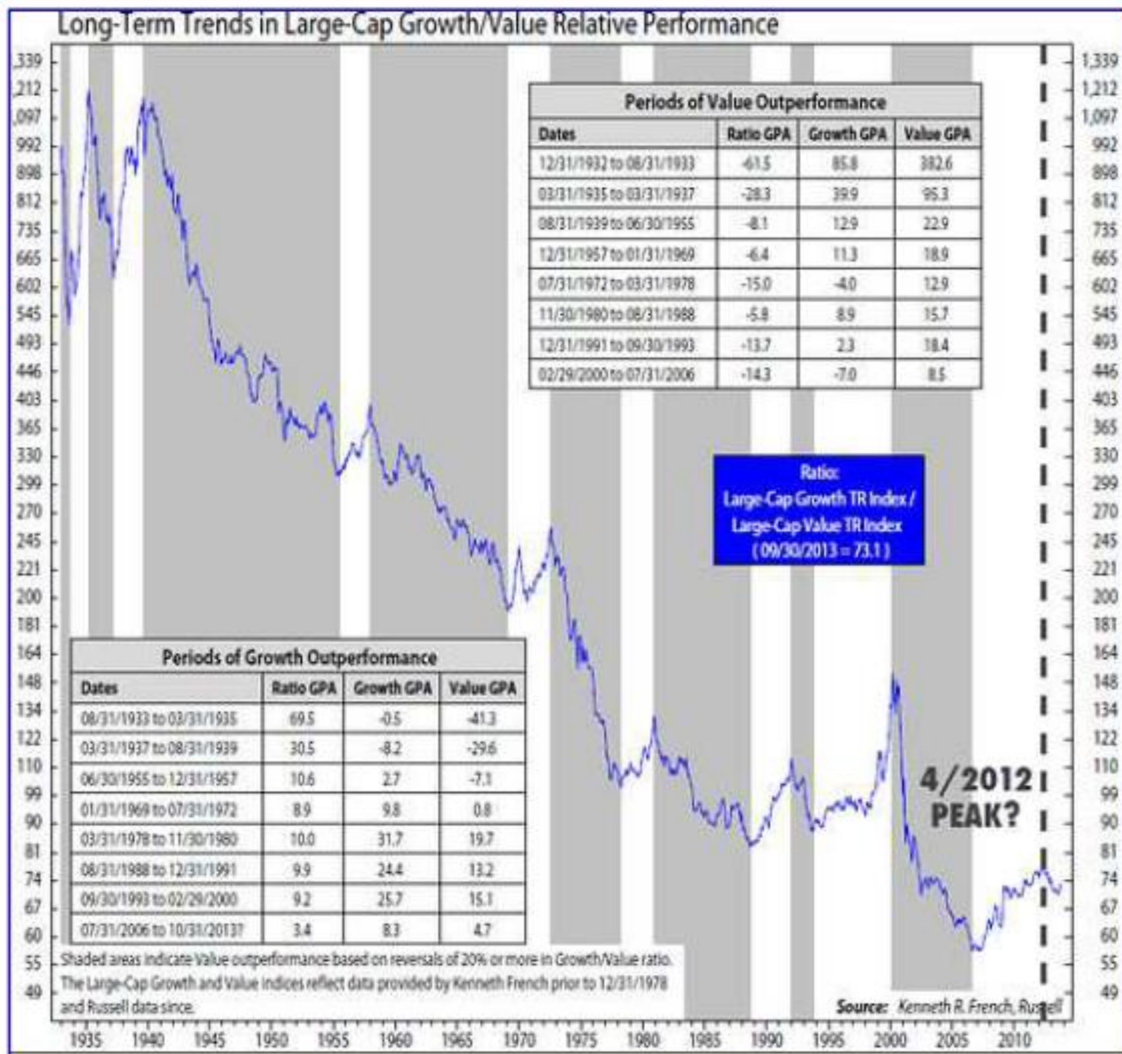
September 9, 2016 The Week

Our thoughts:

"Hard times for stock pickers" will continue. Historically, U.S. stocks have produced a 10% nominal annual return. Beating the "market" is a zero sum game. For us to make 12%, means somebody is making 8%. When it comes to "large-cap, actively managed mutual funds", they are looking at a relatively efficient segment of the market within which very bright portfolio managers are competing. To a very large extent, they are the market. One option, which continues to grow in popularity, is to not even try to beat the market by indexing it at the lowest possible cost. Our approach is to invest in those Factors - Value, Momentum, Quality, Size (when combined with Value and/or Quality), etc. - which academic research has shown to outperform the market. The

debate within academia is not over whether these Factors beat the market, they do, but why. Adherents to the Efficient Market Hypothesis (EMH) believe that investors are more or less fully rational and informed, define risk as volatility, and theorize that investors in these Factors are being compensated for accepting more risk. Those of us in the Behavioral Finance camp don't believe that investors are either fully rational or informed, and turn to psychological biases to explain the why. For the individual investor with a sufficient time horizon, the academic debate over "why" shouldn't matter. The growing popularity of "Smart Beta" Funds is the result.

The starting point for any investor should be their Risk Profile. An investor's Capacity to bear risk is largely a function of time horizon. The Value Factor currently provides a painful example of why. We have previously shared this graph:



Periods of Value Outperformance			
Dates	Ratio GPA	Growth GPA	Value GPA
12/31/1932 to 08/31/1933	-61.5	85.8	382.6
03/31/1935 to 03/31/1937	-28.3	39.9	95.3
08/31/1939 to 06/30/1955	-8.1	12.9	22.9
12/31/1957 to 01/31/1969	-6.4	11.3	18.9
07/31/1972 to 03/31/1978	-15.0	-4.0	12.9
11/30/1980 to 08/31/1988	-5.8	8.9	15.7
12/31/1991 to 09/30/1993	-13.7	2.3	18.4
02/29/2000 to 07/31/2006	-14.3	-7.0	8.5

Periods of Growth Outperformance			
Dates	Ratio GPA	Growth GPA	Value GPA
08/31/1933 to 03/31/1935	69.5	-0.5	-41.3
03/31/1937 to 08/31/1939	30.5	-8.2	-29.6
06/30/1955 to 12/31/1957	10.6	2.7	-7.1
01/31/1969 to 07/31/1972	8.9	9.8	0.8
03/31/1978 to 11/30/1980	10.0	31.7	19.7
08/31/1988 to 12/31/1991	9.9	24.4	13.2
09/30/1993 to 02/29/2000	9.2	25.7	15.1
07/31/2006 to 10/31/2013?	3.4	8.3	4.7

At the time it was published the authors were suggesting that Growth stocks' most recent period of outperformance had peaked. They were wrong, as we shared in this month's letter. James W. Paulsen, Ph.D Chief Investment Strategist, Wells Capital Management: "Charts 13 and 14 illustrate that value has been persistently dismissed in this recovery. It began overvalued, being favored in the aftermath of the dramatic

growth-led dot-com run, but has cheapened considerably in this recovery. Indeed, among either small or large cap stocks, value relative to growth is about as cheap as anytime in the post-war era."

For investors with a sufficient time horizon, the solution to the periodic underperformance of any one Factor is a portfolio that is diversified among various Factors. The Value and Momentum Factors, for example, can be synergistic when properly used.

What about the investor who's time horizon turns volatility from an opportunity to a risk. Should Factor investing still have a role? Our answer is yes. This month we shared "Managed Futures: Understanding a Misunderstood Diversification Tool" by Andrew Miller, CFA and recommended a quantitatively Managed Futures OEF (ASFYX) that uses Momentum to reduce risk. We also shared research from Alpha Architects on hedging to reduce Maximum Drawdown, our preferred risk metric. We are currently using QMNIX, a Global Long/Short Market Neutral OEF based on Value, Momentum and Quality, to reduce volatility for clients. The S&P 500 TR index (yellow line) has been added to QMNIX's Morningstar graph below.

Chart 13

Large cap value vs. growth stocks — Relative Total Return Index*. Percent above / below post-war trendline.
Total Return Index of all NYSE, AMEX and NASDAQ stocks which reside in the upper half in terms of market capitalization. Value stocks are those which have a market cap to book ratio lower than 30% of all large cap stocks and growth stocks are those which have a market cap to book value ratio higher than 30% of all large cap stocks. The composition of the two portfolios are constructed in June of each year.

We are not "stock pickers" in any traditional meaning of the term. While we recognize that the Warren Buffets of the world do exist, we do not count ourselves among them. What HCM can do is apply the best findings of Academic Research to each client's Capital Management.