"Momo Is a No-Go" Really?

On April 17th one of our DIYers once again shared a Dividend.com Newsletter, and, once again, we provide our analysis:

Momo Is a No-Go

If there's been one constant over the last few years, it's been that "growth" has beaten "value" by a wide margin.

As the economy has heated up and we've moved further into the business cycle, investors have been drawn to various growth-style stocks and their better earnings potential. And this trend has persisted for a multitude of quarters and was only exacerbated when pro-business Trump was elected.

But recently, momo stocks have become a no-go.

As valuations have continued to hit historical highs, investors have gotten a little uneasy about just how much potential they are placing in the hands of growth stocks. And because of that, growth has started to flounder. For investors – especially income seekers – now could be value's time to regain the spotlight.

A Huge Surge Upward

Historically, value has long beaten growth. However, over the last few years, the relationship has been reversed. In the early part of the recession recovery, economic growth was less than ideal. So investors favored those stocks that had high margins and low CAPEX requirements, which meant a hefty dose of technology and healthcare. FANG leaders like Facebook (FB) and Amazon (AMZN) became the market's standard bearers.

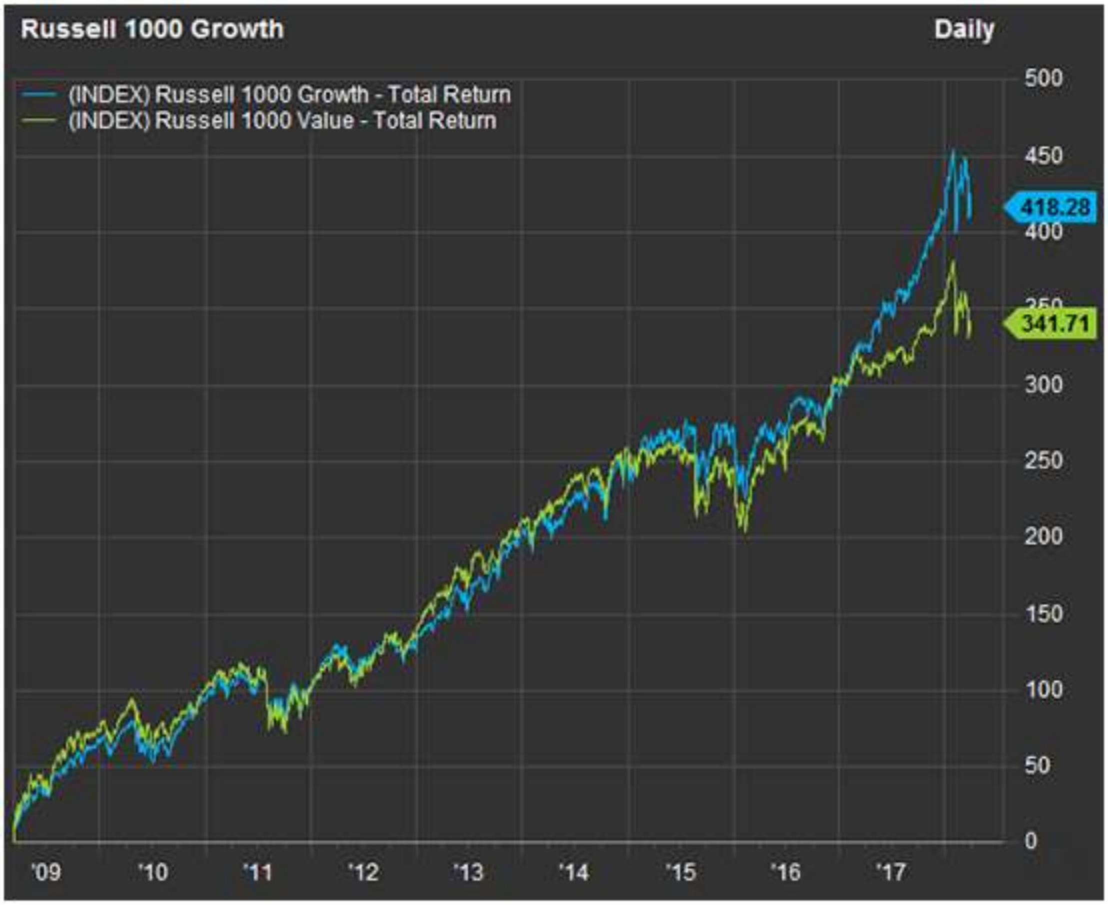
Then Trump was elected and his pro-business policies set the economy moving ahead. Economic growth finally returned and that growth spread across the globe into struggling Europe and Japan. As a result, high-margined tech stocks and other growth-focused equities had the potential to earn even more in the better business climate. Shares of growth-styled equities surged even more and crushed value into oblivion.

Just take a look at this chart for the Russell 1000 Growth Index vs. the Russell 1000 Value Index. You can see the difference in returns once the economic recovery finally started to really cook. Likewise, momentum stocks – which show continued forward movement and are dominated by growth names – have managed to outperform the broader market in a big way. The MSCI Momentum Index returned 10.7% (which is tracked by MTUM, an ETF we continue to use for most clients) annually compared to 6.9% for the S&P 500.

The Problem With That Surge

For investors in the FANGs and other growth names, the last couple of years have been wonderful for returns. Stocks have pretty much had a straight shot upward with hardly any bouts of volatility. But in that, growth has gotten very expensive.

Stocks as a whole have seen various valuation metrics rise to historic levels. The often touted cyclically adjusted P/E ratio or CAPE ratio is still sitting at highs not seen since the last recession. But when breaking down the market into value and growth/momentum styles (It is important not to conflate growth stocks and the Momentum Factor, as we discuss below.), the disparity in valuations is huge.



Source: MarketWatch

Currently, the Russell 1000 Value Index can be had for a P/E of 19 and price-to-book (P/B) of 1.95×. Not too cheap when looking at long-term averages, but not too expensive either. Contrast this to the Russell 1000 Growth Index. The Russell Growth can currently be had for a P/E of 26 and P/B of a whopping 6.95×. The value index is yielding a full 1.25% more than its growth twin as well.

That high valuation for growth has caused some big-time concerns for investors. Volatility, big intraday swings and the market's inability to brush off geopolitical problems have sent stocks reeling. Bearing the brunt of those concerns has been growth and momentum equities. Investors have quickly abandoned the FANGs and other high-growth names in recent weeks. For example, Facebook has sunk more than 12% since the market's peak back in February.

A Reversal in the Making

The question is whether this is just a short-term blip for momentum stocks or the start of something bigger. The answer may not be what FANG and growth stock investors want to hear.

Although economic growth has returned, we've potentially moved further down the business cycle. Data has started to support the idea that we are starting to move on the downward slope. And while the Republican tax cuts have the potential to boost earnings down the road and kick the can, so to speak, investors have already front-loaded and priced the effects of the cuts into stocks' valuations. There won't be any additional "boost" later on. We've already gotten that.

(According to Peter Lynch, **"The way you lose money in the stock market is to start off with an economic picture."** As the manager of Fidelity Investments' Magellan Fund between 1977 and 1990, Lynch averaged a 29.2% annual return, consistently more than doubling the S&P 500. During his 13-year tenure it was the best performing mutual fund in the world, with assets under management growing from $18 million to $14 billion. With that noted, there is evidence that global growth has peaked. With significant U.S. fiscal stimulus this year and next, our primary concern remains the economy overheating, resulting in the Fed accelerating their interest rate increases. However, BCA Research's Geopolitical Strategy provided the above Table in their April 18, 2018 issue.)

SPX Returns During Periods Of Loose Fiscal And Tight Monetary Policy

CYCLES (YEAR, MONTH)	RETURNS (%)
1954 DEC / 1955 DEC	30.0
1958 JUN / 1959 DEC	32.0
1965 DEC / 1968 DEC	12.4
1977 DEC / 1978 DEC	1.1
1987 DEC / 1988 DEC	12.4
1998 DEC / 1999 DEC	19.5
2015 DEC / 2016 DEC	9.5
AVERAGE (16 MONTHS)	16.7
MEDIAN (12 MONTHS)	12.4

In fact, without the tax cuts, the pace of earnings growth this year would have been less than 2017's jump in EPS for the S&P 500.

Time for Value Stocks

With higher valuations and a lessened economic picture, momo's days in the sun may be looking a little long in the tooth. We could finally be seeing the start of mean reversion. That's great news for income seekers.

Historically, value stocks have been some of the best places to find yield. And now, they have to potential to perform on a high total return basis. This could mean adding a hefty dose of value stocks to your portfolio in the weeks ahead in order to take advantage of the shift from growth and higher yields.

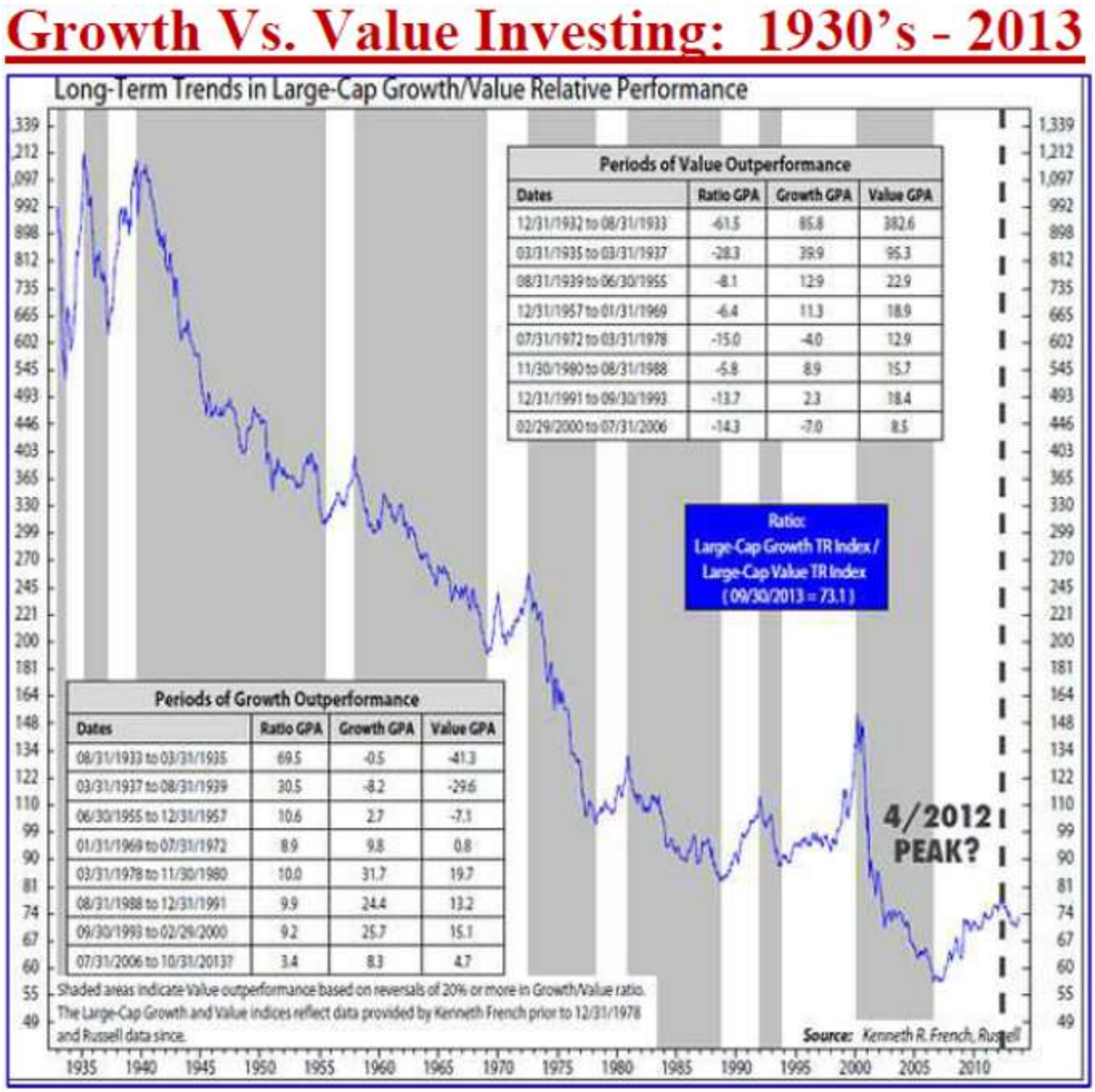
An easy way to do that would be the iShares Russell 1000 Value ETF (IWD). The ETF bets on the previously mentioned index and holds 710 different "value" stocks, including Berkshire Hathaway (BRK-A) and Johnson & Johnson (JNJ). Moreover, that blend of stocks produces a 2.63% dividend yield. That's pretty high and falls within the best range for total returns. All in all, the ETF offers a cheap and easy way to add exposure to value (IWD doesn't come close to exploiting the Value Factor.) and the end of growth/momentum's reign.

The Bottom Line

Driven by technology stocks, growth and momentum-styled equities have been king of the hill since the recession ended. However, high valuations and a bout of volatility have shifted sentiment back to value stocks. For income seekers, this is great news. The time to bet big on value is now.

Our thoughts

As can clearly be seen in the chart below from our website, over the long run Growth Stocks underperform Value Stocks. Note the "**4/2012 Peak?**" in the chart's lower right hand corner. Was another analyst proclaimingthat now was "the time to bet big on value"? If so, hopefully his "bet" wasn't too "big", since the counter-trend outperformance of Growth continued for another 6 years and counting. As we note on our website: "these periods of underperformance highlight the importance of constructing portfolios that diversify across factors, so underperformance in one factor (in this case Value) does not hamper the entire portfolio."



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

Momentum is one such Factor. In fact, academic studies have shown that Momentum is synergistic with Value, as detailed on our website. However, Momentum is not just another term for Growth Stocks, at least not among academics and those Investment Advisors like HCM that attempt to apply their findings in the real world.

From Morningstar:

A Look Under the Hood of 5 Momentum Funds

By Alex Bryan, CFA | 06-14-17

Momentum investing is based on the observation that recent performance tends to persist in the short term. On paper, it has been one of the highest-returning factor strategies documented. But it is also the hardest to capture in practice. There are only a handful of rules-based funds that explicitly target stocks with high momentum, but they can look and perform differently from one another .... So, a closer look is necessary to uncover the best option.

In the academic literature, momentum is commonly measured based on performance over the past 12 months (excluding the most recent one, as performance tends to revert over that horizon), updated each month.

Applying this simple approach to stocks larger than the median name on the New York Stock Exchange, a market-cap-weighted portfolio of the highest ranking 30% would have outpaced the lowest ranking 30% by 6 percentage points annualized over the trailing 50 years through January 2017. But this would be a tough strategy to put into practice, because it requires very high turnover that can create high transaction costs. Most momentum funds take steps to reduce transaction costs, which can cause their portfolios to deviate from this simple academic construction and reduce their style purity. ...

The least expensive of the four ETFs ..., iShares Edge MSCI USA Momentum Factor (MTUM), is also the most compelling. It targets stocks with the strongest risk-adjusted momentum and weights them according to both the strength of their momentum and market capitalization. To do this, it ranks stocks by their price returns over the past seven and 13 months (excluding the most recent one), scaled by their volatility over the past three years.

... this risk-adjustment should help the fund avoid loading up on the riskiest names during bull markets, which tend to underperform during market reversals. It should also increase the fund's exposure to stocks with momentum that is more likely to persist. This is because stocks with steady price improvement are more likely to enjoy gradual improvements in fundamentals that investors may underappreciate than those with greater volatility. Such underreaction can lead to persistent price movements. Investors are more likely to underreact to a string of small changes than they are to larger and more discrete ones, such as news about FDA approval for a new drug. So, the quality of momentum (consistency of price movements) matters.

This strategy was designed with capacity in mind. It only rebalances twice a year and it applies buffers around its selection cut-off to mitigate unnecessary turnover. ...

MTUM is the most concentrated portfolio of the bunch and it has exhibited the highest tracking error to the Russell 1000 Index. This concentration gives the fund slightly greater exposure to firm-specific risk than its peers, though it appears manageable. Despite this concentration, the fund has exhibited lower volatility than its peers, owing to its risk-adjusted selection criteria. The combination of its cost advantage, strong exposure to the momentum factor, and cost-efficient implementation make this the most attractive momentum ETF, in Morningstar's view. (We have added SPY (the S&P 500 ETF, orange line) to Morningstar's current chart for comparison.)

Our other concern, as noted, is Dividend.com's recommendation of IWD for Value. The Russell 1000 index is the Large Cap component of the Russell 3000, while the Russell 2000 component is widely used as a benchmark for Small Cap stocks. Morningstar's analyst as of 7/5/2017:

"The fund targets stocks representing the cheaper and slower-growing half of the Russell 1000 Index, using three metrics: price/book, projected growth, and historical sales growth. This sweeps in more than 600 stocks, which the fund weights by market capitalization. These holdings tend to have less-attractive business prospects than their growth counterparts, so they are not necessarily bargains. But they could become undervalued if investors extrapolate lackluster past growth too far into the future.

Market-cap-weighting skews the portfolio toward the largest value stocks, which are not necessarily the cheapest. This approach can actually reduce the portfolio's exposure to stocks as they become cheaper, as this typically accompanies a decline in market capitalization. ... These large-cap stocks may offer lower return potential than smaller stocks, but they also tend to be less risky.

Because the fund casts a wide net, it includes some stocks with modest value characteristics. In fact, nearly a third of the fund's portfolio overlaps with its growth counterpart, iShares Russell 1000 Growth IWF."

As we have previously shared, using the right valuation metric(s) matters, as does concentration, with the best results coming from the cheapest decile, not the cheapest "710" stocks out of 1,000. We currently track QVAL, and several of our clients hold its Foreign sibling IVAL. QVAL's 40 stock portfolio results from the highest Quality half of the cheapest decile based on EV/EBIT, a far better valuation metric than any of the 3 used by IWD, as detailed on our website. As shown below, QVAL (blue line) has actually outperformed both IWD (orange line) and its Growth Stock sibling IWF (green line) since the election.


11/09/2016
-04/18/2018
Zoom:1D 5D 1M 3M YTD 1Y 3Y 5Y 10Y Maximum Custom
BATS:QVAL:+8.42|+37.39%
ARCX:IWD:+17.52|+16.71%
ARCX:IWF:+37.91|+37.01%
%
40.70
20.70
0.70
Volume
01/2017
03/2017
05/2017
07/2017
09/2017
11/2017
01/2018
03/2018