August 2018

On the 24th the S&P 500's new closing high brought its most recent Correction to an official end. From the front page of the WSJ on the 22nd:

Bull Market Set to Become Longest

By Michael Wursthorn And Akane Otani

U.S. stocks are on the verge of surpassing their longest-running rally, ratifying a market rebound that began in the ashes of the financial crisis and defying those who have questioned its staying power.

Wednesday will mark 3,453 days since the S&P 500 hit its low of 666 on March 9, 2009. Since then, the broadest U.S. blue-chip index has more than quadrupled in price terms, creeping within striking distance of its January all-time record and outpacing most rival major global indexes.

... The latest leg of the bull run for the S&P has been driven by booming economic growth in the U.S., as well as renewed strength in quarterly corporate earnings. Investors have also bet that the global economy will continue to expand at a steady pace even amid turbulence in some emerging markets such as Turkey and Venezuela.

The largest advances in recent months and years have been concentrated in the U.S. technology companies that have practically become synonymous with technical prowess and business dominance, notably Apple, Amazon. and Google parent Alphabet.

The gains, aided by the U.S. corporate tax cut in December, deliver a rebuttal to skeptics who have argued that everything from a slowdown in China's growth to rising U.S. interest rates to intensifying trade tensions would dash the market's run. ...

Few investors would have bet that the longest bull market in U.S. history would follow on the heels of the worst financial crisis since the Great Depression. A decade ago, storied investment firms like Bear Stearns and Lehman Brothers disappeared, while others including Merrill Lynch were sold under intense market pressure. Many analysts and investors believed in March 2009 that, even with broad market indexes down 40% and more from their peaks 18 months earlier, worse tidings were yet to come.

Instead, the economy struggled back to its feet over a period of years. Investment flows inevitably shifted away from a hamstrung financial industry toward fast-growing, consumer-facing technology companies that were devising products that managed to change everything from the ways Americans shopped for clothes to how they communicated with one another. ...

The current rally isn't the hottest. The previous record S&P bull market that ended with the tech bust in March 2000 rose 417% over 3,452 days—far above the current rally's 323%. ...

A slightly different take came the next day:

Calling Bull on the Longest Bull Market

Who cares how long this bull market has been going, so long as you're making money?

By James Mackintosh

Investors in big U.S. stocks will have no trouble believing that we are on the threshold of the longest bull market ever, with Wednesday setting a new "record" of 3,453 days. Quibbles about exactly what happened in 1990, 1998 or 2011 won't matter for those who had the foresight and luck to hold the S&P 500 during its 320%-plus run from the low of March 9, 2009.

What truly matters for investors is that the market has gone up a lot—really, a lot—over a long period. But given how much attention bull markets and new records get, it is worth spending a bit of time on the quibbles.

The widely accepted definition of a bear market is a drop of 20% from the last peak in this cycle, while bull markets are usually measured from the lowest point reached until the peak before the next bear market.

On this basis, the broad U.S. market has only been in a bull phase since October 2011, when most stock gauges were back in a bear market, down 20% from their postcrisis highs hit earlier that year.

The S&P 1500, Russell 1000, Russell 3000 and Wilshire 5000 were hurt by their holdings of smaller companies, which fell fast as the market plummeted in the wake of the U.S. credit-rating downgrade and eurozone implosion.

The S&P 500 itself fell 19.4% from its postcrisis closing high to the closing low of October 2011, although even here we can split hairs. Use intraday highs and lows and the index was down 21.6%, for a new bear market. Certainly to many investors it felt like a renewed panic, and nothing like a bull market.

Whether today marks a record is open to doubt either way. Based on closing prices, there was no bear market from 1987 until 2000 in the S&P 500, making that by far the longest bull run. Based on intraday prices, there were bear markets in 1990 and 1998, but that run was still longer than the run since 2011.

... U.S. stocks have been making big money. From 2009 to 2011 they rebounded with the rest of the world, but since then they have soared ahead. Measured in dollars, British, eurozone, Japanese and emerging-market equities have all roughly doubled from the 2009 lows (emerging stocks bottomed out a few months earlier), while U.S. stocks have quadrupled.

This isn't about a weaker dollar, at least against other major currencies. A weak currency can certainly help stocks priced in that currency—just look at the Caracas stock exchange's 17,266% gain this year, before Venezuela's bolivar was abolished to try to deal with hyperinflation. But the dollar has strengthened from its 2009 lows against most currencies, and barely had any inflation. ...

Whatever measure we use, there has been a big bull market for a long time, and we should care. Investors are heavily influenced by the recent past, and tend to extrapolate it too far into the future. The danger with every bull is that it runs too far. ...

However, for all the excess, it is still hard to identify a true bubble, certainly nothing on the scale of dot-coms in 1999 or housing in 2006. Long booms don't have to end in unsustainable exuberance and froth, but history suggests they often do.

Our view, as previously shared, is that March 9, 2009 marked the beginning of the current Secular Bull Market, while 2011 saw a Cyclical Bear Market. The first of two quotes comes from noted economist Kenneth Boulding: **"Anyone who thinks steady growth can continue indefinitely is either a madman or an economist."** We shared the second quote, from Rudy Dornbusch, in June, but it bears repeating: **"Expansions don't die of old age, they are murdered by the Fed".**

Follow-ups

We always respond when a client, or DIYer on our distribution list, has a question or concern. Often their inquiry is accompanied by the cause. We share our response when we believe it may be of value to other clients. On **8/14/18** we wrote **Turkey's tailspin**, in response to a client sending a NYT article about "Turkey's Financial Crisis". We concluded **Our thoughts** with: "While Turkey's current crisis may get a footnote as another example of Populism's economic consequences (As noted by the Signal on 8/14, "the effects of Erdogan's politically-motivated policy of pumping loads of cash through the economy – while dismissing inflation as a conspiracy rather than a consequence – began to spook ... creditors, making Turkey's economy increasingly fragile."), the odds of contagion are very low, and the odds of it bringing the current Bull Market to an end even lower." While our view hasn't changed, this from the front page of Friday's WSJ:

Emerging-Currency Rout Worsens

By Mike Bird and Saumya Vaishampayan

Pain, Not Gain

Currencies in developing economies have slumped this year.

Change against the U.S. dollar

Source: FactSet

The Argentine peso hit a record low—prompting the country's central bank to raise interest rates to 60%—and the Turkish lira slid further, as emerging markets most vulnerable to a rising dollar bent under the stress on Thursday.

While Argentina and Turkey are in particular trouble because of domestic issues, developing economies around the world are being squeezed as the Federal Reserve raises interest rates, boosting the U.S. currency. That has pushed up the cost of some developing nations' large dollar-denominated debts, prompting central bankers to voice concern about the Fed's direction.

Emerging markets were rattled by a 7.5% overnight fall in the Argentine peso against the dollar after President Mauricio Macri said he had asked the International Monetary Fund to speed up delivery of a $50 billion bailout. On Thursday, the Argentine central bank raised interest rates by 15 percentage points to 60% to curb the decline, but the currency fell further and finished the day with a 12.2% loss.

Meanwhile, Turkey's lira fell 2.8% against the dollar Thursday, putting it close to the low it hit earlier this month on worries about political interference in monetary policy and the country's large dollar debt pile.

The South African rand fell 2.5%, while the Indonesian rupiah finished the day at its lowest level against the greenback in nearly three years. The Brazilian real was close to a more than two-year low and India's rupee hit a record low.

The tumult highlights a heavy international dependence on the dollar. Some 48% of the world's $30 trillion in cross-border loans are priced in the U.S. currency, up from 40% a decade ago. Exchange-rate fluctuations affect the ease of servicing that debt. And with U.S. interest rates still low by historical standards and the dollar only halfway back to its 2016 highs, the stress could increase as the Fed keeps tightening.

“After what we saw happen in Turkey, the market started to ask what country was next: South Africa, Brazil, Indonesia,” said Eric Wong, a fixed-income portfolio manager at Fidelity International. “The market is still gripped at times by fear, trying to differentiate the good ones from the bad ones.”

The market moves come amid a debate about the effects of U.S. monetary policy on the rest of the world—and how they might cycle back to the U.S.

“Given the dominance of U.S. financial markets and institutions, and the dollar’s prominence in global finance, any actions taken by the Fed inevitably reverberate around the world,” said Eswar Prasad, professor of economics at Cornell University.

Fed Chairman Jerome Powell said in May that “the role of U.S. monetary policy is often exaggerated” when it comes to global financial conditions, with fast growth in emerging economies, and commodity prices, playing bigger roles in capital flows. His counterparts in India and Indonesia, however, have voiced concerns about the Fed’s policy direction and pleaded for more international coordination.

The strain is felt most palpably by governments and companies that rely heavily on overseas funding. Moody’s Investors Service compares external debts due in the next year and bank deposits from overseas against currency reserves to compile an “external vulnerability indicator.” The measure points to fragility in South Africa, Argentina and Turkey, as well as Ghana, Sri Lanka, Malaysia among other countries.

In the case of Turkey, external debts stood at 53% of gross domestic product at the end of 2017, according to the International Monetary Fund.

Last week, the lira rebounded amid moves by officials to make betting against the currency difficult for international investors. ...

Investors are concerned that President Recep Tayyip Erdogan of Turkey has pressured the central bank to hold down interest rates, despite rocketing inflation and the lira’s 44% fall against the dollar this year. ..

Currencies pegged to the dollar have also come under pressure. Hong Kong has spent heavily to defend its link to the dollar, while central banks in Bahrain and Lebanon have pledged to maintain their pegs. ...

The Fed’s effects on the rest of the world may eventually flow back to the U.S., as the rising dollar and higher bond yields make debt more expensive and suck money out of other countries, harming their economies and international trade demand. As the Fed has raised rates and unwound its massive bond-buying program—known as quantitative easing—the yields on U.S. Treasurys have increased, making that market more attractive for international investors.

“There’s a stark divide between the Fed thinking that the effects of unwinding QE will be minor, local and likely to already be priced in, versus what we find in market terms, which is that it’s likely to be major and global,” said Matt King, global head of credit-products strategy at Citi.

On **4/22/18** we wrote **"Momo Is a No-Go" Really?** in response to a DIYer sending us a Dividend.com Newsletter that concluded, "The time to bet big on value is now."

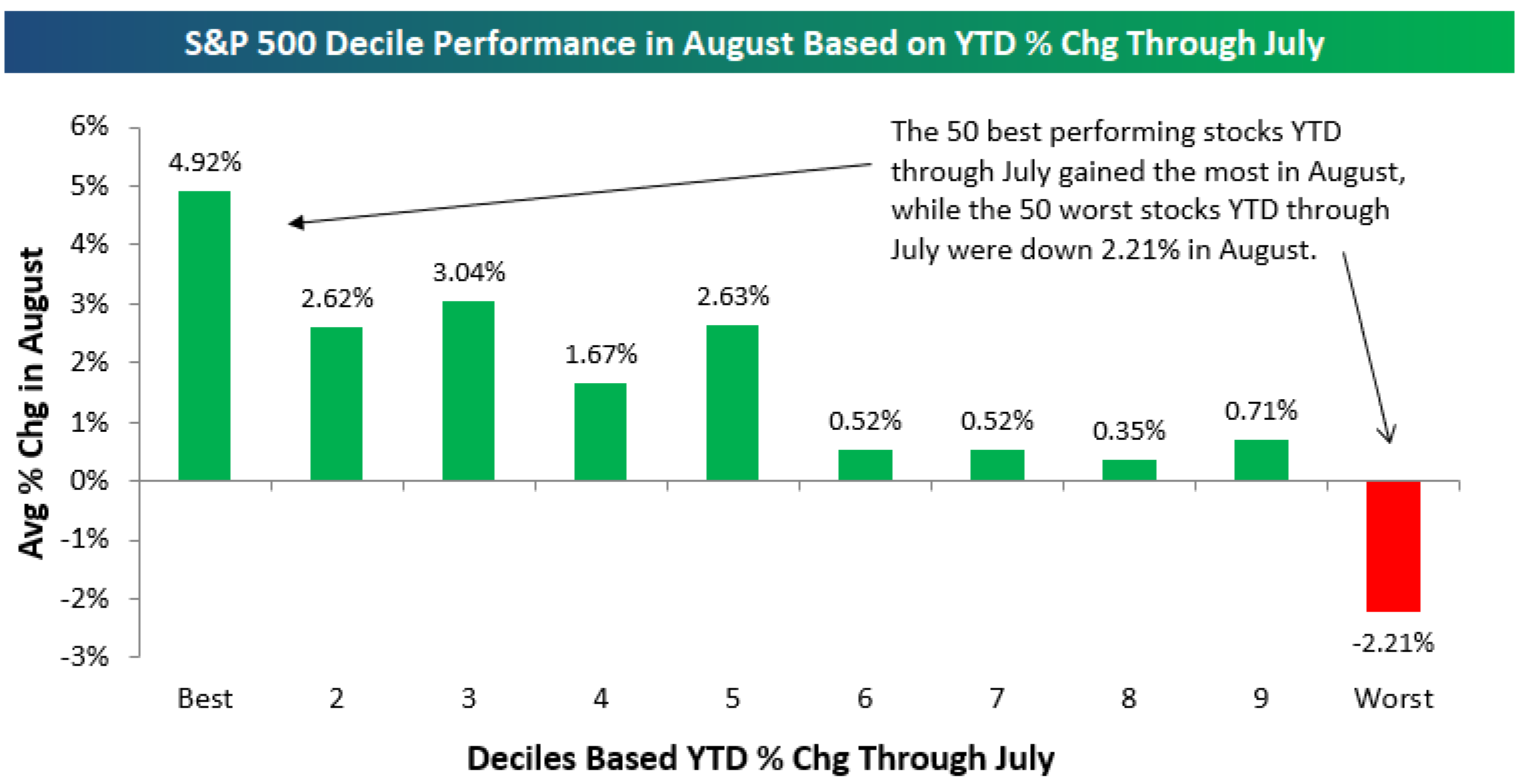
Our thoughts included: "As we note on our website: "these periods of underperformance highlight the importance of constructing portfolios that diversify across factors, so underperformance in one factor (in this case Value) does not hamper the entire portfolio."

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."

August a Continuation of Trend

Aug 31, 2018

Below we show our decile analysis of S&P 500 gains in August. To construct these analyses, we show how each 10% bucket of stocks in the S&P 500 (50 per bucket) by a given metric performs. In this example, we've broken the S&P 500 into deciles based on their percentage change in the first 7 months of the year through July. Over the course of August, performance in the other 7 months was highly correlated to performance this month. As shown in the chart below, the 50 best performing stocks YTD through July were up almost 5% in August, with the 2nd through 5th deciles also performing quite well. The bottom half of the market in terms of YTD performance through July generally didn't do as well in August. That was most true for the 50 stocks that performed the worst through July, which dropped on average 2.2% in the month of August. Owning winners is often derided by contrarians as a way to underperform, but the decile analysis below is one example of momentum begetting more momentum in financial markets.



On **4/7/18** we wrote **"Large Is Still Beating Small" Really?** in response to the same DIYer sending us another Dividend.com Newsletter that included, "Given that the trends are still in place for large-caps to keep on beating smaller firms (Not only have large-caps not beaten small-caps "since about 2013" when properly measured, but both history and current "trends" support the Size Factor, especially when combined with the Value or Quality Factors.), the time to keep betting big is now (not if Capital Appreciation matters)." with our parenthetical comments in red. From Thursday's WSJ:

Small Stocks Hang On to Big Gains, for Now

Tax cuts, trade frictions boost investor demand for shares of smaller companies

By Michael Wursthorn

Soaring profits at smaller publicly traded companies are driving the Russell 2000 to new records as investors bet U.S. economic strength will boost smaller companies while trade frictions hit their multinational counterparts.

The sweeping tax cut passed last year has driven corporate profits up across the country, especially at small businesses that get most of their sales from within the U.S. A resurgence in economic growth and consumer spending has brightened prospects for the stock market's smaller cohorts, analysts say, while the shadow of a trade war has damped the returns of big, multinational stocks such as industrial manufacturers.

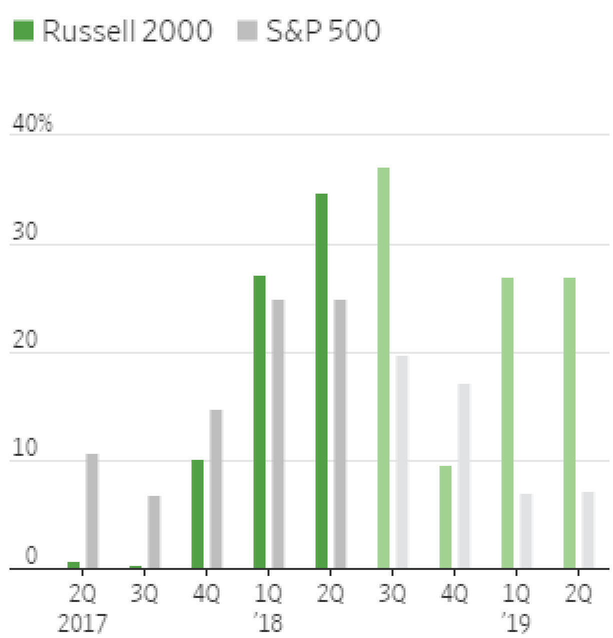
With more than 90% of the Russell 2000 having reported second-quarter results so far, earnings throughout the index of small-capitalization stocks grew 35% from a year earlier, while sales jumped 10.5%, according to Michael O' Keeffe, chief investment officer at Stifel Nicolaus & Co. That is better than the S&P 500, which grew profits

Outperforming

Index performance, year to date

Note: As of Aug. 29
Source: SIX

Earnings growth from a year earlier, quarterly



Note: Data are as of Aug. 9 for the Russell 2000. Figures later than 2Q 2018 are projections.
Sources: Stifel Financial Corp., Bloomberg (Russell 2000 earnings); FactSet (S&P 500 earnings)

and sales from a year earlier by 25% and 10%, respectively, according to FactSet. ...

Small-cap stocks continue to hold a commanding lead over their bigger counterparts, as trade tensions have flared and ebbed. The Russell 2000 has climbed 13% this year, notching 29 record closes, while the S&P 500 has gained 9% and last week reached its first new closing high since January.

For now, investors are betting that the tit-for-tat trade spat between Washington and Beijing and other allies will continue to have a bigger impact on multinational companies that get revenue from overseas, compared with smaller companies. The S&P 500 gets about 30% of its revenue from outside the U.S., while Russell 2000 companies have foreign exposure of about 21%, according to a Merrill Lynch research note. ...

Solid consumer spending, strong business investment and a surge of exports, among other factors, helped push second-quarter gross domestic growth up to 4.1%, the fastest pace in nearly four years. The National Federation of Independent Business said its Small Business Optimism Index climbed in July to the second-highest level in its 45-year history, as business owners expect the strong sales to continue. ...

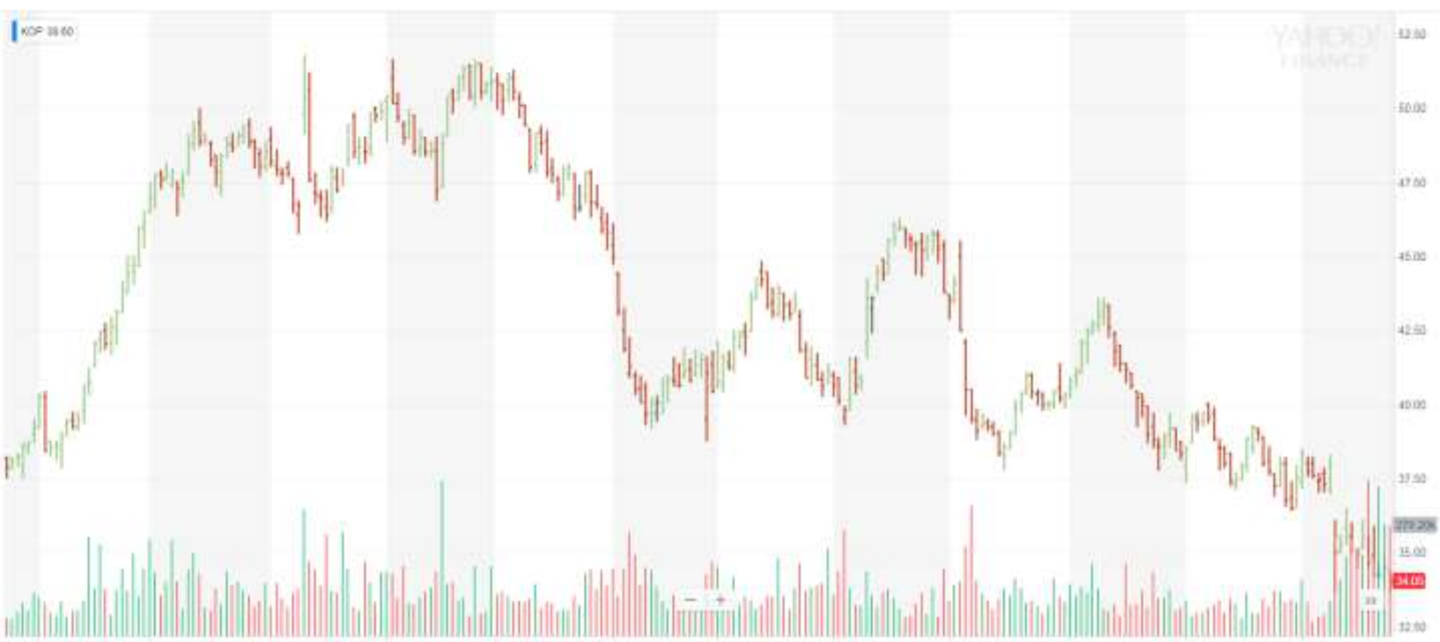
That strong economic footing is setting small-cap stocks up for another blockbuster quarter of earnings in the third quarter—and next year. Third-quarter earnings projections for the Russell 2000 have gotten rosier, with companies' profits expected to increase 37% from a year earlier, according to the data compiled by Mr. O'Keeffe.

Earnings growth will dip in the fourth quarter, according to the analysis, but growth rates of about 27% are projected for the first two quarters of 2019. S&P 500 earnings are projected to fall in the third quarter from the prior three-month period, according to FactSet. ...

Positions

FSIC - On 8/9, closing down 7.4% with 3x Average Volume on a 5.9% Negative Earnings Surprise, our BDC analyst sold. We waited for the typical bounce, selling for all clients on 8/31, with 2 out of 6 analysts lowering their Earnings Estimates for both 3Q & 4Q over the last 4 weeks, 1 out of 5 lowing their Target Price, and no new Insider Buying.

KOP - On 8/23 established 2% positions @ 34 in this chemical company, an IVA System pick, for all clients focused on Capital Appreciation that are investing in individual stocks.



Insider Buying:

Participants	Relation	Transaction Type	Shares	Trade Price	Trade Date
SULLIVAN JAMES A	Officer	Open Market Purchase	1,000	35.7300	08/14/2018
JOHNSON R MICHAEL	Officer	Open Market Purchase	25,000	35.3600	08/14/2018
NEUPAVER ALBERT J	Director	Open Market Purchase	5,000	35.8800	08/14/2018

MIC - On 8/13 established 2% positions @ 44.94 for several clients:

Insider Buying:

Trade Date	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
08/07/2018	3	MACQUARIE GP, STANLE..		44,656
08/06/2018	3	MACQUARIE GP, LENTZ ...		54,500
08/08/2018	3	MACQUARIE GP, FROST ...		48,022
08/09/2018	2	MACQUARIE GP, DAVIS ...		7,000
06/07/2018	6	MACQUARIE GP, BROWN...		110,230

High Dividend Opportunities on Feb. 22, 2018:

40% Overreaction Creates A Buying Opportunity For This High Quality Company - Yield 10.2%

Macquarie Infrastructure Corporation (MIC) is a highly diversified company which owns and operates a group of businesses providing basic services to customers in the United States. Its businesses consist of:

1. **Bulk liquid terminals business**: MIC provides bulk liquid storage, handling and other services at ten marine terminals in the U.S. and two in Canada and is one of the larger participants in this industry in the U.S
2. **Airport services business**: A network of aviation fixed-base operations ("FBOs") that provide fuel, terminal, aircraft hangaring, leasing services where appropriate, and other services primarily to owners and operators of general aviation aircraft at 69 airports in the U.S
3. **Renewable Energy Service**: MIC invests in solar, wind and gas-fired power generation facilities in the U.S.
4. **MIC Hawaii:** MIC owns a utility in Hawaii. ...

So basically MIC is in the infrastructure business which is set to see fast growth as the global economy improves.

Here, I would like to add that the company has an investment grade balance sheet, and has been a dividend growth stock for many years, and has a track record of outperforming the S&P 500 index.

MIC has plummeted today by 40%

... after the company released its 4th quarter results. The results were good in general:

- Revenues were up 7.8% in 2017 compared to 2016.
- The company achieved a healthy 8.2% increase in cash flow for the year 2017 compared to 2016.
- MIC has increased its dividends **every quarter** since November 2013. The dividend paid in November 2017 was 10% higher than the dividend paid in November 2016.

There are 3 reasons ...

1. MIC expects Free Cash Flow produced in 2018 to decline by between 8% and 10% versus 2017. This is because the company is facing some headwinds in its bulk liquids storage segment. Certain heavy oil contracts were not renewed late in the year. Management says that these terminals can be repurposed to handle other commodities.
2. Management decided to cut the dividend to $1.00 per quarter (or $4.00 per year), which represents a 30% reduction in the dividend. There are two reasons for the dividend cut. The first reason relates to the expected decline in Free Cash Flow. The second reason is that the company plans to internally finance new growth projects that will allow it to benefit from the recent tax reforms.
3. MIC was an expensive stock, and stocks that are expensive tend to over-react to bad news. ...

The Bottom Line

MIC is a high quality company with a diversified set of businesses and an investment grade balance sheet.

The reduction of 8%-10% in cash flow definitely **does not warrant** a 40% decline in the stock price. We are currently seeing an over-reaction.

After the stock has declined, it now yields 10.2%.

Based on our estimates, the dividend should have a coverage of 120% based on free cash flows.

MIC now trades at an attractive valuation of just 8 time cash flows.

MIC has many MLP-like features without the hassle of a K-1. The company issues 1099 tax forms.

This is a relatively large cap stock with a market cap of $3.2 billion.

Buy Alert

We are advising our members to buy MIC in order to take advantage of the huge selloff, and to lock in the yield of 10.2%.

on Aug. 17th:

4 Strong Buys For Today

I would like to highlight to our members 4 strong high-yield picks to consider buying/adding today.

Pick 1: MIC, Yield 8.6%

Macquarie Infrastructure Corporation, an infrastructure stock that we hold in our "Core Portfolio", continues to see strong momentum. We added MIC to our portfolio after management decided to reduce the dividend by 30% back in August 2017. One of the reasons why management reduced the dividend is to increase cash so that they can internally finance new growth projects in such a way that would allow the company to benefit from the recent tax reforms. Also reducing the dividend reduces the risk of dilution to shareholders. The stock back then over-reacted and lost 40% of its value. We saw the opportunity and advised our members to buy the stock.

The reasons we were bullish on MIC are as follows:

1. After the big selloff, the valuation of MIC was compelling.
2. This is an infrastructure stock that is well positioned to benefit from the Global economic recovery.
3. MIC has a solid management team with a long history of outperformance. This management was able to produce substantial returns to investors, with shares returning 225% from 2012 to 2017 in addition to a very high dividend yield. The stock had consistently increased its dividend during that period.
4. One of my strongest bullish points was that MIC's management reward was based on the stock price performance each quarter. Therefore it was likely that this management did a conservative dividend cut that would allow them to grow at a fast rate in the future. So they likely have "cleaned the kitchen sink" in one shot, so that the share price would outperform in the future.

We are happy that we made this call. Despite the fact that MIC shares returned 28.5% since our "Buy Alert" in August 2017, there are many reasons why we are still bullish on this stock, which include some **huge insider buying** that has been happening almost every week during the year 2018.

The insider buying has been enormous and amounting to over $200 million in value. ... The last insider buying occurred this month in August with about $3 million of new insider purchases. MIC's dividend coverage is now at 120%, putting the valuation of this 8.6% yielder at less than 10 times Free Cash Flow which is still cheap. The stock has still a lot of recovering to do since the last selloff.

... We remain bullish on this stock which still pays a hefty yield of 8.6% and recommend that members who do not have exposure yet consider to add one. Note that MIC issues 1099 tax forms (no K-1s), which has many advantages.

MIC remains **a Strong Buy** at the current price.

During August we worked with 3 potential clients, 2 of whom are focused on Capital Appreciation and were looking for a Funds only approach:

Recommended Portfolio

%	Symbol	Type	Description	Factors (1)	Yield	(2)	Exp.	M*	Risk (3)
10	SFREX	OEF	Global Real Estate-Large Blend		3.7%	Q	0.39%	5	1.0
10	MTUM	ETF	US Large Growth	M	1.1%	Q	0.15%	5	1.0
10	PRDSX	OEF	US Small Growth	S, V, Q, M	0.0%		0.79%	4	1.3
20	SMLF	ETF	US Small Blend	S, V, M, Q	0.9%	Q	0.30%	4	1.1
20	SMMV	ETF	US Small Blend	S, LV	1.5%	Q	0.20%		0.7
15	ISCF	ETF	Foreign Small/Mid Blend	S, V, M, Q	2.2%	S	0.40%	4	1.2
15	GPIIX	OEF	Foreign Small/Mid Growth	S, V, Q	0.3%	A	1.37%	4	1.4
								Weighted Average:	**1.1**

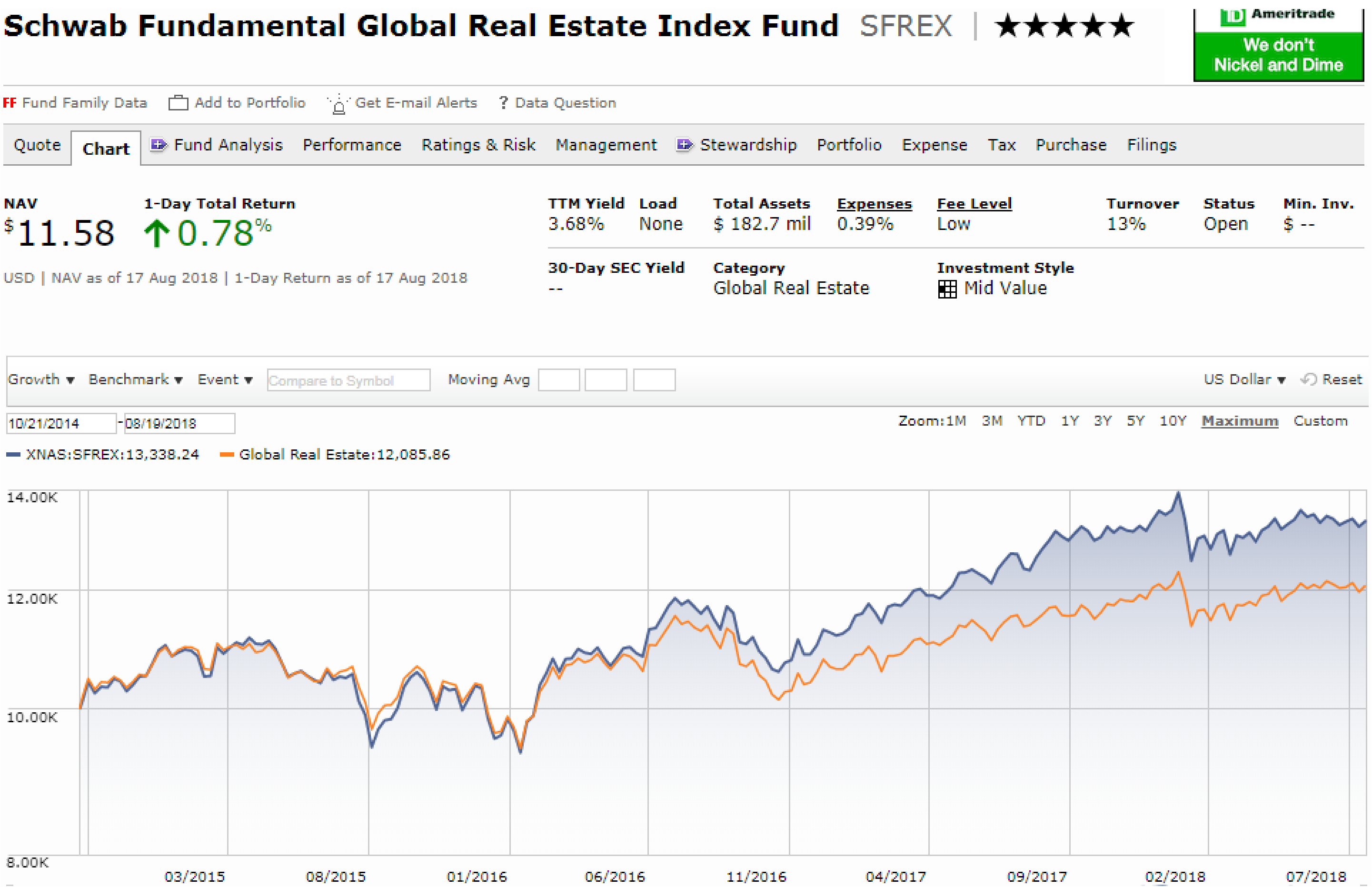
Notes	
1	V=Value, M=Momentum, Q=Quality, S=Size, LV=Low Volatility
2	Distribution Frequency: A=Annual, M=Monthly, S=Semi-Annual, Q=Quarterly
3	Ratio of average historical Max. Drawdowns to S&P 500 declines greater than 10% since 2007

In the above table we have provided our recommended **%** allocation to each Fund, whose **Symbol, Type** (OEF=Open End Fund, ETF=Exchange Traded Fund), and **Description** (based on Morningstar's Categories) are shown, as well as their **Factors** (**Note** 1), which are fully explained on our website, **Yield,** Distribution Frequency (**Note** 2), **Exp**ense, **M**orningstar rating, and **Risk** (**Note** 3). Morningstar's performance rating system:

"Morningstar rates mutual funds and ETFs from 1 to 5 stars based on how well they've performed (after adjusting for risk and accounting for sales charges) in comparison to similar funds and ETFs. Within each Morningstar Category, the top 10% of funds and ETFs receive 5 stars and the bottom 10% receive 1 star. Funds and ETFs are rated for up to three time periods, three-, five-, and 10-years, and these ratings are combined to produce an overall rating. Funds and ETFs with less than three years of history are not rated."

As noted on our site, Hughes Capital Management (HCM) "applies the academic findings of Behavioral Finance to the management of Individual Investment Accounts .... A factor is something that explains stock returns, ranging from ... Value, to stock price Momentum. The concept of Factors has been around since Eugene Fama (who won the Nobel Prize in Economics in 2013) and Ken French began developing statistical models to explain stock returns relative to the broader market. Since their initial work, more and more factors have been added, and just in the past few years the idea has exploded in popularity, with so called “Smart Beta” funds (another term for Factor based investing) sprouting up everywhere one looks. Yet despite the newfound popularity and hype for this investing approach, very few of these Factors withstand academic scrutiny." Five of the **Factors** which we consider compelling, and that I teach in my University of Oklahoma Advanced Topics in Investments class are shown in **Note** 1.

SFREX - This passively managed OEF primarily invests in stocks that are included in the Russell RAFI Global Select Real Estate Index developed by Rob Arnott's Research Affiliates. The index measures the performance of real estate companies, including real estate investment trusts (REITs), in U.S. and non-U.S. markets, including both developed and emerging. It ranks and weights global real estate securities by three fundamental measures of company size, adjusted sales, retained operating cash flow, and dividends plus buybacks rather than by market capitalization.



MTUM - In an interview, Eugene Fama (the father of the Efficient Market Hypothesis) admitted that "…the one thing that causes lots of trouble is the evidence that there's some short-term momentum in returns…. in my view that's the biggest challenge to market efficiency." We have added the S&P 500 (orange line) to Morningstar's chart:

This is a cost-efficient momentum strategy.

by Alex Bryan, CFA
4/18/2018

Suitability

IShares Edge MSCI USA Momentum Factor MTUM is one of the most attractive momentum funds available. This low-cost strategy targets stocks with strong recent performance, based on the observation that recent performance tends to persist in the short term. It effectively captures this phenomenon, while keeping costs in check, which should set up attractive category-relative performance over the long run, supporting its Morningstar Analyst Rating of Silver.

The fund targets large- and mid-cap stocks with strong risk-adjusted price performance over the past seven and 13 months, excluding the most recent one. This focus on risk-adjusted performance should moderate the fund's volatility and reduce the fund's exposure to stocks that may struggle when the market changes direction. Stocks that make the cut are weighted according to both their market capitalization and momentum. This can lead to some large positions in individual names, but the fund caps these weightings at 5%. The resulting portfolio lands squarely in large-growth territory. It should effectively complement value-oriented holdings because momentum tends to work well when value doesn't, and vice versa.

To mitigate turnover, the fund only reconstitutes twice a year and applies a wide buffer around the stocks it targets. These adjustments reduce the fund's style purity, since momentum can shift from month to month. But they also improve cost efficiency. The fund can still experience high turnover. In the fund's most recent fiscal year, turnover was 129%. However, it has not yet distributed a capital gain. The exchange-traded-fund structure allows the managers to transfer holdings out of the portfolio through a nontaxable in-kind transaction with the fund's authorized participants.

The fund's approach has worked well so far. From its inception in April 2013 through March 2018, it outpaced the Russell 1000 Growth Index by 140 basis points annually, with comparable volatility. This was largely due to its overweighting in the healthcare sector and more-favorable stock exposure within the technology, industrial, and consumer cyclical sectors.

Fundamental View

In theory, investors should arbitrage any predictable price pattern away. Yet, simple momentum strategies have historically worked (on paper) in nearly every market studied. One plausible explanation is that investors under-react to new information, causing prices to adjust more slowly than they should. For instance, event studies have demonstrated that stocks beating earnings expectations have historically tended to offer excess returns for many weeks after the announcement. Similarly, stocks that miss expectations have tended to continue to underperform.

Investors may also be reluctant to sell losers in the hopes of breaking even and quick to sell winners in order to lock in gains (disposition effect). This behavior could also prevent stock prices from quickly adjusting to new information. Once a trend is established, investors may pile into a trade or extrapolate recent results too far into the future, pushing prices away from their fair values, which may contribute to the long-term reversals underlying the value effect (the tendency for stocks trading at low valuations to outperform).

While momentum strategies have a good long-term record, they may struggle during periods of high volatility or market reversals, as relative performance is less likely to persist during those periods. As a result, the fund can underperform when it is most painful. For instance, its benchmark lagged the MSCI USA Index by 3.8 percentage points during 2008. Heading into a bear market, momentum strategies tend to have an overweighting in riskier stocks, which may underperform during a correction. After a market downturn, they tend to load up on defensive stocks, and they may miss out on some of the upside during a sharp recovery.

To improve performance when volatility spikes, the fund's benchmark rebalances in between the scheduled reconstitution dates if market volatility significantly increases. When this rebalancing is triggered, the index focuses on more-recent momentum to construct the portfolio. This adjustment may help, but the fund will likely still struggle during periods of high market volatility. There is also a risk that momentum may become less profitable as more investors attempt to take advantage of it. That said, the momentum effect hasn't gone away even though it was first published in the academic literature in 1993. Like any strategy, momentum can underperform for years. This risk may limit arbitrage and allow momentum to persist.

The fund's moderate style tilt takes some juice out of the strategy. However, it still captures the essence of the style at a lower cost than if it pursued a more aggressive rebalancing approach. It has a good chance of beating the market if momentum continues to pay off. But even if momentum doesn't pan out, the fund's low expense ratio doesn't hurt performance much.

The portfolio includes around 120 names, including Microsoft MSFT, Netflix NFLX, and Bank of America BAC. The composition of the portfolio and its sector weightings can change dramatically over time. Relative to the Russell 1000 Growth Index, the fund currently has greater exposure to the financial-services sector and less exposure to technology and healthcare stocks. There are no limits on the fund's sector tilts.

Portfolio Construction

The fund tracks the MSCI USA Momentum Index, which draws stocks from the large- and mid-cap-oriented MSCI USA Index. This strategy captures momentum in a cost-efficient way, supporting the Positive Process Pillar rating. In May and November, MSCI calculates the ratio of each stock's price returns over the past 13 and seven months (excluding the most recent one) to its volatility over the past three years. The one-month exclusion addresses the tendency for performance to reverse over that horizon. The index averages these two scores and selects the highest-scoring stocks until it reaches a fixed target number of stocks. To reduce turnover, new constituents must rank in the top half of the index's target number of securities to get priority over stocks that were previously in the index. Stocks already in the index only have to rank within 1.5 times the target number of securities to remain in the index. Holdings are weighted according to both the strength of their risk-adjusted momentum and their market cap, subject to a 5% cap. In addition to the scheduled semiannual reconstitution, MSCI may do an off-cycle rebalance of the index when the month-over-month change in the trailing three-month volatility of the market is larger than the 95th percentile of such monthly changes historically. When this occurs, the index only uses each stock's seven-month risk-adjusted momentum score.

Fees

The fund's 0.15% expense ratio makes it a bargain, giving it a very low cost hurdle to overcome. Therefore, it earns a Positive Price Pillar rating. Over the trailing three years through March 2018, the fund lagged its benchmark by 22 basis points annually.

PRDSX - Morningstar's chart shows this OEF's performance, along with that of its Category Peers (orange line), and the S&P 500 (green line), since its current portfolio manager, Sudhir Nanda, took over.

A proven process coupled with a superb record and low fees make this an excellent small-cap option.

by Linda Abu Mushrefova
06/18/2018

Quantitatively driven T. Rowe Price QM U.S. Small-Cap Growth Equity is an excellent option for investors seeking low-priced exposure to the MSCI U.S. Small Cap Growth Index. Portfolio manager Sudhir Nanda has been a member of T. Rowe's quantitative equity group since 2000. He brings a wealth of experience to the strategy and is further supported by nine quantitative analysts and a five-member dedicated IT team. The team is expected to grow in the near term as it has taken on additional responsibility. Additionally, T. Rowe's group of fundamental analysts can be used as needed. Resources are sufficient at this strategy and have scaled well in response to a growing product lineup.

The strategy uses a disciplined approach that systematically ranks names within the fund's investable universe based on three broad metrics: valuation, profitability coupled with capital allocation and earnings quality, and momentum. Valuation accounts for 40%-45% of the score, quality 35%-40%, and the remainder in momentum.

Given the relatively low emphasis on momentum, the fund's resulting turnover is well below the small-growth Morningstar Category peer average, which is a positive for investors. Further, the team typically invests in about 300 names. The diverse portfolio, coupled with a low-turnover approach, afford this strategy greater capacity than its typical peer.

The fund has been remarkably consistent from October 2006 through March 2018. It outperforms its peers 100% of the time based on rolling three-, five-, and 10-year returns. The team's ability to outperform on an absolute basis while taking on less risk than its bogies can be attributed to their thoughtful approach. Specifically, security selection has driven performance, and the disciplined portfolio construction process has helped keep risk in check.

Finally, fees are low, which means the team faces a lower hurdle to produce alpha for investors. For investors seeking small-cap exposure, this is a great option that we expect will continue to deliver over the long term; it is deservedly upgraded to a Morningstar Analyst Rating of Gold.

Process Pillar: Positive

A quantitative model that has been in place since manager Sudhir Nanda came aboard in 2006 drives this strategy. It gives the heaviest weighting to valuation, which accounts for 40%-45% of a stock's ranking, and likes to value companies on cash flow, as Nanda has found that to be the most stable and efficacious measure. The next-largest weighting, at 30%-35%, goes to earnings quality and profitability and capital allocation, which seeks to identify names with high return on equity, companies that are buying back stock or have a solid dividend policy, and where cash flow exceeds income. Price momentum also figures in the models, but it's the smallest piece; that results in low turnover relative to peers, somewhat atypical for a quant strategy. Their disciplined approach earns a Positive Process Pillar rating.

The model output is a weighted average rank of 1-10. Names that rank 1-4 are bought, and those scoring 7-10 are sold. The team can override the model, but this is not the norm. In addition to the model, Nanda can also source T. Rowe's fundamental analysts when the models rank two similar stocks similarly. He also seeks their help within biotech, as the models don't work as well in this space. The team invests in about 300 names ensuring diversification, and its approach affords it higher capacity than its typical peer. The team stays fully invested.

The team ensures that sector bets are kept to a minimum relative to the MSCI U.S. Small Cap Growth Index, but it's not an index-hugger. Security selection drives performance for this strategy, and single-name risk is minimal given the fund's 300 holding portfolio. The maximum position size for a single name is 1%, and position sizing is determined by a combination of alpha potential, risk of the stock, and benchmark weighting. The team does not use an optimizer for this strategy, so portfolio construction is more qualitative in nature.

Sudhir Nanda likes to enter into a position gradually, typically initiating a position at 5-10 basis points and subsequently adding 1 or 2 basis points at a time. The sell discipline is similar, but the team will sell positions outright if required to by an extraordinary event. The goal is to account for less than 7% of average daily trading volume.

If a name is set to leave the fund's index, the team does not typically exit the position immediately. Either the name has become a value stock or has grown into a mid-cap. If it has become a value stock, the team will continue to hold it if it still scores well. If it has become a mid-cap, the team will hold on to it if it is still attractive but will no longer add to the position. The team tends to hold on to its winners and has a slightly higher average market cap than the benchmark as a result.

Performance Pillar: Positive

Since Sudhir Nanda took over the strategy in October 2006, it has topped its small-growth category peers and its MSCI U.S. Small Cap Growth Index benchmark with remarkable consistency. For example, it bests peers over rolling three-, five-, and 10-year periods 100% of the time. For the same time periods it tops its benchmark 89%, 95%, and 100% of the time, respectively. It has delivered superior absolute performance while taking on relatively less risk than its bogies and earns a Positive Performance rating.

The managers' disciplined approach ensures that sector bets are kept to a minimum and that performance is consistently driven by security selection. Their diversified portfolio of more than 300 names ensures that risk is spread out. Their below-average risk taking contributes to their impressive risk-adjusted performance, which has landed the fund in the top quintile of its category over the trailing five- and 10-year time periods.

While long-term performance has been stellar, the fund may lag in frothier markets owing to its quality and valuation bias. For example, the fund has lagged peers over the trailing one- and two-year periods. While it may sacrifice some of the upside, it more than makes up for this with its downside protection. Overall, this is a great relatively low-risk option in the small-cap space.

People Pillar: Positive

Sudhir Nanda became the lead manager here in October 2006 and has delivered for investors during his tenure. He also serves as the head of the quantitative equity team at T. Rowe Price. He has been with the firm, specifically as a member of the quantitative team, since 2000. Prior to joining, he was an assistant professor of finance at Penn State University, Harrisburg. He brings a wealth of experience to the strategy, earning it a Positive People rating.

In addition to Nanda, the team consists of nine quantitative analysts, one portfolio specialist, and a five-person dedicated IT team that helps to maintain and support the model that drives this team’s strategies. The analyst team continues to expand as they have taken on additional responsibilities with another analyst slated to join in the upcoming months. Additional resources have been added at a moderate pace as a result of new product launches. For example, as of June 2017, Sudhir Nanda, Prashant Jeyaganesh, and Vinit Agrawal have assumed portfolio management responsibilities for T. Rowe Price QM U.S. Small & Mid-Cap Core Equity TQSMX. That's a lot of new responsibility, but Nanda says the team has been building models for similar strategies for years in the course of doing quant work for T. Rowe's fundamental portfolio managers, and the team is able to scale its work efficiently. Nanda invests $100,001-$500,000 in this fund.

Parent Pillar: Positive | 04/06/2017

T. Rowe Price is evolving but retains the strong research-focused culture that's driven its long-term success. Despite the retirements of some long-tenured portfolio managers, the former CEO, and outgoing CIO Brian Rogers, the firm's careful focus on succession planning and long transition periods have eased the process. Even with a changing of the guard, there's no lack of talent. Successful former portfolio manager Rob Sharps is now co-head of global equities and oversees five CIOs who are among the firm's top managers. The analyst team is on solid footing, and the firm has continued hiring despite the pressures facing active managers. CEO Bill Stromberg, who joined T. Rowe in 1987 as an analyst, maintains an investment focus while recognizing that the business must evolve to flourish in an industry that's gravitated toward passive investing. The firm is bolstering its technology resources and is expanding its distribution overseas, achievable goals given its pristine balance sheet. ... T. Rowe is sensibly adapting, and its fundholder-first mentality and ability to attract and retain investment talent support its Positive Parent rating.

Price Pillar: Positive

This small-cap offering is priced very attractively relative to peers, earning it a Positive Price rating.

The no-load shares account for about 71% of assets and rank in the top quintile of similarly distributed peers. Its prospectus net expense ratio of 0.81% falls well below peers’ median of 1.17%. The remaining two share classes, which were launched in 2016, also fall below average. The Adv and I share classes charge 1.04% and 0.66%, respectively. The Adv share class accounts for less than 0.5% of assets, with the remainder in the I share class. (HCM always attempts to get our clients into the Institutional shares with their lower management fee when possible.) Investors seeking small-cap exposure should consider this low-cost option.

SMLF - From "For Factor Investors, It Pays to Go Small" by Morningstar's Alex Bryan, CFA on 12-6-17: "For those who do want to profit from momentum in the small-cap arena, it would probably be best to get that exposure through a multifactor fund, like iShares Edge MSCI Multifactor USA Small-Cap ETF (SMLF) (0.30% expense ratio). This is because 1) it will have lower turnover than a stand-alone momentum fund, and 2) it should better diversify risk. This fund targets small-cap stocks with strong value, momentum, quality, and small size characteristics under constraints that mitigate sector bets and turnover. Its holistic approach and demanding selection criteria should give it potent exposure to the factors it targets."

We have added the Russell 2000 (orange line), the most widely followed benchmark for Small-Cap stocks, and the S&P 500 (green line) to Morningstar's chart for comparison:

SMMV - captures the Low Volatility Factor among Domestic Small-Cap Stocks. We have again added the Russell 2000 (orange line), and the S&P 500 (green line) to Morningstar's chart. While the Russell 2000 has slightly outperformed SMMV since its inception, it has done so with significantly higher risk, with SMMV having a **Risk** ratio of 0.7 relative to the S&P 500.

ISCF - The iShares Edge MSCI Multifactor Intl Small-Cap ETF seeks to track the investment results of an index composed of global developed market small-capitalization stocks, excluding the U.S., that have favorable exposure to the Value, Quality, and Momentum Factors. We have added EFA, iShares MSCI EAFE ETF, which is the largest non-U.S. developed market ETF, to Morningstar's chart for comparison:

GPIIX - We have been using Grandeur Peak's International Opportunities Fund for International Small-Cap exposure almost since its inception in 2011, and were responsible for getting E*Trade to offer this OEF. While it is hard Closed to all investors, HCM was granted a waiver. Morningstar's chart compares its performance (blue line) to its Peers (orange line), and benchmark (green line):