

ABR Dynamic Funds' Series on Stagnation Solutions: Part 5

Equity Factors

Preface

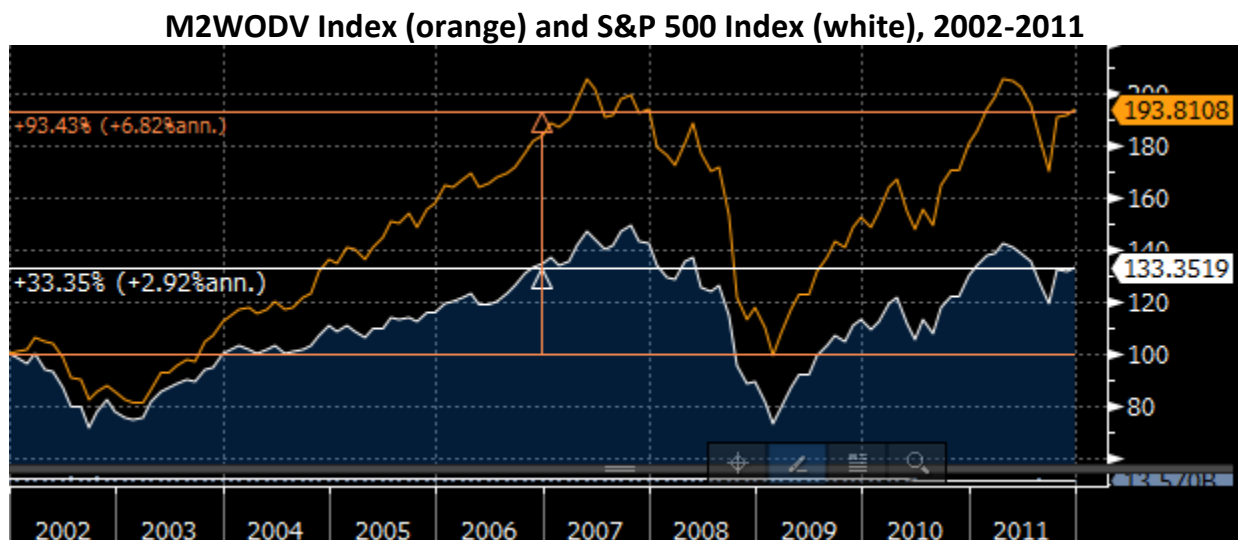
In the first installment, we noted that, at the time this series was written, the S&P 500 Shiller cyclically-adjusted price to earnings ratio (CAPE) was approximately 30 (of course, that can change quickly), and that value has historically indicated a next 10-year annualized return for the S&P 500 of about 3%. The last time the S&P 500 Shiller CAPE was about 30 was near the beginning of 2002. Over the next decade (2002-2011), the S&P 500 annualized return was 2.9%. Therefore, we have chosen that 10-year period to illustrate the equity replacement possibilities throughout this series. That choice reflects neither (1) a prediction that the next 10 years will play out just like the decade from 2002-2011, nor (2) a belief that the Shiller CAPE's forecasts are quite that accurate over time.

Factors

There are a select few equity "factors" which have shown outperformance over long in-sample backtests and also achieved outperformance in out-sample tests and realized results. Investors who are convinced that a factor (or factors) works over the long-term may consider a long-only (or net long) equity factor exposure.

The MSCI USA Diversified Multi-Factor Index (M2WODV Index) uses systematic exposure to the value, momentum, quality, and size factors. As with all the other choices in this series, it was selected simply for illustration purposes, in part due to its systematic nature and published methodology, not as any sort of endorsement.

The following graph shows the M2WODV Index and the S&P 500 Index over the decade from 2002-2011, for reasons covered in the preface. **As the graph shows, M2WODV Index meaningfully outperformed the S&P 500, producing a 6.82% annualized return over this decade (vs. the now familiar 2.92% for the S&P 500 Index).**



Source: Bloomberg

Additional Observations

- Even if factors work over the long-term, a decade is not the long-term. Factors have had 10-year periods of underperformance in the past. In fact, this same M2WODV Index has performed almost the same as the S&P 500 Index over the most recent 10 years.
- Deciding which factors to use is just the beginning. There are numerous ways to implement factors that affect investor results. Just a few examples include: attempts to avoid value traps; attempts to avoid momentum crashes; and combinations of factors, especially those that are negatively correlated to one another.
- It may be important to consider factors net of all costs, as they have higher turnover than market-capitalization indices.
- Factor implementation may, but does not always, include tax considerations. Factors which are implemented in separately managed accounts have shown the potential to harvest short-term capital losses which may then be used to offset short-term capital gains in other investments. This does not constitute tax advice; consult factor managers and tax professionals to learn about this possibility.
- U.S. equity replacements (such as many long-only or net long factor strategies) that are selected in part for risk/return profiles that have been similar to the S&P 500 should not be mistaken for significantly diversifying allocations. We've called them replacements, after all.

Next Week's Preview: The next installment will pivot from possible S&P 500 replacements (which have historically generated return profiles similar to the S&P 500) to possible S&P 500 complements (which have historically generated significantly diversifying return profiles).

Notes/Disclosures

Some of the indices may contain some hypothetical results. There are inherent limitations to hypothetical results. Past performance does not guarantee future results. No index presented in this installment is representative of any strategy at ABR Dynamic Funds, LLC. It is not possible to invest directly in an index. The information presented in this installment does not constitute a complete analysis of any index or strategy, and this installment contains no recommendation to buy, sell, or hold any investment. All data was obtained from sources believed to be accurate; however, ABR Dynamic Funds, LLC cannot and does not guarantee the accuracy of such data.