IMPERIUM CAPITAL

momentum

Weekly Digest

Factor timing to do or not to do?

8 April 2019

– *Jernej Bukovec, CFA*

There has been lots of debate in recent years on the subject of factor timing and whether investors should attempt to time the allocation to certain factors to maximise potential returns or otherwise take a more static approach to factor allocations.

First, let me explain what I mean by factors. Factors are strategies that select securities based on characteristics that have proven to be associated with higher investment returns, such as; company valuation ratios, profitability, margins, beta and price performance. Some well-known factor strategies are value, momentum, quality, low-risk and size to name a few. For example, investing in a momentum strategy involves buying stocks that have recently performed well with the belief they should continue to do well.

Looking at the performance history of each factor we can observe that each of them offers a premium return above the market over the long-term, but in the short-term, the returns can be volatile. Each factor endures periods of significant underperformance which can sometimes last for many years. Fortunatley, factors have low corelations to each others and as one performs badly there are others that do well. Given that, many investment practitioners try to find the "holy grail" of factor investing: a market signal that would enable them to time the factor exposure and avoid periods of significant drawdown. But do such timing signals exist and if so then how reliable are they?

There are two schools of thought among academics. The first believes that factor timing is possible, although difficult and it should be part of everyone's investment process at least in moderation. One popular approach to factor timing is to estimate the relative valuation between different factors. Another is to link the specific factor performance to particular stages of the economic or market cycles. For example, the momentum factor is expected to do well in the later stages of the economic cycle while the value factor is expected to do well in periods of economic recovery, which of course requires the ability to predict the economic cycle...

The second group considers factor timing or any other market timing too difficult, and therefore not worth the effort. They point to the limited evidence of the timing signals having reliable predictive power on future returns. Most investors struggle with hindsight bias* and a lack of empirical out-of-sample evidence. Every market cycle is different and just because the value factor did well in the last economic recovery (in-sample), there is no guarantee that the same will happen in the next economic recovery (out-of-sample). Additionally, factors can be out of favour for long periods which makes any valuation measurement less accurate in predicting next year's factor returns.

At Momentum we take a longer-term view to factor allocations. At the margin, we will act as contrarians, meaning we will reduce exposure to factors that have significantly outperformed and reallocate to the under-performing factors. However, we certainly appreciate the difficulty of rotating between factors with precision consistently. As such, we prefer to have strategic levels of exposure to all the aforementioned factors in portfolios with the ultimate aim of building portfolios capable of performing in a wide variety of market environments, which should lead to superior risk-adjusted returns.

* Hindsight bias is when people have a tendency to view events as more predictable than they really are in hindsight

The Marketplace

- UK has requested a further Brexit extension
- Encouraging signs that a US-China trade deal is in sight
- Brent crude prices rallied 2.9%, ending the week at $70.3 per barrel
- Gold ended the week flat at $1291.7 per ounce

Market Focus

US

- US weekly jobless claims fell to 202,000 in the week ending March 30th, reaching a 50-year low
- US non-farm payrolls rose 196,000 in March, rebounding from the previous months low and ahead of expectations of a 177,000 increase. Average hourly earnings rose by 3.2% from the prior year, down from a 3.4% rise in the previous month
- Longer-term bond yields rose over the week, with the US 10-year Treasury yield rising to a two-week high of 2.5%. Notably, the 3-month/10-Year Treasury Yield curve is no longer inverted
- President Trump and Vice Premier Liu He to meet at the White House with the expectation of pushing through a final trade deal
- US equities advanced 2.1% on the week, the benchmark index posted gains for seven consecutive days, driven by the strong performing materials and financials sectors

UK

- The Composite PMI fell to 50 in March from 51.4 in February. The services sector fell below 50, into contractionary territory, to 48.9 for the first time in 2 ½ years
- Parliament has blocked, by a razor thin margin of 313 to 312, a no-deal Brexit. EU leaders will meet to discuss the terms of a possible extension this week, though some countries, notably France have expressed reservations
- UK equities rose 2.4% on the week while UK Gilts fell 1.1%

Europe

- Germany's factory orders plunged the most in a decade during February, falling 4.2% in February from January, and 8.4% from a year earlier. Weaker demand is expected to continue
- Continental European equities rose 2.5% on the week. Encouraging Chinese economic data and optimism over a US-China trade deal continue to outweigh the disappointing regional data in the euro area

Rest of The World

- Japanese equities rallied 2.1% on the week. In terms of data, Japan's unemployment rate fell 0.2% to 2.3% in February
- In China, the Caixin Manufacturing PMI jumped to 50.8 in March, above 49.9 in the previous month
- Improving data and encouraging signals that the yearlong US-China trade war is finally heading towards a deal helped Chinese equities post strong returns, advancing around 5%
- In a reversal of last weeks losses, Turkish stocks rose 5.3%, boosted at the end of the week by the offer from the European Bank for Reconstruction and Development to assist Turkey in dealing with the growing level of nonperforming loans in its banking sector

Past performance is not indicative of future returns.

Source: Bloomberg. Returns in local currency unless otherwise stated.

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Asset Class/Region	Currency	Currency returns			
		Week ending 6 Apr. 2019	Month to date	YTD 2019	12 months
Developed Market Equities					
United States	USD	2.1%	2.1%	15.8%	10.2%
United Kingdom	GBP	2.4%	2.4%	12.0%	7.8%
Continental Europe	EUR	2.5%	2.5%	15.3%	5.3%
Japan	JPY	2.1%	2.1%	10.1%	-3.5%
Asia Pacific (ex Japan)	USD	2.0%	2.0%	13.7%	-1.0%
Australia	AUD	0.0%	0.0%	10.9%	11.5%
Global	USD	2.0%	2.0%	14.8%	5.4%
Emerging markets equities					
Emerging Europe	USD	2.5%	2.5%	10.5%	-5.5%
Emerging Asia	USD	2.3%	2.3%	13.6%	-4.0%
Emerging Latin America	USD	3.2%	3.2%	11.3%	-5.1%
BRICs	USD	2.5%	2.5%	16.9%	-0.2%
MENA countries	USD	2.1%	2.1%	10.1%	9.1%
South Africa	USD	6.2%	6.2%	10.9%	-13.1%
India	USD	0.6%	0.6%	8.5%	7.3%
Global emerging markets	USD	2.6%	2.6%	12.8%	-4.7%
Bonds					
US Treasuries	USD	-0.5%	-0.5%	1.7%	4.3%
US Treasuries (inflation protected)	USD	-0.3%	-0.3%	3.0%	2.8%
US Corporate (investment grade)	USD	-0.2%	-0.2%	4.9%	5.1%
US High Yield	USD	0.5%	0.5%	7.8%	6.2%
UK Gilts	GBP	-1.1%	-1.1%	2.4%	3.7%
UK Corporate (investment grade)	GBP	-0.6%	-0.6%	4.0%	3.8%
Euro Government Bonds	EUR	-0.2%	-0.2%	2.3%	1.9%
Euro Corporate (investment grade)	EUR	0.0%	0.0%	3.2%	2.4%
Euro High Yield	EUR	0.7%	0.7%	6.0%	2.4%
Japanese Government	JPY	-0.5%	-0.5%	1.3%	1.9%
Australian Government	AUD	-0.7%	-0.7%	3.3%	8.0%
Global Government Bonds	USD	-0.7%	-0.7%	1.2%	-0.9%
Global Bonds	USD	-0.5%	-0.5%	1.7%	-0.3%
Global Convertible Bonds	USD	1.2%	1.2%	6.9%	0.2%
Emerging Market Bonds	USD	0.0%	0.0%	6.2%	2.4%

Source: Bloomberg. Past performance is not indicative of future returns

Asset Class/Region	Currency	Currency returns			
		Week ending 6 Apr. 2019	Month to date	YTD 2019	12 months
Property					
US Property Securities	USD	1.1%	1.1%	17.2%	19.9%
Australian Property Securities	AUD	-3.2%	-3.2%	10.3%	15.2%
Asia Property Securities	USD	-0.2%	-0.2%	15.1%	9.0%
Global Property Securities	USD	0.3%	0.3%	14.8%	10.5%
Currencies					
Euro	USD	-0.1%	-0.1%	-2.1%	-8.3%
UK Pound Sterling	USD	0.2%	0.2%	2.1%	-7.0%
Japanese Yen	USD	-0.9%	-0.9%	-1.9%	-3.8%
Australian Dollar	USD	0.0%	0.0%	0.8%	-7.6%
South African Rand	USD	2.4%	2.4%	2.1%	-15.1%
Swiss Franc	USD	-0.5%	-0.5%	-1.7%	-3.7%
Chinese Yuan	USD	-0.1%	-0.1%	2.4%	-5.9%
Commodities & Alternatives					
Commodities	USD	1.8%	1.8%	10.9%	-0.5%
Agricultural Commodities	USD	1.0%	1.0%	-1.1%	-9.9%
Oil	USD	2.9%	2.9%	30.7%	2.9%
Gold	USD	-0.1%	-0.1%	0.8%	-2.5%
Hedge funds	USD	0.1%	0.1%	2.7%	-3.4%

Source: Bloomberg. Past performance is not indicative of future returns

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