The Man and the Machines

Conference Call: Question & Answer Session Transcript

<u>Questions Answered by Michael Goldstein:</u>

- You mentioned retail investors have kept buying bonds even as rates have gone up. What will it take to break this? Will they really just give up on the asset class as rates head towards 3% or will it take a really big shock?

  We think we need rates between 3-3.5% to have a significant impact on retail investor behavior after taking into account where their cost bases lie and their behavior up until this point. A normalization of the term premium in the bond market is probably enough to create a significant shift in sentiment as signs of a more normal economic cycle rears its head. That would be the story that undermines the retail broker's confidence.

- How close do you think we are to the point where capex growth exceeds earnings growth? And historically has that been the inflection point for the market?

  We don't think we are close to that point given it hasn't happened in 7½ years. If it does happen I would think that the corrosive effect on market multiples would take a year or two to develop, given the cash flow dynamics now in place. I don't think it's necessarily the inflection of those two series that's decisive, rather it's the ultimate consequences of the shift that will influence stock behavior.

- On slide 12 you showed GARP stocks are cheap compared to value stocks. Is that relative valuation level consistent with a neutral regime? What does this relationship generally look like in a Growth regime (i.e., I'd expect GARP to trade at a big premium)?

  I think it's a little unusual. Part of what we're documenting here has to do with the multiple expansion in the financials. That they've seen massive expansion and that's why the chart looks as it does. So the market is anticipating that the yield curve will steepen and that the systematically-important companies will benefit from deregulation. So I'd say that this time is atypical because there has been this single dynamic that is captured in this chart.

- A number of questions on slides 15. Any thoughts on the likelihood of yield curve flattening this time around? And if so the degree thereof?

  Well it basically depends on if you think the Fed is on the curve, ahead of the curve or behind it. To think the curve is going to not flatten you have to believe they are behind the curve and that the bond market will figure that out. My view is that they are probably somewhat behind the curve. 8 out of 10 odds would say you should expect flattening but I would expect less of that than during the precedents, having to do with the level of real yields and the absence of the term premium. The behavior of the curve is not the definitive answer on what to do with the financials, rather, it's one thing among many.

- What are the biggest changes you'd make to your models if you officially concluded that Bretton Woods II really was over?

  We'd decrease the emphasis put on the level of free cash flow yield, because some skepticism towards the repeatability of past free cash flows would be warranted, given the margins reached this level because of globalization. We'd also diminish the penalty on capital spending. The market would probably perceive a first-mover advantage to those companies that started spending more, since they could no longer rely on emerging market partners to do most of the heavy lifting for them.

- What are you more worried about: protectionism, the Fed, or self-undermining behaviors from companies and consumers that start over-spending on the prospects for higher nominal growth?

  Protectionism, by a significant margin over the other two. The whole valuation paradigm in equities hinges on the margins in the manufacturing segment of the market, as per slide 22. A threat to those margins, which mostly got to this level in the first place because of globalization, would be a threat to the market's multiple.

Questions Answered by Rocky Cahan:

- Related to your Portfolio Analytics product – are you able to show how managers performed in the context Regime. For example, are you able to show if a growth manager outperformed or underperformed their peer group in value and growth regimes?

  Yes, we can definitely do that, and indeed would recommend it. One thing we've noticed in running Portfolio Analytics for a number of our clients is that knowing what game is being played really matters to performance. The regime indicator is a good way to get a read on where the best odds lie and it seems successful managers are often the ones that show enough flexibility to tilt towards the areas of the market where the odds are advantageous at a particular point in time. Even if you have to stick to a style box, there are still things you can do within that box that can nudge the odds in your favor, as we saw with the example I showed you of the two growth managers.

- You said momentum doesn't work any more for stocks with high passive ownership? What about for stocks with low passive ownership?

  We looked at how momentum performs in each quintile of passive ownership, and in the lowest quintile it has the "right" sign, as in high momentum stocks on average outperform over the next year. But the alpha is pretty weak, which is consistent with our broader work on momentum that shows it's not a great signal any more market-wide. What we found very interesting though was repeating the analysis for stocks with high hedge fund ownership. There we found momentum is still quite powerful. That to us isn't a huge surprise: if the marginal buyer of a stock is a passive product it probably makes sense that the price trend tells us little about the underlying company; but if the buyer is a fundamentally-focused investor than the price trend does still contain some information.

- Do stocks in ETFs with big positive or negative flows outperform or underperform in the short-term?

  We came across an interesting academic paper that finds a reversal effect in the next month, so the ETFs with big share increases, i.e., inflows, in the previous month actually underperform in the next month. And the opposite for those with share declines. That seems to support what we found at the stock-level in our momentum analysis: hot ETFs are more likely to reverse rather than keep going up. We're working on a study on this topic so we'll have more to say on it in the next few weeks.

- If passive investors just chase performance why are the numbers for active managers struggling? Shouldn't they benefit from what amounts to new dumb money?

  Well first, the scorecard for passive products since the middle of last year has been terrible. Because all the passive products they were launched during the big bull market in bonds of course were launched with great price charts at the time but suffered as soon as rates bottomed. So passive products can't exactly claim to be immune from all the travails of active investors. But on the second part of the question, we are starting to see passive-induced distortions, like the momentum effect I just mentioned, that are exploitable by active investors. We're doing more work on this because we do believe there will be opportunities that are created in a world where a lot of investors never trade at the individual stock level.

- What do the big quant funds actually do with Big Data? Is it just a buzzword of does it really work?

  They basically use Big Data to create lots of little alpha signals, that I like to call alpha drones, that might number in the thousands or tens of thousands. For example, to take the clichéd example these days, they might use satellite pictures of retailers' parking lots to predict earnings surprises for a handful of retailers. And then maybe use web scraping to collect online buzz about the latest smart phones to predict sales volume for a handful of phone makers. So instead of the traditional, linear approach where you rank all the stocks in the market on some attribute, say P/E or momentum, you now have all these little signals that apply to a subset of the market. And then you have an overarching model that allocates capital to all those little alpha signals. The problem with trying to suddenly jump on board the Big Data bandwagon is that each signal on it's own might have a hit rate only a shade above 50/50, say 50.1%. So if you just pick a few signals that sound cool you're bound to be disappointed. It works for the big quants because they're flipping those slightly biased coins thousands of times. But if a fundamental manager just picks a few signals and expects them to make a meaningful difference that's probably wistful thinking. You have to go big and go all the way or not at all.