December 5th, 2016

MARKET INSIGHTS

The latest Market Insights
from the Connected Wealth team

Disparity Where Art Thou?

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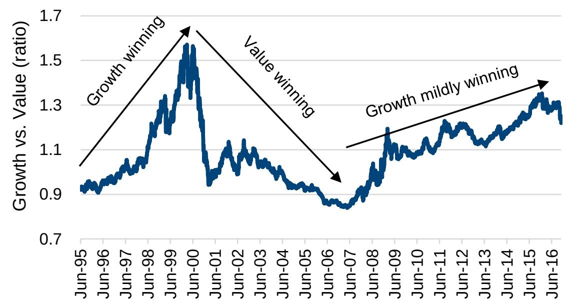
The market is a dynamic ecosystem, or a community if you prefer, with many participants interacting with each other and with the market itself. One trader's or investor's behaviour doesn't change the market, but get more and more behaving in a similar fashion and things change, the market changes. Here is a fun historical example. In the 1960s and early 1970s, it was the rise of the Nifty 50, these were higher growth, high price-to-earnings companies with which the market fell in love and it was said, you just had to buy and hold *em* forever. As more money poured in, more fund managers became 'growth' managers, it also set the stage for the rise of the 'value' manager to dominate for the next two decades. Growth, value, dividend, momentum, regardless of the strategy, increased clustering of capital to one strategy does have a crowding effect, diminishing returns and can create potentially better returns in other less followed disciplines.

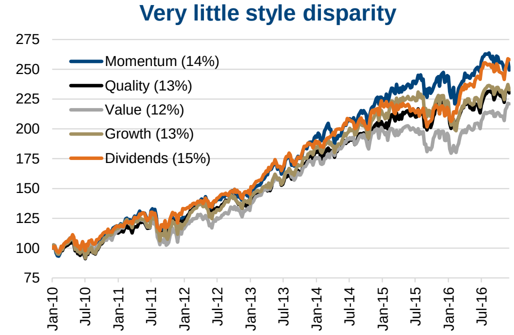
So what is going on today? Growth has been winning, very mildly, over the past half-decade or so (top chart). Even more notable is all styles appear to be rather clustered together since the equity market recovery began in 2009. The 2nd chart is a total return factor index for momentum, quality, value, growth and dividends. We included the compound annual return for each in the legend, and as you can see they are all clustered at 12-15%. We are starting to see some divergence in the past year, but for the most part disparity has been absent.

The same clustering of returns has occurred within the S&P 500 as well. We measure the annual returns of each index constituent and chart the percentage of companies that beat the index by 15% or more, or underperformed by 15% or more. As you can see in the bottom chart, this stock disparity has been very low since 2010.

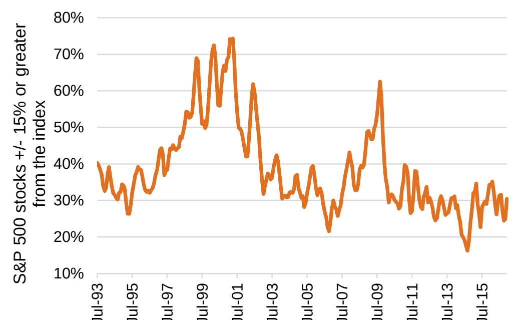
Growth vs. Value



Very little style disparity



Stock Disparity.....still waiting



What is causing this clustering or lack of disparity?

This could be an evolution change in the market, but we don't think so. We do believe there are two primary causes, one which is dissipating and the other continues to strengthen.

Monetary Policy – In all its forms, overnight rate, QE, moral suasion, monetary policy is one of the bluntest tools for impacting the economy and markets. And during this market recovery/advance, monetary policy has been used to the extreme. This helped usher in a macro driven market, where big macro factors have had a bigger impact than individual company fundamentals or news. When Trump defeated Clinton, all financials flew higher. It didn't matter much if they were a regional, money centre or diversified. When Draghi pledged to whatever it takes to save the euro, everything in Europe went up.

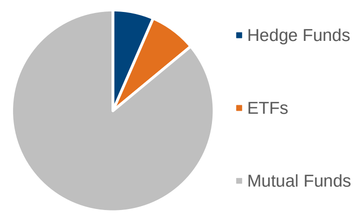
Dominated by the macro, this does contribute a lot to the clustering of returns at the style and company level. Everyone is winning on good macro news, and everyone loses on bad macro news.

However, this macro force on the market is beginning to soften. We now have a U.S. Fed that is tightening and QE in some other jurisdictions is starting to be reduced. Although that could change, the simple divergence between central banks should help loosen the macro's hold on the markets.

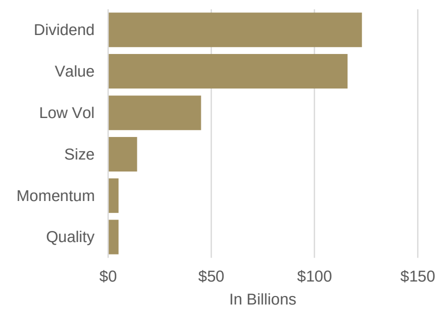
The Rise of Exchange Traded Funds (ETFs) – There is now about $3.4 trillion invested in ETFs, passing hedge funds assets this year but still a fraction of the mutual fund industry which sits at about $40 trillion (top chart). With most ETF assets invested in broader indices, positive flows inherently contribute to less disparity. For instance, if you buy or sell the Dow Diamonds, you are effectively buying the Dow 30 stocks in the same proportion as the index. Which means you are eliciting the same buying or selling across all names. That reduces disparity.

As ETFs continue to grow market share or assets under management, this influence will continue. However, one difference of late has been the rise of smart beta or factor based ETFs. As these are focused on key themes or factors, they can actually drive greater disparity at the style level. Imagine if all investors fell in love with one style, say momentum. As money flowed only to those names in the momentum index, they would rise while others would not. The 2nd chart is the ETF assets by factor, with Dividend and Value remain the most in vogue.

World Still Dominated by Funds



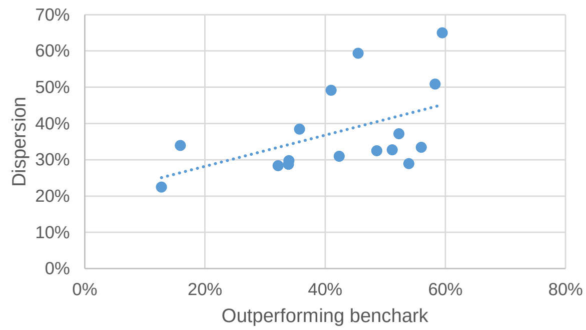
Smart Beta Factor Breakdown



Portfolio Implications

The bad news for active managers is less dispersion in the index makes it harder to outperform. We charted the annual dispersion for the S&P 500 against the number of funds outperforming that benchmark annually. The higher the dispersion, the greater the success in managers beating the index after fees. Now the S&P 500 is one of the harder indices to beat given its well diversified, and there is a ton of talent trying to outperform. That job will continue to remain difficult as long as we continue to have dispersion sub 40% (bottom chart back on page 1). You need the winners to add enough value to overcome the losers plus fees. Low dispersion means the winners are probably not winning by enough.

Dispersion and Active Fund Performance



The good news for active managers is it is very easy to see into which styles the herd money is going. With that, there is opportunity. There are also strategies that focus on less liquid names or companies on the cusp of being added to an index, that can take advantage of this passive money flows.

Active management is not dead, but as the market evolves so must it.

Charts are sourced to Bloomberg unless otherwise noted.