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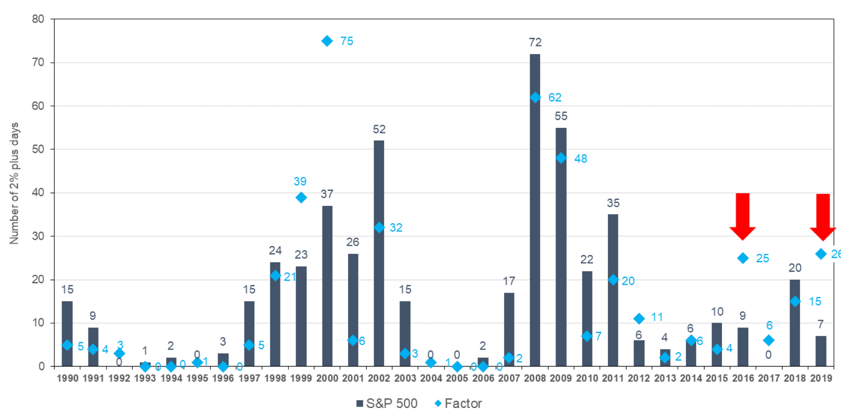
VALUE LOOKING FOR SOME (POSITIVE) MOMENTUM

- *In 2019, sentiment around global trade induced frequent shifts in investors' risk appetite*
- *Very few themes worked*
- *Factor diversification disappeared*

If you had followed the market from afar in 2019, you may have seen a different stock market than those who experienced it daily. While the broader equity market enjoyed relative tranquility on its way to impressive gains, the experience in the factor investing space was far different.

First, market volatility in 2019 was low compared with 2018, as fears over trade, a potential recession and interest rate hikes never fully materialized in overall equity prices. The S&P 500 benchmark had only two months with negative returns—May (-6.6%) and August (-1.8%). Additionally, there were just seven trading sessions in which the index closed up or down more than 2% over the year, well below the historical average (Exhibit 1).

Exhibit 1: Market volatility vs. factor volatility
2% plus move days by calendar year for the S&P 500 Index and factor spreads



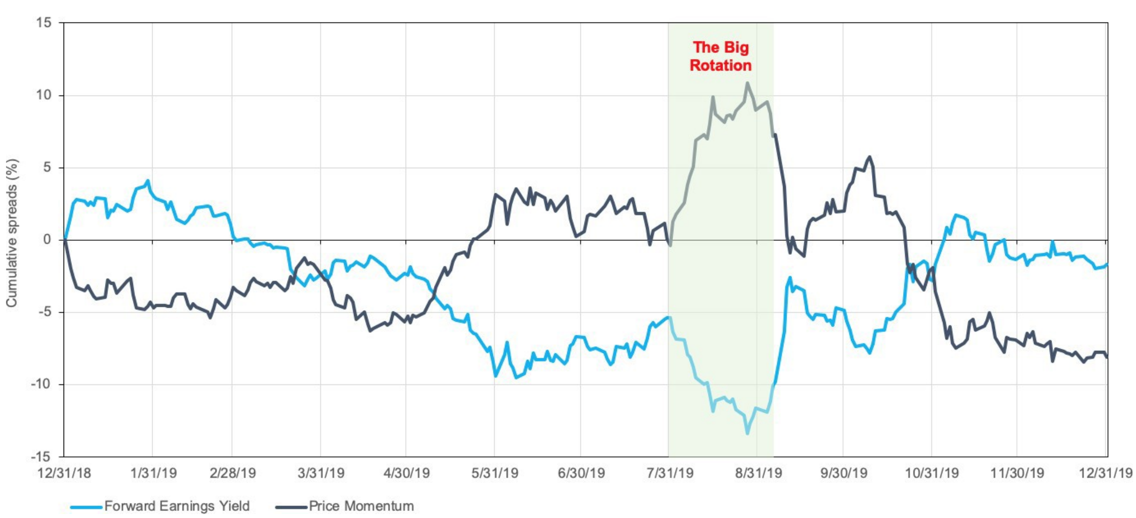
Past performance does not guarantee future results.

Source: Columbia Threadneedle Investments; S&P Global Inc.
Note: S&P 500 universe; GICS Sector neutral; stocks are square root capitalization- weighted; daily returns; daily rebalancing. Volatility is defined as the number of days with +/-2% or bigger moves. Factor represents the number of days the daily return spread difference between the top and bottom quintiles for value compared to momentum strategies exceeded +/-2%. Momentum is treated as the 1-month lagged 11-month stock return; Value is based on forward earnings yield.

Beneath the calm surface of equity market returns, style returns were far more volatile. The most prominent example was the remarkable reversal seen between momentum and value strategies from August to September. Following one of the best months for momentum relative to value in August, September was just as extreme in the other direction. Ultimately, the return differences between momentum and value exceeded 2% on 26 separate occasions throughout the year, more than twice the historical average.

In addition, factor diversity among all equities was lacking. As illustrated in Exhibit 2, the return charts for the price momentum and earnings yield strategies mirror each other. While a negative correlation between these two factors is expected, 2019's correlation of daily returns was -0.88, twice the magnitude of its historical average. This trend was not isolated to these two strategies but was also evident across a large pool of factors. Such an extreme level of correlations likely meant that the same underlying driver—fears over economic uncertainty—was dictating the payoffs of many factors. Therefore, as the returns of any single factor increasingly offsets those of another, the diversification benefits of using multiple factors in portfolio construction diminishes, especially when most of these factors failed to perform in line with historical trends. A simultaneous failure of both price momentum and earnings yield strategies during a rolling 12- month period has only occurred about 5% of the time in the past three decades.

Exhibit 2: Cumulative summed daily quantile spreads within S&P 500 in 2019

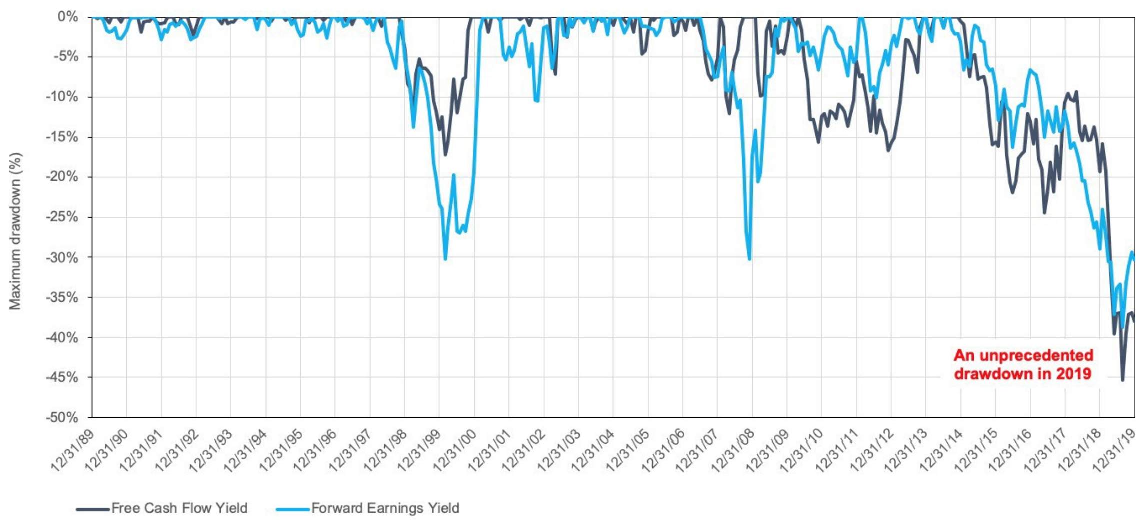


Source: Columbia Threadneedle Investments; S&P Global Inc.
Note: S&P 500 universe; Sector neutral; Factor represents the daily return spread between the top and bottom quintiles. Momentum is treated as the 1-month lagged 11-month stock return; Value is based on forward earnings yield.

Finally, 2019 was the third consecutive year that value stocks lagged their growth counterparts by a wide margin. Over this period, recession fears erupted periodically, crimping investors' appetite for risk. A prevailing thought among investors was that cheap stocks are cheap for a reason, and if the economy weakens, value stocks are in danger of becoming value traps. With this line of thinking, investors tended to favor growth stocks, particularly those companies whose businesses they perceived to be resilient through an economic cycle. This view has taken a toll on strategies that go long the cheapest stocks and short the most expensive, with losses being witnessed on both sides of the trade.

In late August, when the yield curve became inverted (10-year Treasury yield below its 2-year counterpart) for the first time since 2007, investors' fears regarding the inevitability of a recession reached a climax, with cheap stocks underperforming and safe-haven assets flourishing. This led to value factors, such as free cash-flow yield and forward earnings yield suffering an unprecedented level of drawdown (Exhibit 3).

Exhibit 3: Maximum drawdowns for owning cheap stocks (1990-2019)



Source: Columbia Threadneedle Investments; S&P Global.
Note: The maximum drawdown is calculated from the relative performance between the best-performing 20% of stocks in each GICS sector (GICS sector neutral) based on a given factor and the overall universe. Relative performance is defined as the ratio between the compounded returns of the top 20% and that of a buy-and-hold strategy of the full investment universe. A maximum drawdown is the maximum observed loss from a peak to a trough of the relative performance, before a new peak is attained. Free cash flow yield is defined as the trailing 12-month free cash flow divided by enterprise value; Forward earnings yield is defined as forward 12-month earnings per share divided by stock price.

SUMMARY

Global stock markets enjoyed one of the strongest years in memory, extending the longest bull market in history and hitting multiple all-time highs to close the year (and decade). Against this celebratory backdrop, 2019 turned out to be a very difficult year for factor investing. A conjunction of choppy factor returns, a lack of information diversity and record underperformance of cheap stocks created a perfect storm, as investors' risk appetite yo-yoed throughout the year. For factor investing to work there can't be a high level of positive correlation among factors, but neither can there be a high level of negative correlation, such as we saw between value and momentum in 2019.

We can't predict when value factors will reach their shelf clearing price, but that may not even be the point. Quantitative strategies work best when multiple factor approaches work independently and don't undercut the efficacy of individual factor strategies. We believe that 2019 was unusual in that regard and that factor investing will return to more normative outcomes.

Past performance does not guarantee future results.

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