DuPont Capital

EQUITY STRATEGY REVIEW
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US Small Cap, Structured Equities

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Value as an investment framework had a pretty rough go of it in the last decade, but we think today's setup is noteworthy on several fronts.

Exhibit 1 shows the performance of the Russell 2000 Value index ("Value") relative to the Russell 2000 Growth index ("Growth") starting in 2010. When the line is declining, Value is underperforming Growth. Clearly, last decade was not kind, with Value underperforming Growth to the tune of 30%. Surprisingly, Value's underperformance has been a persistent yearly phenomenon. The almost lone exception was 2016, where Value outperformed by 17% (2012 was marginally positive at +2%).

Interestingly, today's setup looks eerily similar to 2016 in the following ways, which could have positive ramifications for value in 2020:

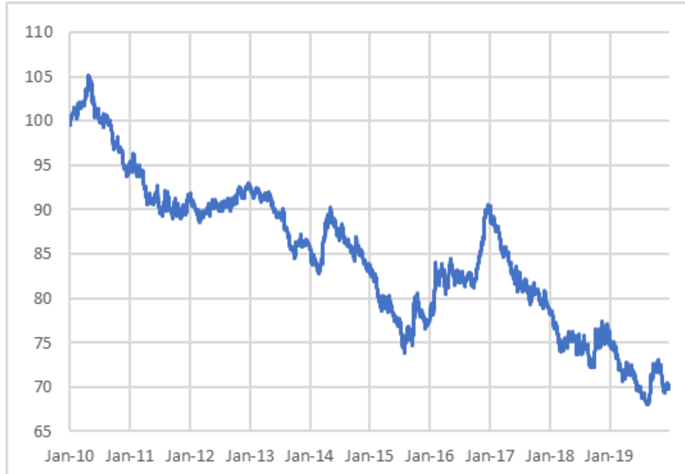
- Going into 2016, Value underperformed Growth by 23% from 2010 to 2015. Since 2017, Value has underperformed by 22%.
- Value bottomed in August of 2015 and somewhat rallied into the end of the year. In 2019, Value bottomed in September and somewhat rallied into the end of the year.

What makes things more interesting are valuations. Last summer we wrote about how cheap the forward earnings-to-price value factor had become. To gauge cheapness, we observed the difference between the 97th percentile and the 3rd percentile of the Russell 2000 forward IBES earnings to price ratio. Our conclusion was that while value looked cheap, we weren't ready to jump in just yet. Exhibit 10 shows an expanded list of factor valuation spreads, giving a broader picture of what we might typically expect comprises value.

Broadly speaking, with roughly 4 of the 5 valuation spreads currently 2+ standard deviations above the mean, value is undeniably cheap. In fact, it's the cheapest its been since 2009 and compares similarly to the 2000 Dot com bubble based upon our data. Most certainly, 2020 sets up cheaper than 2016.

Compounding the return similarities and better valuations versus 2016, the future economic picture is looking similar as well. The Conference Board U.S. Leading Index, typically referred to as the LEI, is a gauge of ten items the Board deems indicative of the future direction of economic growth. Declines in the index foreshadow slower economic growth and vice versa. At the beginning of 2016, the index had been declining for the 17 months prior and bottomed in June 2016. Today, the LEI has been falling for the last 15 months, and we similarly expect it to bottom in the first half of 2020.

Exhibit 1: Value Relative to Growth



Represents the Russell 2000 Value Index relative to the Russell 2000 Growth Index
Source: Bloomberg, Russell

Exhibit 2: Factor Valuation Spreads

	Beginning of 2016	End of 2019
Forward P/E	2.3	2.5
Trailing P/E	1.7	2.5
Book/Price	0.7	1.9
Cashflow/Price	0.4	2.0
Dividend/Price	1.4	0.7

Represents the number of standard deviations from the historical 110 year mean spread.
Source: DuPont Capital

Despite these parallels, there are some dissimilarities that must be factored into the equation. First, the Russell 2000 index sold off 10% in 2H15 while rising 6% in 2H19. Second, economic activity was much weaker in 2015 with 4Q15 GDP growing only 0.1% versus 2.1% in 3Q19 (in real terms). Third, the Fed was much more accommodative in 2016. The Fed funds rate averaged around 40 bps during 2016 while today the rate stands at 155 bps with the futures market forecasting one cut over the next year.

All told, value as a style typically works when valuations are inexpensive, and the market is recovering from a period of economic worry. We believe we may be entering an environment similar to 2016 that was conducive to better returns from value. Value's underperformance and historically low valuations set up well, but we temper our excitement given the macro and economic backdrop doesn't seem to have as much "fuel" as in 2016. From a positioning standpoint, our small cap quantitative process currently is overweight value relative to our long-term factor allocation model we recently employed.

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DuPont Capital's President and CEO, Valerie Sill believes in education and diversity of experience as represented in our investment teams which are comprised of PhDs, engineers, medical doctors, and scientists. We believe their global expertise creates a portfolio implementation edge that benefits our clients.

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