EQUITY STRATEGY REVIEW
JULY 2020

US Small Cap, Structured Equities

Caleb Piper, CFA, Portfolio Manager and Senior Investment Analyst

The modus operandi for a quant investor is capturing factor premia. Just as hunters study their prey - observing movement, feeding habits, and other patterns of behavior - we seek to understand and gain insight into trends in factor premia, pivoting into areas of the market where we believe factor premia to be most easily captured. One of the fundamental ways we try to achieve this is by tracking daily factor returns, looking to gain insight from historical trends as they develop through time. However, individual factor premia can behave very idiosyncratically, which makes interpretation and prediction tricky. To overcome this, we aggregate factor premia into groups where they tend to perform in a more predictable fashion. Exhibit 1 shows returns for factor groups for the Russell 2000 during the first and second quarter.

As background, the Russell 2000 fell -31% in 1Q20 and gained 23% in 2Q20 to close the first half of the year down -15%. A similar market pattern was observed in 2009, 2012, and most recently 2016. Comparing recent factor behavior to these prior periods, we find the results tend to be pretty predictable. Quality factors, for example, increased 5.8% relative to the market in 1Q20 as market participants chased more profitable companies with stable margins and low leverage. Quality then underperformed the market by 10.3% in 2Q20 as investors shifted into the beaten-up companies in a risk-on environment backstopped by large liquidity injections from the Federal Reserve. This is simply a repeat of history and makes sense to us. The same can be said for the Momentum and Sentiment factor groups.

On the other hand, Value factor performance has been confounding to the point that we have asked - at what point does the hunt for value premia become too illusive to pursue?

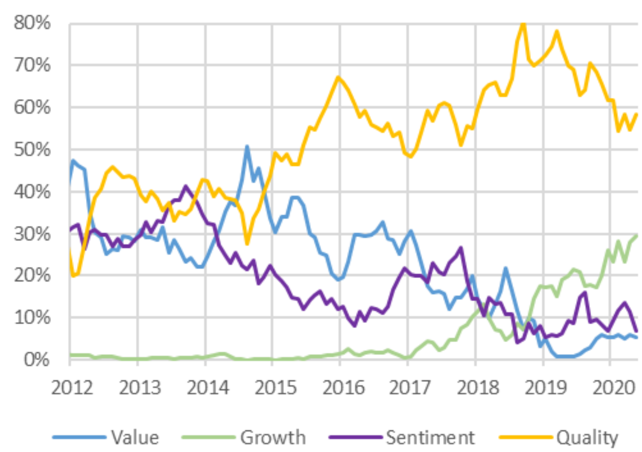
In our 1Q20 update, we noted how over-extended the value premia had become with the valuation spread for Value factors reaching near historic highs in the market downdraft (the spread has only been higher twice in the last 100 years). Past observations would strongly suggest that Value would outperform in a market rebound. However, while Value did rally early in the recovery, it ended up reversing course and actually performed worse in the rebound than it did in the downdraft. Plainly put, this disturbed us greatly.

Most market followers are aware of the trouble the value premia has encountered over the last 10-15 years. As a student of financial history, it is not easy to abandon a premia with such an established long term track record. But the world of Fed intervention via quantitative easing and low/falling growth rates seems to have changed the game for Value.

Exhibit 1: Year-to-Date Factor Premia

Source: Bloomberg, DuPont Capital

Exhibit 2: Factor Allocation Benchmarking Model—Short Term Component



Source: DuPont Capital

To help us better assess the factor landscape, we recently developed a factor allocation benchmarking model. The model relies on historical trends, but has a short-term component allowing for greater sensitivity to current trends in factor premia behavior (Exhibit 2). The short-term component currently suggests a 5% weight to Value, which essentially agrees with the premise that Value is becoming almost too illusive to bother pursuing.

With respect to the US Small Cap Portfolio, we moved our Value allocation closer to the short-term model view during 1Q20. However, beginning in 2Q20, we increased Value back inline with what the longer-term component would suggest, hoping to catch an uplift from the market rebound. Unfortunately, as detailed above, the hunt was unsuccessful, and we fully expect to reduce our value weight going forward.

One Righter Parkway • Suite 3200 • Wilmington, DE 19803 • (302) 477-6000

ABOUT OUR FIRM:

DuPont Capital Management is an SEC registered investment advisor based in Wilmington, Delaware. Since the firm's establishment in 1993, we've had a long history of developing global investment opportunities in both traditional and alternative strategies across equity, fixed income and alternative investments. Our investment team structure gives us the ability to be flexible and adapt to changing market conditions. DuPont Capital's focus is delivering consistent investment management results for our clients. Our history of institutional asset management is rooted back to 1942 when our former parent company, DuPont, established a pension plan for its employees. Corteva Inc. succeeded DuPont as sponsor of the DuPont Pension Plan in 2019. DuPont Capital is a wholly owned subsidiary of Corteva and continues to manage the legacy DuPont Pension Plan.

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.

For additional information, please contact:

Mr. William Smith
Managing Director
Business Development and Client Service
(302) 477-6204
Bill.Smith@dupontcapital.com

IMPORTANT DISCLOSURES: