US Small Cap, Structured Equities

Caleb Piper, CFA, Portfolio Manager and Senior Investment Analyst

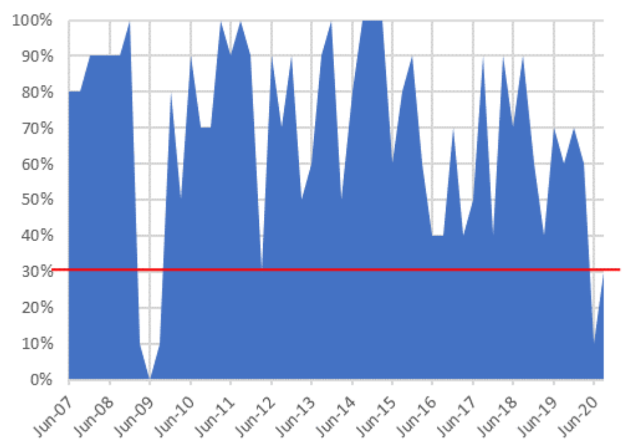
Life's experiences have taught me numerous lessons over the years, one of which is to try and always buy quality. This lesson is reinforced every time I go to my grill. Being born in Australia, I love to grill (though I've never thrown a "shrimp on the barbie"). After going through several cheap, inexpensive grill experiences, my wife convinced me to bypass the illusion of cheapness and purchase something that will last, something that I will enjoy. While I still vividly remember the initial pain of forking over that original purchase price, 8 years later the grill is still going strong and I have enjoyed every moment of its existence.

Investing is no different - it pays to buy quality. Which is why quality factors comprise almost 60% of our small cap multifactor model and are by far the largest family of factors we employ in our strategy. And it's a very diverse "family". We have factors that measure returns, whether that be cashflow returns, returns on investment, equity, and asset returns. We have profitability measures, whether that be asset adjusted profit measures or different profit margin measures. We have stability measures that look at the volatility in revenues, margins, and profits. We have balance sheet measures that assess the stability of accruals, and changes in asset levels. All these combine to give a mosaic assessment of a stock's quality and result in a portfolio that is biased to quality companies.

One of the most attractive features of this family of factors is their consistency. Quality is the only factor family in our model that has a factor hit rate above 60%. Stealing an analogy from baseball, its like the guy who bats an amazing 0.450 but has never hit more than a double. That's Quality. It will never hit those big returns, but it will be there consistently month in and month out feeding alpha to the portfolio. And that is why the last few quarters have been so unique because Quality hasn't worked.

One way to measure factor performance is to rank the universe by the factor and compute the return spread between a basket of the top 20% of stocks versus the bottom 20%. Exhibit 1 shows the percentage of factors within the Quality family that outperformed on a quarterly basis using this method, with the red line depicting the most recent quarter at 30%. As can be seen, this is a rare strike out and only occurs in 2 prior periods. One briefly in 2012 after the market rebounded from the European banking crisis and the other following the 2008 global financial crisis.

Exhibit 1: Percentage of Quality Factors Outperforming



Source: Bloomberg, Russell, DuPont Capital

As mentioned, each of these occurrences followed sharp market declines. The subsequent rallies typify high risk taking by investors, where companies that were oversold during the market downdraft are embraced again. This phenomenon is usually short lived. As history indicates, in quarters following poor performance, 80-90% of Quality factors typically outperform in subsequent periods. We expect the same this go around, and as such, we will likely be increasing our weight towards quality factors within our multifactor model framework in the near future.

One thing we would note that is different this time is Value. Value is usually the antithesis of Quality. During both market rebounds discussed above, where Quality factors failed, more than 70% of the Value factors outperformed. This time it was around 35%! Despite this, the price recovery has been one of the sharpest in the history of the index, largely led by Growth. Something is indeed different this time! As a side note, if you have been readers of our past commentaries, you would be excused if you thought we were value haters – we are not. We are data driven investors and unfortunately value just keeps serving up horrible data points.

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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

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