EQUITY STRATEGY REVIEW
JULY 2021

US Small Cap, Structured Equities

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Life always finds ways to humble you. When I was in high school, I couldn't understand the appeal of debating. I was a numbers guy. Debate was for book worms, nerds, or people that just wanted to be argumentative I thought. Now that I'm a little older, wiser, and a parent of eight wonderful children what do I do? Put them in a debate league of course! I divulge this because we currently find ourselves in the midst of an important debate within our factor allocation framework - when will the value rally come to an end?

As discussed last quarter, we find it more informative to split the Value factors into three subgroups – Asset Value, Earnings Value and Cashflow Value. Performance of the three has been telling. Since the market low in March 2020, the long short spread for Asset Value has returned an impressive 41.2% compared to down -13.4% and -6.1% for the other two respectively. Since Asset Value has been the driver of the recent value rally, we suspect identifying potential clues to its demise might help us settle our debate.

Of the three subgroups, Asset Value is, by far, the most cyclical in nature. This is interesting because one of the most notable attributes of the market rebound has been Beta's outperformance (beta has evolved into a good indicator of a stocks cyclicality). This behavior is not atypical as Beta tends to outperform following periods of weakness (the more severe the weakness, the stronger the outperformance). This time around is no exception with Beta's long short spread up 118% since last year's low.

We scoured history for other periods of outperformance to look for any clues that might foreshadow the value rally's expiry. We identified 5 periods in the last 15 years where Beta's rolling 6-month performance was up double digits (a low bar, but high beta stocks generally underperform the market). Each period followed a fairly significant market downdraft [Exhibit 1]. Significantly, Asset Value showed positive relative performance in each period.

The post-2008 Global Financial Crisis period best mirrors the current Beta rally in terms of duration but differs in terms of performance and structure. The magnitude of the current rally is far less than that of 2009 (+118% versus +180%). Beta also initially exploded post-GFC with nearly three quarters of the outperformance accruing in the first 7 months, while the back half was more subdued. Today's rally took longer to get going with the bulk of outperformance generated in the second half of the period. Other identified periods were shorter in duration, though performance tended to be front-loaded as in '08, suggesting Beta rallies typically come in with a bang and go out with a whimper.

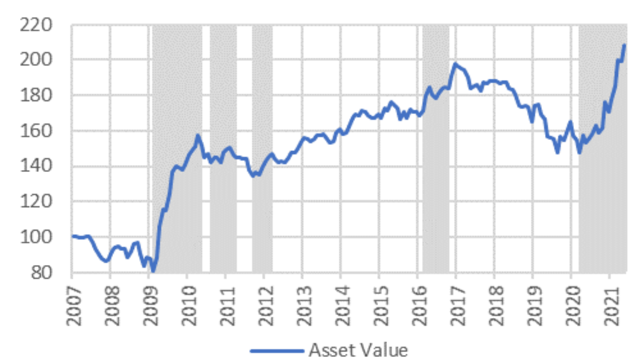
The implications for Asset Value are more muddied. While the factor outperformed in all identified Beta rallies, the structure was as discussed above in only three of five periods (i.e. concentrated in first half). While this makes it difficult to come to any substantive conclusion about the magnitude of future performance, it does suggest some degree of longevity remains.

Exhibit 1: Periods of Beta Outperformance

Prior Market Action	Beta Outperformance Start	Beta Outperformance End	Period Duration	Factor Returns Beta	Factor Returns Asset Value
2008 Global Financial Crisis	03/01/09	04/30/10	14	180%	94%
2010 Double Dip Fears	09/01/10	03/31/11	7	22%	3%
2011 European Banking Crisis	10/01/11	02/29/12	5	20%	7%
2015 China Growth Scare	03/01/16	09/30/16	7	26%	8%
2020 Covid-19 Selloff	04/01/20	05/31/21	14	118%	41%

Source: DuPont Capital, Barra

Exhibit 2: Asset Value Historical Performance



Source: DuPont Capital, Barra

One thing I learned from judging my children's debate league is debate outcomes are rarely conclusive. For Beta, it seems like we should wait for the whimper before declaring the rally's end. This would imply continued outperformance of Asset Value for a short while. But then what? That is inconclusive too. Exhibit 2 shows historical performance of Asset Value's long short spread, with Beta rallies shaded in grey. Of the four previous post-Beta rally periods, three showed subsequent underperformance (two short in duration) while the post-2012 rally showed a sustained leg of outperformance. We suspect that given the velocity of the rally to date, we are likely to experience a period of prolonged weakness, leading us to begin scaling out of Asset Value factor components in our multi factor allocation process. As always, time will tell.

As they say, its darkest just before dawn. The investment environment, as laid out above, is extreme. But extremes aren't usually sustained for very long. We believe this to be the case and expect better things for quantitative strategies in 2021.

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DUPONT CAPITAL

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ABOUT OUR FIRM:

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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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