Value Your Wealth - Part Six: Fundamental Factors

In this final article of our *Value Your Wealth* Series we explore four more fundamental factors. The first four articles in the Series researched what are deemed to be the two most important fundamental factors governing relative stock performance - the trade-off between growth and value. In Part Five, we explored how returns fared over time based on companies market cap. Thus far, we have learned that leaning towards value over growth and smaller market caps is historically an investment style that generates positive alpha. However, there are periods such as now, when these trends fail investors.

The last ten years has generally bucked long-standing trends in many factor/return relationships. This doesn?t mean these factors will not provide an edge in the future, but it does mean we need to adapt to what the market is telling us today and prepare for the day when the historical trend reverts to normal. When they do, there will likely be abundant opportunities for investors to capture significant alpha.

> The five prior articles in the *Value Your Wealth* series are linked below:
>
> Part One: Introduction
>
> Part Two: Quantifying the Value Proposition
>
> Part Three: Sector Analysis
>
> Part Four: Mutual Fund and ETF Analysis
>
> Part Five: Market Cap

Four Factors

In this section, we explore four well-followed factors to understand how they performed in the past and how we might want to use them within our investment decision-making process.

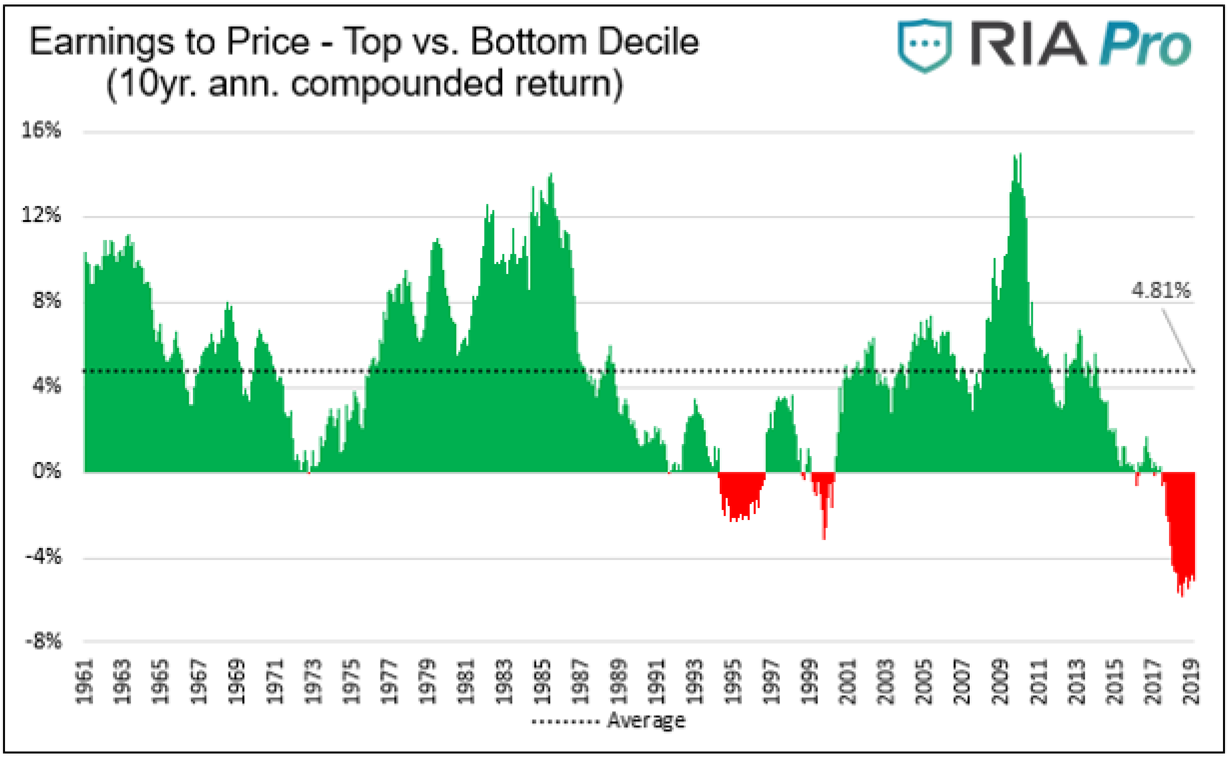
The graphs in this article are based on data from Kenneth French and can be found HERE. The data encompasses a wide universe of domestic stocks that trade on the NYSE, Amex, and NASDAQ exchanges.

Earnings to Price

Investors betting on companies with a higher ratio of Earnings to Price (E/P), also known as the earnings yield, have historically outperformed investors betting on companies with lower E/P ratios.

Such outperformance of companies priced at relatively cheap valuations should be expected over time.

The following chart compares monthly, ten year annually compounded returns for the highest and lowest E/P deciles.



The graph of E/P is very similar to what we showed for growth versus value. Other than a period in the 1990s and the current period value outperformed growth and the top E/P companies outperformed the bottom ones. This correlation is not surprising as E/P is a key component that help define value and growth.

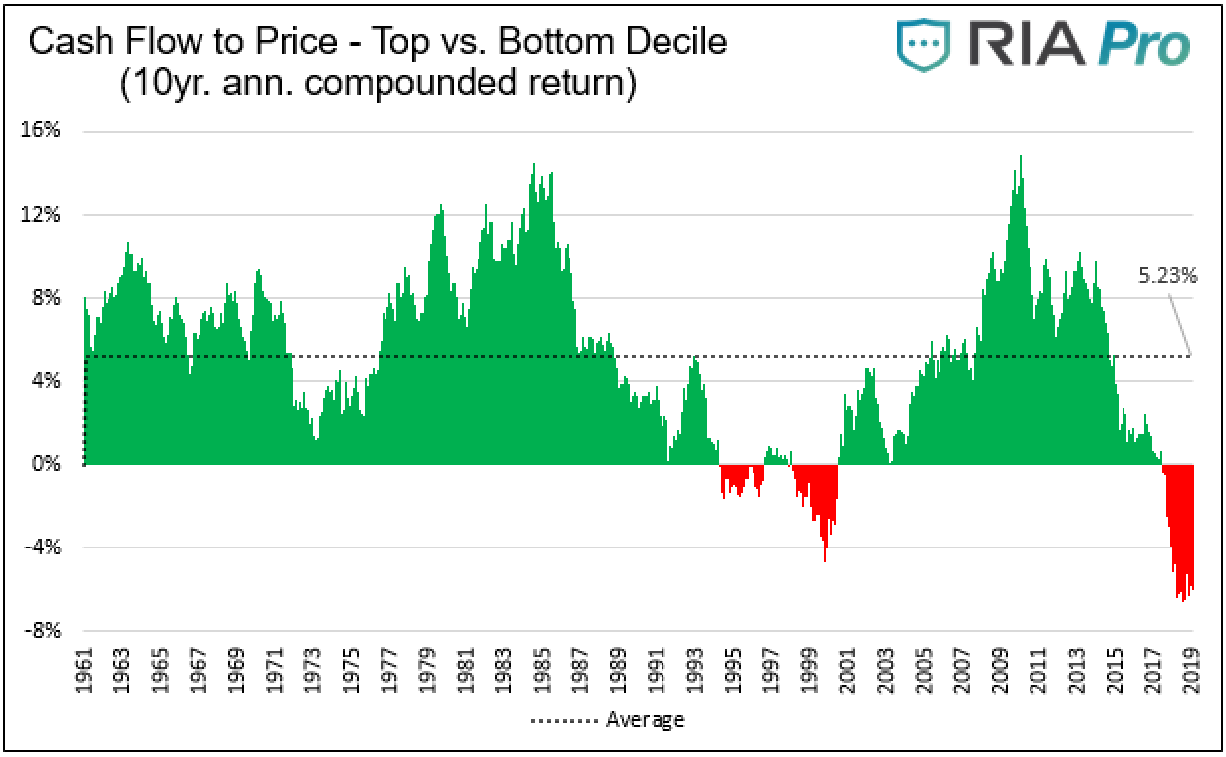
Investors buying the top ten percent of the cheapest companies, using E/P, have been docked almost 5% annually or about 50% since the recovery following the financial crisis versus those buying the lowest ten percent of companies using this measure.

Given our fundamental faith in mean reversion, we have no doubt this trend will begin to normalize in due time. To help us gauge the potential return differential of an E/P reversion, we calculate future returns based on what would happen if the ten-year return went back to its average in three years. This is what occurred after the tech bust in 2000. In other words, if the ten year annualized compounded return in late 2022 is average (4.81%) what must the relative outperformance of high E/P to low E/P companies be over the next three years? If this occurs by 2022, investors will earn an annual outperformance premium of 28.1% for *each* of the next three years. The returns increase if the time to reversion is shorter and declines if longer. If normalization occurs in five years the annual returns drop to (only) 14.75%.

Needless to say, picking out fundamentally solid stocks seems like a no-brainer at this point but there is no saying how much longer speculation will rule over value.

Cash Flow to Price

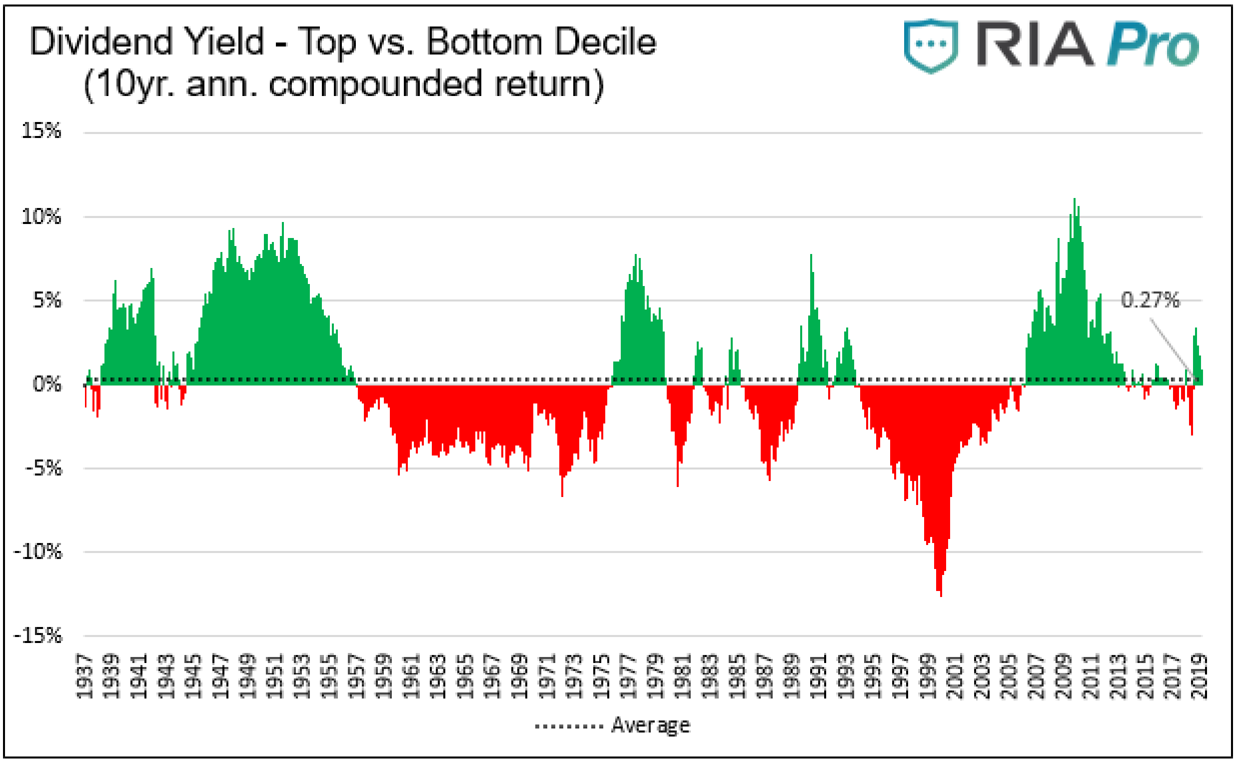
The graph below charts the top ten percent of companies with the largest ratio of cash flow to price and compares it to the lowest ones. Like E/P, cash flow to price is also a component in value and growth analysis.



Not surprisingly, this graph looks a lot like the E/P and value vs. growth graphs. Again, investors have shunned value stocks in favor of speculative entities meaning they are neglecting high quality companies that pay a healthy dividend and instead chasing the high-flying, over-priced ?Hollywood? stocks. Also similar to our potential return analysis with E/P, those electing to receive the most cash flows per dollar of share price will be paid handsomely when this factor reverts to normal.

Dividend Yield

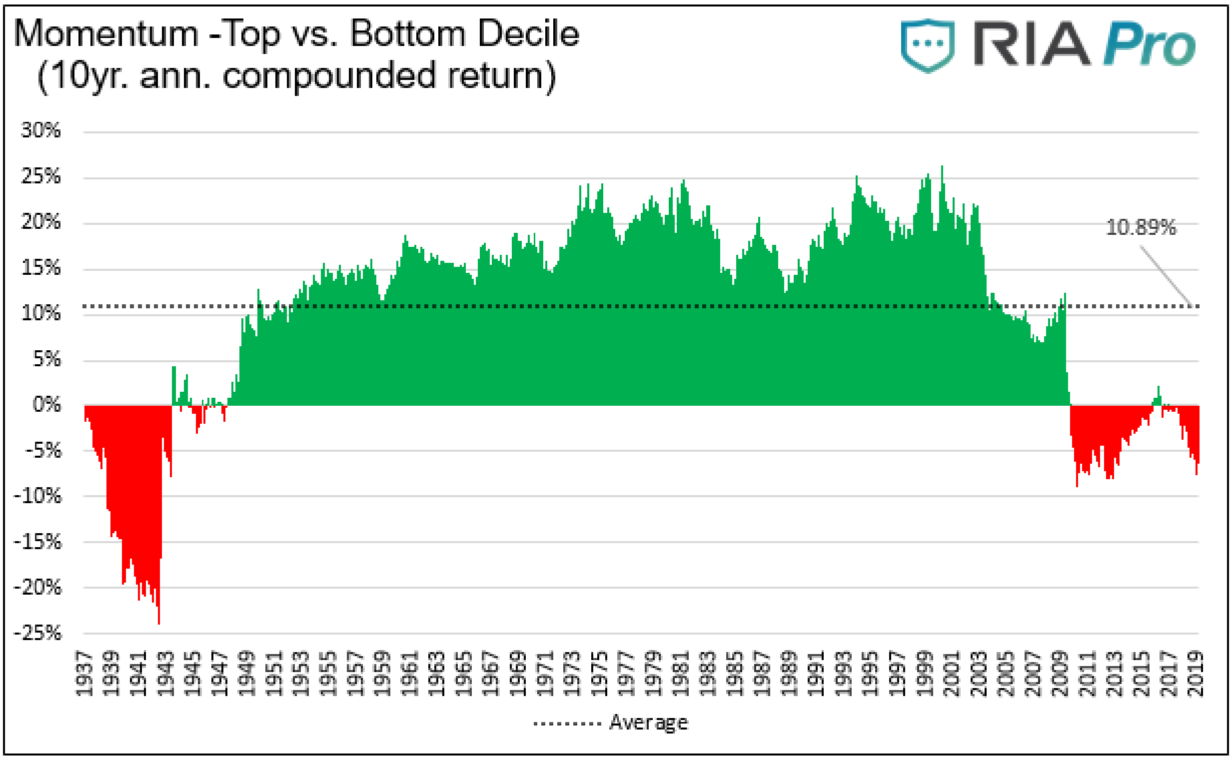
Over the last 100 years, using dividend yields to help gain alpha has not been as helpful as value versus growth, market cap, earnings, and cash flows as the chart below shows.



On average, higher dividend stocks have paid a slight premium versus the lowest dividend stocks.While dividend yields are considered a fundamental factor it is also subject to the level of interest rates and competing yields on corporate bonds.If we expect Treasury yield levels to be low in the future then the case for high dividend stocks may be good as investors look for alternative yield as income. The caveat is that if rates decline or even go negative, the dividend yield may be too low to meet investors? bogeys and they may chase lower dividend stocks that have offered higher price returns.

Momentum

Momentum, in this analysis, is calculated by ranking total returns from the prior ten months for each company and then sorting them. Before we created the graph below, we assumed that favoring momentum stocks would be a dependable investment strategy. Our assumption was correct as judged by the average 10.89% annual outperformance. However, we also would have guessed that the last few years would have been good for such a momentum strategy.



Quite to the contrary, momentum has underperformed since 2009. The last time momentum underperformed, albeit to a much a larger degree, was the Great Depression.

Our initial expectation was based on the significant rise of passive investing which favors those companies exhibiting strong momentum. As share prices rise relative to the average share price, the market cap also rises versus the average share and becomes a bigger part of indexes. If we took the top 1 or 2% of companies using momentum we think the strategy would have greatly outperformed the lower momentum companies, but when the top and bottom ten percent are included momentum has not recently been a good strategy.

Summary

Factors give investors an informational edge. However, despite long term trends that offer favorable guidance, there are no sure things in investing. The most durable factors that have supplied decades of cycle guidance go through extended periods of unreliability. The reasons for this vary but certainly a speculative environment encouraged by ultra-low and negative interest rates has influence. Investors must recognize when they are in such periods and account for it. **More importantly, though, they must also understand that when the trends are inclined to reverse back to normal. The potential for outsized relative gains at such times are large.**

At RIA Advisors, Factor analysis is just one of many tools we use to help us manage our portfolios and select investments. We are currently leaning towards value over growth with the belief that the next market correction will see a revival of the value growth trends of the past. That said, we are not jumping into the trade as we also understand that growth may continue to beat value for months or even years to come.

Patience, discipline, and awareness are essential to good investing.