July 2018

It's more Cyclical than Secular

Sionna believes market pricing is as much about human excess as it is about underlying security fundamentals. One feature of human weakness is that current market trends are often erroneously interpreted as the new secular normal. In reality, these trends are likely cyclical phenomena, which are so infrequent that present decision makers are unaware of their cyclical nature.

Most careers last 30-40 years and most participants are younger rather than older due to attrition. To put this in perspective, merely 10% of CFA Society Toronto's members are age 55 or older. If we extrapolate, not many of today's participants in capital markets experienced or carry the scars and lessons of the 2000 Tech Mania blow-off. Roughly a third may not have personally experience the 2008 financial meltdown. All of this helps to explain why short-termism is so pervasive.

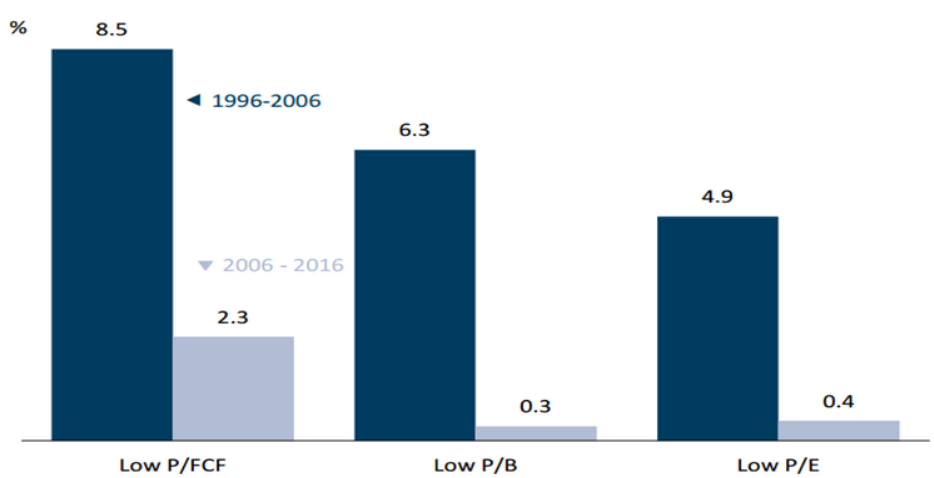
A number of today's trends may be perceived as long term and permanent in nature. As students of financial market history, we view those same trends as cyclical in nature and potential sources of future alpha. We call these collective beliefs: myths.

Let's start with some of the easy ones and leave the most pernicious one for last.

Myth #1 – Growth over Value

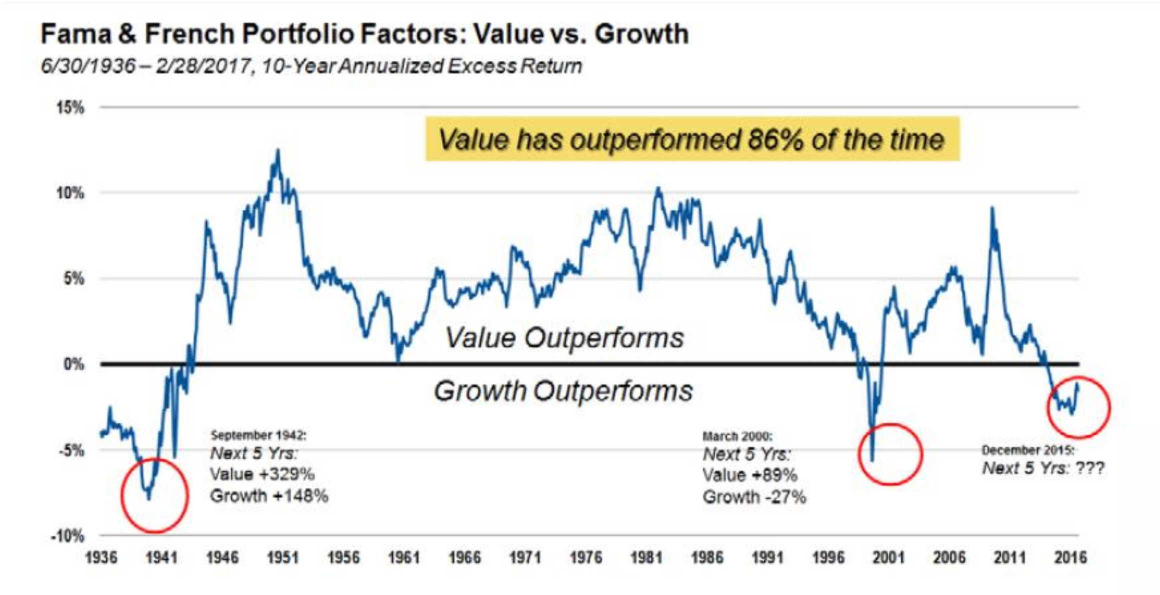
In the last decade, value has underperformed the growth and quality styles. Further, the average annual alpha generated from value factors this past decade are significantly less than the previous decade. The length of this underperformance, which is still "new", may suggest to some a fundamental long-term shift. There is an undercurrent that this boring old-school style of investing will never again deliver exceptional returns. We see this manifesting through investors chasing "new-age" smart beta, hedge funds and private equity alternatives to achieve above-average returns.

Average Annual Alpha Generated from Value Factors (U.S. Market)



Note: Rolling 12-month long/short sector neutral tertiled factor performance; as of 9/30/2016.
Source: RBC Capital Markets, Investment Strategy Research Playbook, January 4, 2017

However, looking at the following chart once a truly longer-term time horizon is taken into account, the story changes. Looking back to the 1930s (which was also deflationary) we see a period of lengthy value underperformance. That period was followed by a rising rate environment and an impressively long period during which value outperformed. Most importantly, when we look over the long run, value has historically bettered the growth style most of the time.



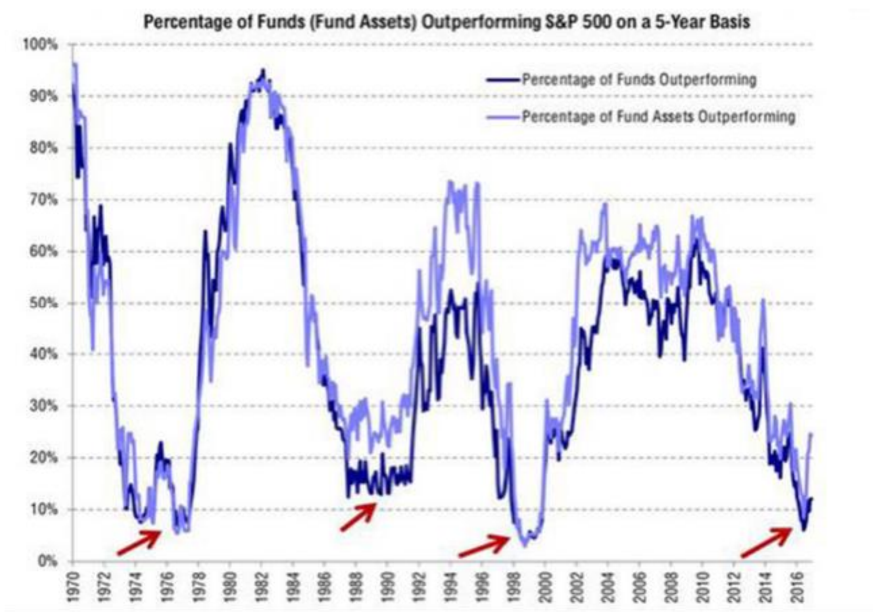
Source: Eugene Fama & Kenneth French. Templeton Global Research Library. August 2017.

Myth #2 – Passive Beats Active after Fees

Active after fees does not materially outperform passive index tracking funds, and there is no solid method of identifying best-in-class managers who all seem to eventually fall prey to mediocrity. So, people believe the answer is to just buy passive; passive is modern and prudent and cost effective compared to active in the long run. S&P Indices Versus Active (SPIVA) reports have been highlighting that active managers as a group underperform benchmarks. SPIVA data (going back to 2001 for the U.S. and 2007 for Canada), suggests that fewer and fewer managers are outperforming and that the market may be becoming more efficient suggesting this is perhaps a new secular unrelenting trend.

The SPIVA Scorecard analysis for Canadian equities focuses on the primary series for each fund and excludes institutional and fee-based series. Thus, it appears to be focusing its studies on the highest fee (and least popular series today), Series “A”. As of May 31, the median Canadian Equity Commission Based Series A had an MER of 2.25%, while the median Canadian Equity Fee Based had an MER of 1.05%. This appears to be making the comparison for active very challenging.

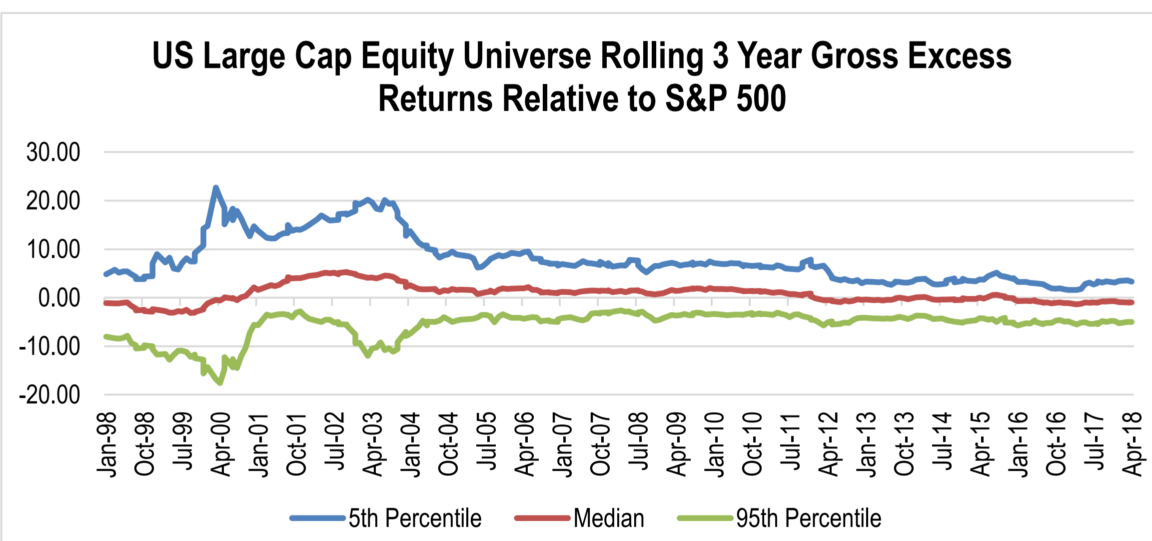
That said, when we look at the following chart, first we observe that active managers as a group have previously underperformed multiple times and historically, when fewer than 15% of the funds outperform, a recovery to more than 50% of funds outperforming follows. We saw more than 50% of U.S. active managers outperform in the last two quarters of 2017, however in the first quarter of 2018, they did not. The rest of the story is yet to be written, but an improvement of performance is suggested.



Source: CRSP, Bloomberg, Robert Shiller, Instinet research, Marketwatch; Minack Advisors

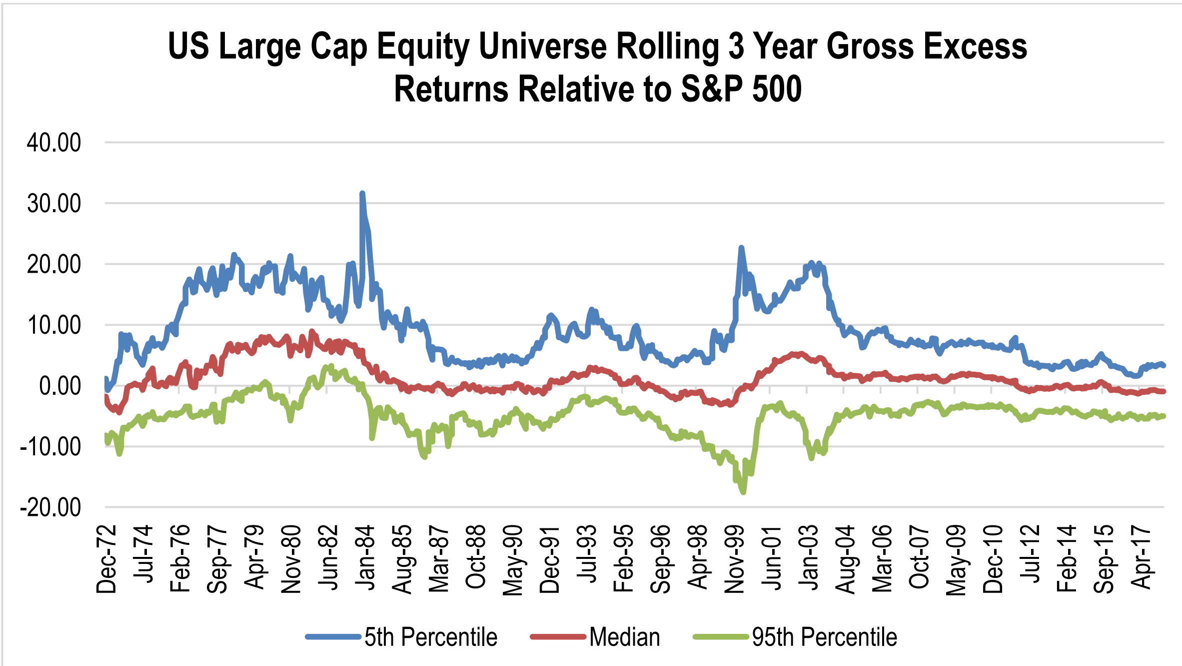
Myth #3 – Market is now Too Efficient for Active Managers to Beat after Fees

The following chart (starting in 1998 and ending in 2017) demonstrates performance of active managers over a rolling three-year time horizon and the returns by the fifth and 95th percentile managers. The chart shows that the spread of returns has narrowed over the time period, which highlights that it has become more difficult for an active manager to beat the Index (particularly in the U.S., as EAFE and Canadian Managers have fared better). This suggests that as ETFs became more prevalent, managers were finding the market harder to beat. It not only indicates that the market has become more efficient over time and that trend was secular and relentless, but that it was wiser to index the U.S. and then use capable active managers for EAFE and Canada.

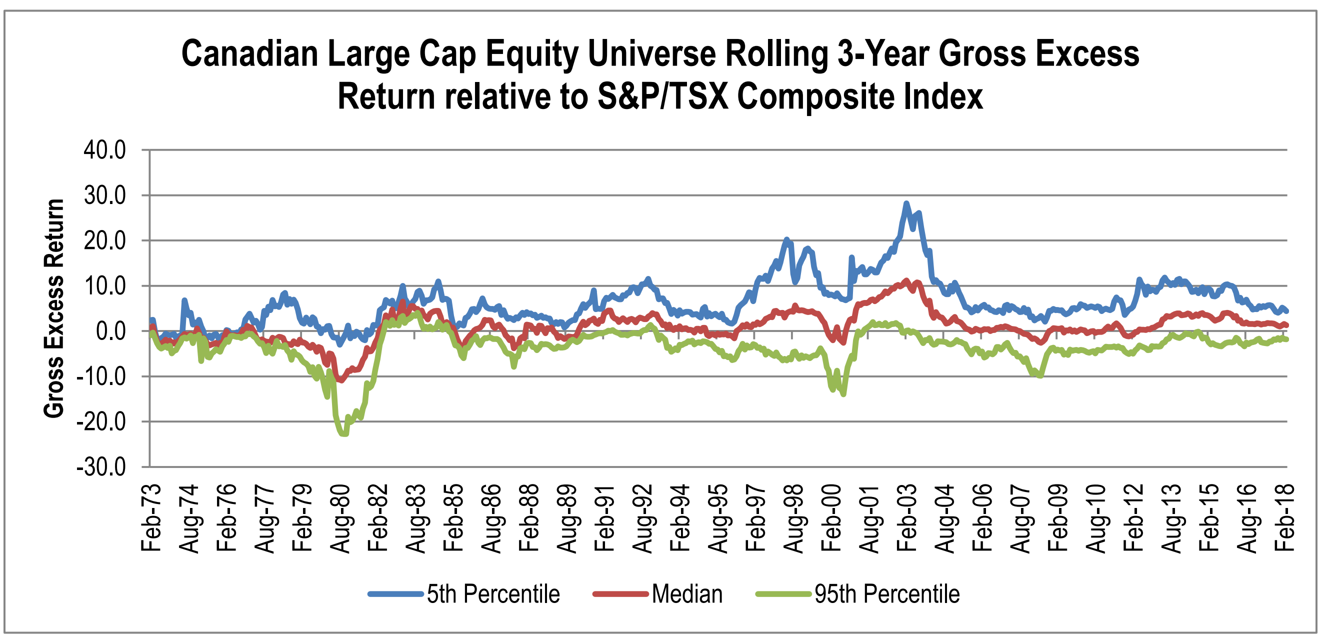


Source: eVestment, Sionna Investment Managers.

However, we wondered what a longer-term story might tell us. When we extend the universe's data as far back as available, to 1971, we see the narrowing of opportunity sets has occurred a few times in the past, and we would argue that the current trend appears to be more cyclical than secular.



Source: eVestment, Sionna Investment Managers.



Source: eVestment, Sionna Investment Managers.

If the market is truly driven by fundamentals, then it is theoretically possible that more players and speed of processing could result in the market becoming more efficient and low-cost indexes might be a sensible alternative.

However, it is known that market participants have a natural "Physics Envy"; we would like the markets to be less messy, more orderly and predictable like the laws of math and the provable science of physics. Market equivalence to the orderly and definable E=MC2 is merely an unstable relative economic equilibrium across asset classes. Markets are a human invention and thus are a social science – prices will always reflect our psyche. Market pricing will never be precise since humans are not 100% rational, which has confounded philosophers throughout centuries. As such, markets will always have an element of inefficiency that creates opportunities for active managers.

Technology has relentlessly and incrementally improved over the history of capital markets, and the laws of financial gravity have been largely maintained. Despite technological advances, the humanness of markets has continually created exploitable inefficiencies. Expanding time horizons often illustrate that what looks like a permanent secular trend in the short run, proves to be cyclical in nature in the long run.

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