CAPTURING THE RUBBER BAND EFFECT:
How We Do Deep Value

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ABOUT QMA
Serving investors since 1975, QMA targets superior risk-adjusted returns by combining research-driven quantitative investment processes built on economic and behavioral foundations with judgment from experienced market practitioners. Ultimately, each portfolio is constructed to meet the individual financial needs of the client. An independent boutique backed by the capabilities of one of the world’s largest asset managers, QMA is the quantitative equity and global multi-asset solutions business of PGIM, the global investment management businesses of Prudential Financial, Inc. Today, we manage approximately $128 billion* in assets for a wide range of global clients.

*As of 9/30/2018.

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There is an idealized view that value investors spend their days hunting for buried treasure, “diamonds in the rough” that are just a new CEO, a better distribution plan or a change in economic environment away from becoming the next market darling. In our experience, such companies do exist, but they are rare. Much more common are companies that may never be particularly exciting but may be priced very attractively.

At QMA, the valuation measures we use in our model actually shift to favor these cheaper stocks the more they fall out of favor. This contrarian bent means that there are times, especially when value as a whole fares poorly, when our strategies may fare worse. However, as value stocks underperform they become relatively cheaper, so a portfolio like ours that stays focused in the space gains more exposure to value. (This is the opposite of a momentum strategy, where exposure only increases when the strategy is successful.) What this means is that when the cycle turns, performance may snap back dramatically.1 It also means that investors who stick through a full market cycle tend to see the most benefit. We call it the “rubber band” effect — and it does a lot to explain the big swings we have seen, in both directions, over the past two years.2

Going Deeper
Under normal circumstances, our stock selection process focuses on earnings-to-price (E/P), which research has shown is the most reliable indicator of a company’s value premium over the long term.3 However, as market sentiment changes and the spread between the cheapest stocks (i.e., those with a high E/P) and the most expensive (low E/P) widens or narrows, our strategy incorporates other factors into its analysis. For example, when the spread gets very narrow, suggesting value stocks have been bid up, the model looks at earnings revisions as a way of discovering those that at least represent a better value relative to their business prospects. Conversely, when the spread becomes stretched, our strategy emphasizes book-to-price (B/P). The advantage here is that, as the focus shifts to data such as physical facilities and cash, even if a company has very low or negative earnings (potentially making it appear expensive), our strategy can determine if the stock still has value.

For Professional Investors only.
All investments involve risk, including the possible loss of capital.

1 There is no guarantee this objective will be achieved.
2 Past performance is not a guarantee or reliable indicator of future results.
3 The most seminal study in this area is by McMaster University Professor S. Joe Basu’s “Investment Performance of Common Stocks in Relation to Their Price-Earnings Ratios: A Test of the Efficient Market Hypothesis,” Journal of Finance, June 1977.
T **Trusting the Process: 2016**

In June 2016, E/P spreads reached some of the highest levels ever recorded. The previous time E/P had been more stretched was in early 2009, during the depths of the Global Financial Crisis (GFC). The time before that was in 1999, during the tech bubble when most value stocks were trading at multiples in the low single digits and some of the market’s highest fliers had no earnings at all.

As in 2009, some of the very cheapest stocks in June 2016 were found in the Financials sector. For much of the year, household names like JP Morgan, Discover and Capital One traded at 10 to 12 times earnings, not far above their levels during the GFC. These companies undoubtedly faced continued challenges — low interest rates compressed their lending spreads, heightened regulations added costs and eliminated onetime earnings centers. Even so, based on fundamentals, one would have been hard-pressed to describe these companies as still “in crisis.”

When the E/P spread widens to the 70th percentile relative to its history, our strategy gradually shifts its emphasis to B/P. In early 2016, when Financials already had about a 7% overweight in our portfolios and the spread was stretched to that 70th percentile, our strategy overweight grew as Financials looked even cheaper on B/P than they had on E/P.

Similar patterns were also occurring in other cyclical sectors and industries, including airlines, metals and mining, manufacturers and Consumer Discretionary. As our overweights grew across these segments, a noticeable divide opened up between our portfolios and those of a number of our competitors, who, we could see from reports, had followed the trend into more dividend-oriented stocks that was pushing up the price of sectors such as Utilities and Health Care.

**The Snap Back and Beyond**

JP Morgan, which sat at $70 a share on the eve of the November 8, 2016, US presidential election, surged to $79 by November 15 and $86 by the end of December. As a whole, financial stocks contributed 30% of the 647 basis points (bps) of excess returns that our Large Cap Value strategy generated for 2016, and 55% of the 257 bps in alpha generated by our Mid Cap Value strategy. In some cases, these strategies had trailed by similar amounts just months before.

Additional major moves were seen in Southwest Airlines and Newmont Mining Corporation, among others, as the Large and Mid Cap strategies outperformed their respective benchmarks in nine out of 11 sectors for the year. In small caps, where performance had been down 135 bps relative to the benchmark as recently as September 2016, our Small Cap Value strategy eventually outperformed by 293 bps. In absolute terms, the strategy finished up 35% on the year.

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5 Past performance is not a guarantee or a reliable indicator of future results.

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**Figure 1. QMA’s Model Shifts between Value Factors Based on E/P Spread Size**

As of 9/30/2018.

Source: QMA, Frank Russell Company. Estimate Earnings Revision is a factor used by QMA that represents a proprietary measure of EPS estimate revisions. Please see Notes to Disclosure for a fuller description of the chart. The Russell 1000® Index is a trademark/service mark of the Frank Russell Company. Russell® is a trademark of the Frank Russell Company.

Past performance is not a guarantee or a reliable indicator of future results.
Figure 2. A Higher Weighting of Value as the E/P Spread Widened, Led to the Q4 2016 Rubber Band Effect

As of 1/31/2017.
Source: QMA, Frank Russell Company. C/P refers to cash flow-to-price, another factor used in QMA’s value equity model. Excess returns are shown relative to the Russell 1000® Value Index. The Russell 1000® Index is a trademark/service mark of the Frank Russell Company. Russell® is a trademark of the Frank Russell Company.

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Then in 2017, we saw a more muted version of the same pattern: underperformance through the first 10 months of the year, followed by a rebound triggered by the December 2017 US tax cuts, pulling most of our strategies ahead of their benchmarks at year-end.

**Trusting the Process: 2018**

As we move into 2019, we find that once again the rubber band is stretched. With the stimulative effect of the tax cuts fading as the US Federal Reserve raised interest rates, investors spent the second half of 2018 largely toggling between sectors still promising growth, such as Technology, and those providing some semblance of safety, such as Utilities and Health Care. This has left the less fashionable Financials sector trading at a significant discount to the rest of the market despite solid recent earnings. Consumer Discretionary has also suffered, particularly automakers and homebuilders, as higher interest rates (making auto loans and mortgages more expensive) and new US tariffs on steel and aluminum (increasing automaker input costs) have sent valuations reeling to levels ordinarily reserved for “dead” industries. We view this as a classic overreaction, and therefore head into the new year with financial, automaker and homebuilder stocks among our largest overweights. As expected, this has caused the performance of the QMA value equity strategies to again fall off relative to their benchmarks, and has re-opened the valuation gap relative to competitors who have followed the drift into the benchmark’s pricier segments.
In the meantime, the E/P spread between the market’s cheapest and most expensive stocks has reached 96%, higher even than 2016. Does this mean the next snapback is imminent? We never know when the market will respond or what the catalyst will be, just that when it does it tends to cover a lot of ground in a hurry. We have found that the best way to respond to such periods is to stay focused and use the occasion to gain even deeper exposure to value. As of early January, our strategies had valuations that were significantly lower than their benchmarks, not just on a price-to-book and price-to-earnings basis, but on numerous other valuation metrics. In short, we remain committed to the opportunity represented by deeply valued securities. We don’t think there is anything particularly unique about this cycle, or anything that has fundamentally changed to cause value not to work. We have been here before.

Figure 3. QMA’s Persistent Commitment to Deep Value as Peers Follow a Trend into More Expensive Stocks

As of 9/30/2018. Universe: eVestment Alliance Large Cap Value Equity. Source: QMA and eVestment Alliance. Shown for illustrative purposes only. Please see Notes to Disclosure page for Important Information including risk factors and disclosures. eVestment Alliance is an outside vendor whose software has been used to create this exhibit. QMA pays a fee for this software. QMA has made efforts to confirm accuracy/reliability of the data provided by eVestment Alliance but we disclaim responsibility for its accuracy or completeness.

Past performance is not a guarantee or a reliable indicator of future results.

Figure 4. Just Two Years Later, Another High-Water Mark In E/P Spread

As of 12/31/2018. Source: QMA, Frank Russell Company. The line plots the difference between the median Earnings to Price (E/P) of the most expensive and cheapest quintiles of the Russell 3000® Index, when stocks are ranked on E/P. The Russell 3000® Index is a trademark/service mark of the Frank Russell Company. Russell® is a trademark of the Frank Russell Company.

Past performance is not a guarantee or a reliable indicator of future results.
Notes to Disclosure

Sources: QMA, FactSet, Frank Russell Company, eVestment.

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