2014 Global Factor Round Up

One of the most important discoveries in finance over the past few decades is that stocks of firms that share certain fundamental characteristics called “factors” exhibit different return and risk characteristics than the overall market. Critical to investors is the fact that, over long periods of time, certain of these factors have earned excess returns compared to the overall market.

Broadly speaking, these factors can be distilled into the following categories:

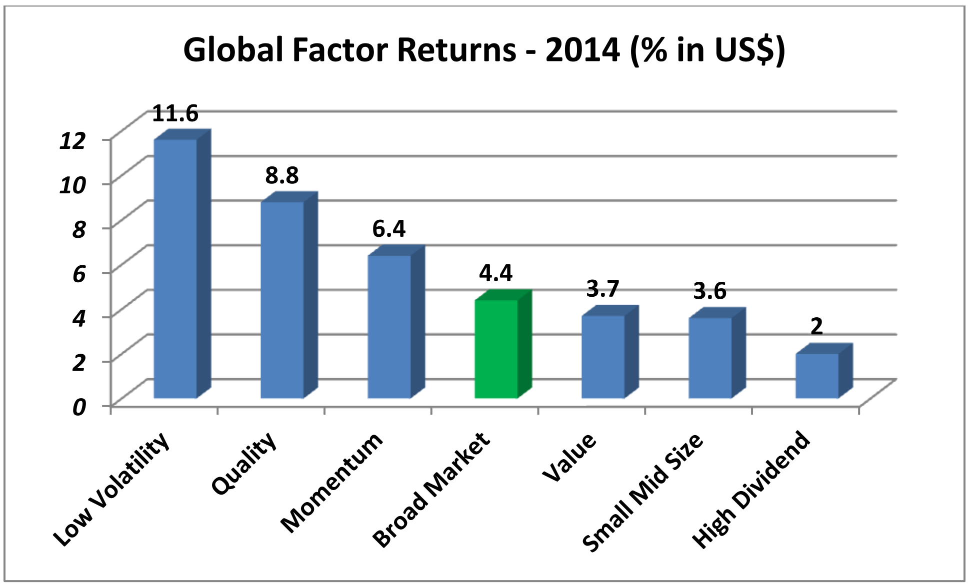
1. **Value:** Stocks that are low-priced in relation to earnings, dividends, cash flow or book value, on average, have outperformed growth stocks over long time horizons.
2. **Size:** Stocks of small and mid-size companies have earned, on average, higher returns than stocks of large companies over long time periods.
3. **Momentum:** Stocks that have exhibited positive momentum – i.e., have performed relatively well over the past 3 to 12 months - have outperformed, on average, over long time horizons stocks that display negative momentum.
4. **High Yield:** Stocks of companies that pay higher dividends, on average, have earned superior returns to lower and non-dividend paying stocks over the long run.
5. **Quality:** Stocks that have evidenced superior profitability in relation to capital have outperformed, on average, firms with poorer profitability in relation to capital over long time horizons.
6. **Low Volatility:** Stocks that have exhibited low volatility have, on average, outperformed stocks that display high volatility over the long run.

There are two primary explanations for the higher returns associated with these factors. One is that **the higher returns represent risk premiums** – i.e., compensation to investors for incremental risks beyond that of the total stock market. For example, small company stocks are not only more volatile than stocks of large companies but are also much less liquid. Value stocks tend to include a higher proportion of heavily indebted companies which dramatically underperform the overall market during periods of extreme market stress.

The second explanation is **offered by behavioral finance**. Investors’ cognitive biases such as “myopia” and “overconfidence” can lead to the persistent mispricing of certain securities. For example, many investors, attracted to the episodic outsized returns of high volatility and low quality stocks, chase these types of stocks despite a pattern of long-term underperformance. Overly optimistic investors overestimate the earnings prospects of growth stocks while underestimating those of value stocks; value stocks then generate superior returns as investors eventually realize that earnings in the value universe are better than initially expected.

Social phenomena such as the "bandwagon effect" can also distort prices. The "madness of crowds" - as evidenced by the railway mania of the 1840's, the Florida real estate boom of the 1920's, the Japanese bubble of the 1980's and the dot.com mania of the 1990's, is a well-documented recurring market spectacle. The herding behavior of investors has also been advanced as an explanation for the returns associated with the momentum factor.

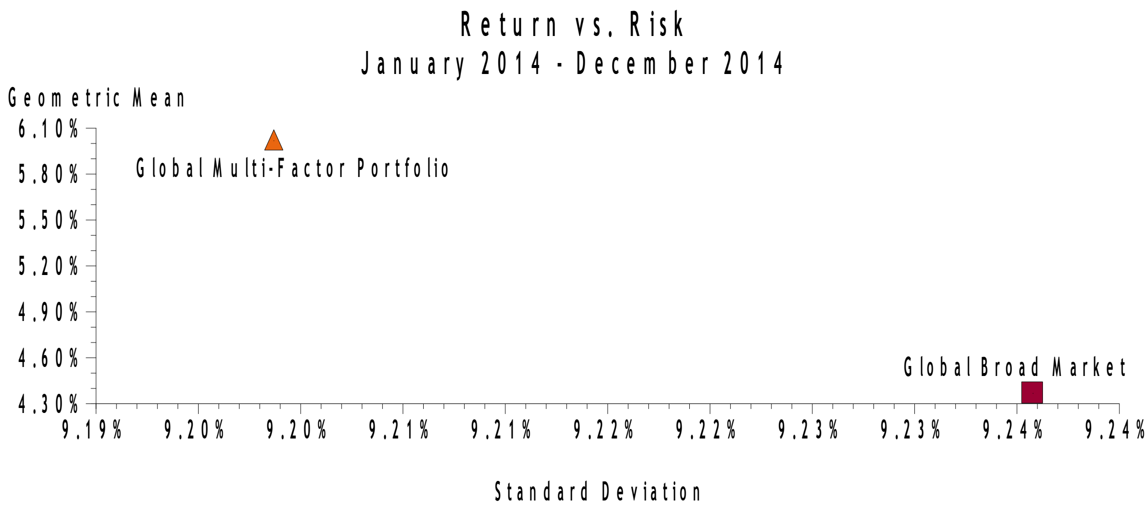
Factor performance can vary as a result of business cycle influences, market sentiment, interest rate changes, sector composition and other variables. The following chart sets out the return earned by each factor globally in 2014 compared to the overall broad market. (See Appendix I for Sources.)



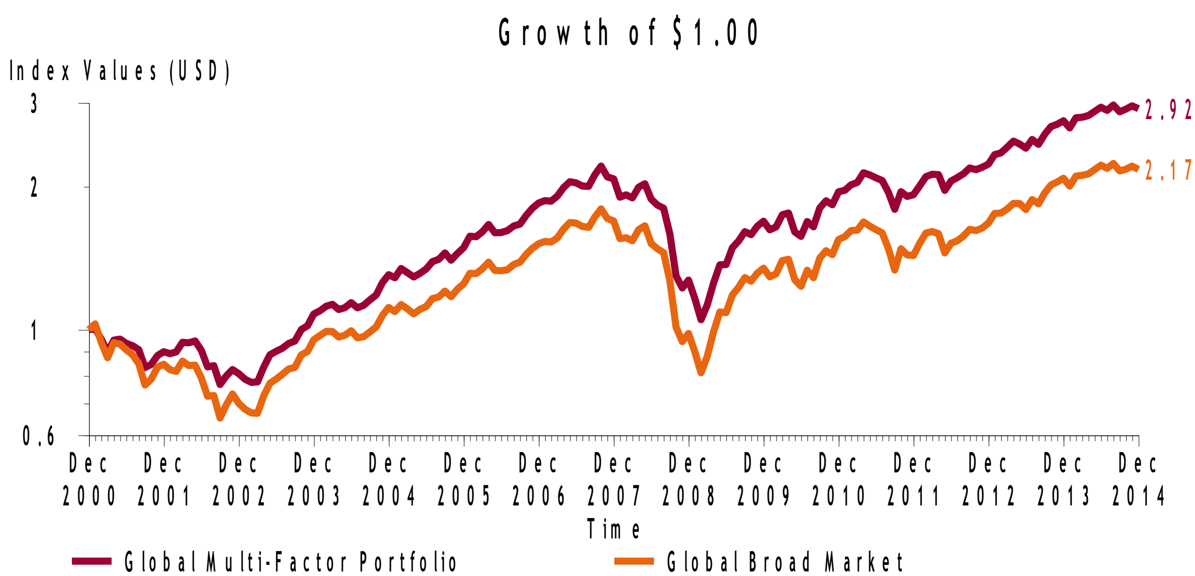
Low volatility returned 11.6% globally, far in excess of the 4.4% return of the broad stock market. Although low volatility was ahead of the broad market in every region – Canada, US, international and emerging markets – its outperformance was particularly strong internationally. Quality came in second with an 8.8% return and was strong regionally with the exception of the US where it lagged the overall market. Momentum's 6.4% return ranked it third place.

There was a trio of laggards. Value and small/mid-size factors modestly trailed the broad global market with returns of 3.7% and 3.6%, respectively. High dividend yield was the loser in 2014 with a meagre 2.0% return. [Tacita Capital warned about the excessive infatuation with this strategy in our January 2012 Commentary entitled "The Dividend Yield Love Affair".] Among other differences, high dividend yield has a higher exposure to energy and materials – the two poorest performing sectors in 2014.

As illustrated in the graph on the next page, a multi-factor portfolio comprised of equal weights of the six global factors returned 6.0% and outperformed the 4.4% return of the broad market. The volatility of the multi-factor portfolio as measured by standard deviation was a minuscule 0.04% less.



2014 will be the tenth year since 2000 in which the multi-factor global portfolio has outperformed the broad market. Over the past fourteen years, the multi-factor portfolio has returned 7.9% annually versus 5.7% for the broad market. Cumulatively, as illustrated by the following graph depicting the growth of $1.00 invested since 2000, the multi-factor portfolio has created nearly 35% more wealth versus the broad market.



A decade ago, “factors” were a fascinating corner of the capital markets but of little practical use to individual investors. Since then, with the advent of low-cost exchange traded funds and the creation of transparent, rules-based factor indices by a number of index providers, a multi-factor portfolio has moved from academic theory to concrete application. Investors finally have an empirically sound approach to pursue market beating returns.

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Appendix I

Global Factor/Portfolio/Market	Index – US$
High Dividend Yield	MSCI ACWI High Dividend Yield
Low Volatility	MSCI ACWI Global Minimum Volatility
Momentum	MSCI ACWI Momentum
Quality	MSCI ACWI Quality
Size	MSCI ACWI SMID Cap Index
Value	50% MSCI ACWI Large Cap Value 50% MSCI ACWI SMID Value
Global Multi-Factor	Equal Weight of the Above 6 Factors; Rebalanced Monthly
Broad Market	MSCI ACWI Investable Market Index

Source: Morningstar