Finding Value in the "Unyielding" New Era of Fed Policy

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Executive Summary

1. Value-based stock selection has suffered in recent years because a bet in favor of value has become intertwined with a bet against both technological disruption and shifting central bank policies.
2. Value as an approach to selecting regions has also underperformed due to the overweighting of emerging markets which has resulted in an implicit short USD exposure.
3. Low nominal yields have directly caused value investors to avoid fixed income over the past few years and miss out on a tremendous rally.
4. Failure to incorporate low bond yields in equity valuation has also caused investors to avoid equities, resulting in further missed opportunities.
5. As rates have reached lower absolute levels, the impact of falling rates is likely to be even greater moving forward.
6. We believe there is little historical evidence to support a mean reversion orientation betting on higher nominal yields.
7. We would caution investors against making portfolio decisions that result in explicit or (more importantly) implicit short fixed income positions.

We started our careers as value investors. If there was a temple dedicated to mean reversion, we were the equivalent of temple monks who not only worshipped at the altar, but we ate, slept and swept the temple of both dirt and non-believers (is there a difference?!).

So, it was with great humility that five years ago we penned, "The Fed Is the New Value Investor." (link here). In the paper, we suggested that traditional value investors or those forecasting expected returns using a mean reversion framework, and referencing long-term historical valuations as a guide, would struggle as Fed policy disrupted the models and the arbitrage opportunities from which these investors historically profited.

What is Value?

It is now fairly well-known that the results experienced from following a value approach, as both a stock-picking tool within markets and as a strategy to allocate across regions, has performed poorly for a number of years.

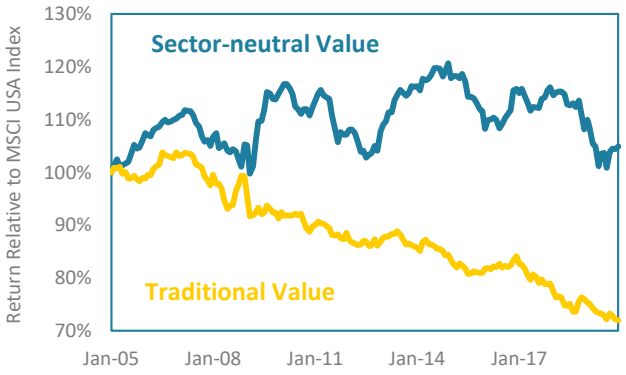

Chart 1: Value: Cheap versus "Broken"[1]
Source: Bloomberg, MSCI

Value and Sector Bets

The goal of a value investor is to invest in assets that are temporarily cheap and **not** in broken business models that are being disrupted by technological innovation. The difference between these two approaches can be seen in Chart 1.

Both the yellow and blue lines involve overweighting value stocks but there are two differences:

1. The blue line represents a sector-neutral approach to value while the yellow line simply selects the cheapest stocks and will load up on out-of-favor sectors.

2. The blue line attempts to incorporate information that the market may already have about a business by using forward earnings estimates while the yellow line uses standard backward-looking measures.

Neither approach has been great, but notice how much better the sector-neutral approach has performed. Also, it's worth noting that the two strategies tracked each other closely at the start of the sample but as technological disruption and central bank intervention have increased, there has been more dispersion. We believe that the neutral approach (blue line) represents a purer approach to identifying truly cheap stocks as opposed to the traditional value methodology (yellow) that makes large and unintended bets against disruption and obsolesce.

[1] MSCI USA Enhanced Value Index, MSCI USA Value Index, MSCI USA Gross Total Return Index (USD).

Value to Make Regional Bets

Traditional value investors have also held an overweight position in emerging markets equities at the expense of underweighting the S&P 500 in recent years. This is another example of how value has inflicted pain on institutional portfolios over a number of years. Further, many of the investors who've been overweighting emerging markets also tell us they avoid macro investing, viewing the approach as "unpredictable" and "unsystematic". We contend that the overweighting of emerging markets equities on the part of these investors equates to an "accidental" (and highly inefficient) macro bet. But, don't simply take our word for it. We believe proof of this can be demonstrated in the chart below:

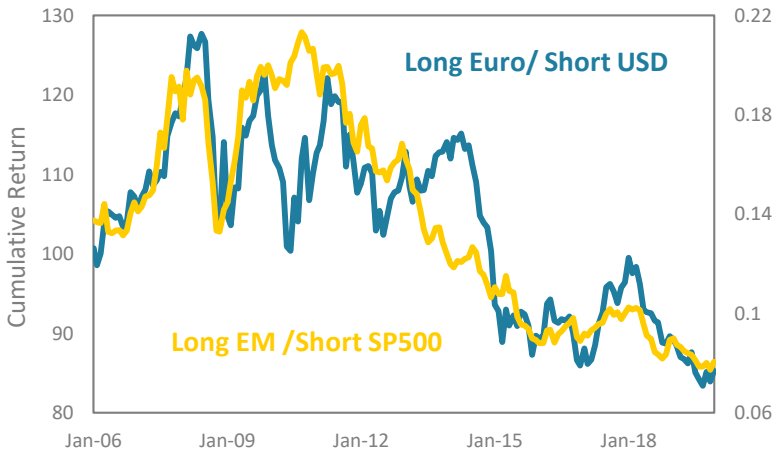

Chart 2: Are You An "Accidental" Macro Manager?[2]
Source: Bloomberg, MSCI

The yellow line represents a long position in emerging markets equities versus a short position in the S&P 500. The blue line shows the return of a long Euro vs. a short USD position. ***The correlation between the two lines is 86%.*** This is not simply a random statistical occurrence. Many emerging countries have higher interest rates than the United States, so emerging market corporates frequently borrow in USD. A rising USD rate causes an increase in the cost of emerging markets corporate borrowing which, in turn, lowers the earnings available for distribution to equity holders.

To cut to the chase, **an overweight position in emerging markets is effectively a short dollar trade**. If you're allocating to this trade you should ask yourself: "What do I know about the future direction of the dollar?". If your answer is "not much" you should consider pairing your emerging markets overweight position with a long USD investment. The point of bringing up the two examples above is not to remind our readers of their biggest money-losing positions. Rather, we are attempting to demonstrate a point we regularly make to clients. We believe a portfolio manager has three jobs:

1 Return Forecasting | **2** Trade Expression | **3** Portfolio Construction

[2] Emerging markets equities represented by MSCI Emerging Markets Index.

In our opinion, both investors and allocators tend to focus on return forecasting at the expense of the other two jobs. We believe that optimizing trade expression is key to avoiding unintentional bets as shown in the examples above. Also, it's equally important to build a truly diversified portfolio so that the success of an entire portfolio isn't dependent on getting a single view right.

While it's probably more fun to spend time trying to predict the future, in our view, it's far easier to get consistent and repeatable edges in trade expression and portfolio construction.

Valuation 101

The present value of **any** asset is a discounted stream of cash flows. The value of an asset can increase for either of two reasons:

Numerator up:
Estimates of future cash flows improve.

Denominator down:
Discount rates decline.

Assets such as corporate bonds have near term cash flows relative to their equity brethren (where most cash flows are in the distant future). Another way of stating this is that equities are **very** long duration assets compared to corporate bonds.

This means two things*:

Corporate credit should be more impacted by changes in short-term rates while equities should be more affected by changes in long-term rates.

More importantly, since equities are longer duration assets, changes in interest rates have a much **larger** impact on their fair value relative to shorter-duration assets such as corporate bonds.

The Most Important Chart

For evidence of the impact of long-term interest rates on equity valuation we refer you to **the most important** chart in this paper:

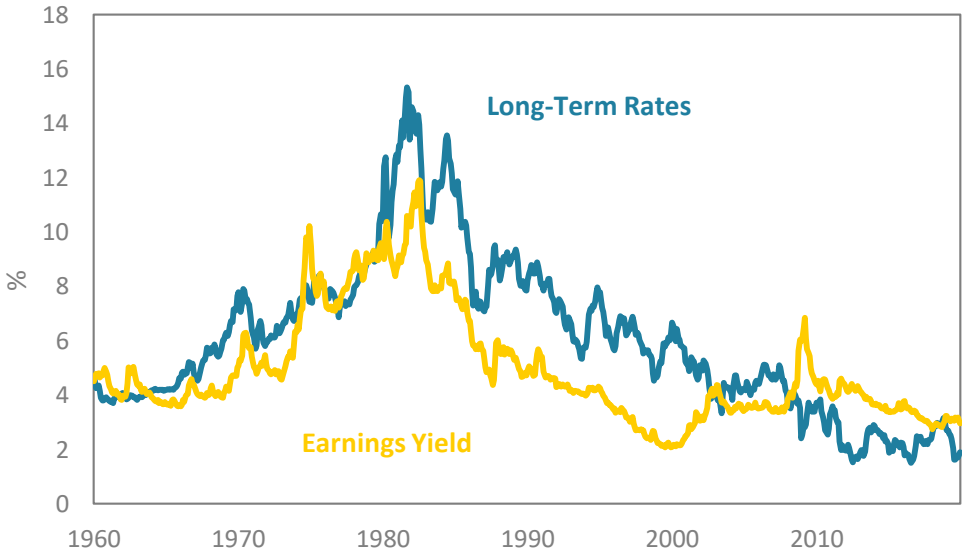

Chart 3: US Treasury Yields and S&P 500 Earnings Yield (10-Year Trailing)
Source: Robert Shiller Data

The blue line is long-term Treasury yields. The yellow line shows the earnings yield of the S&P 500 Index computed using trailing 10-year earnings (inverse of Shiller P/E).

There are many insights embedded in this simple chart that are contrary to the views of most investors and that are regularly dismissed. We'll discuss two of them further.

Mean Reversion in Bond Yields

Aside from value and the bet on emerging markets equities, perhaps the biggest "miss" in most investors' portfolios has been the persistent underweighting of sovereign developed bonds over time. As reflected in Chart 4, investors have consistently bet on higher interest rates due to an unrelenting belief in mean reversion (a *traditional value* approach). The reality is **there is little historical evidence to support a mean reversion orientation betting on higher nominal yields**.

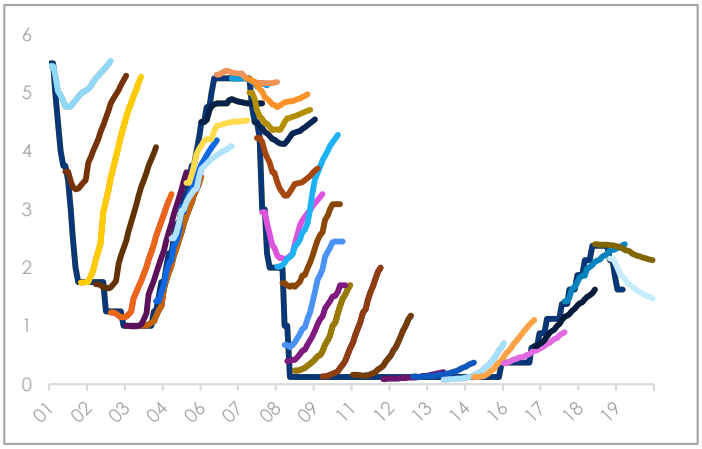

Chart 4: Federal Reserve Rates: Market Implied vs. Realized 2001-2019.

Source: Philadelphia Fed. ECB

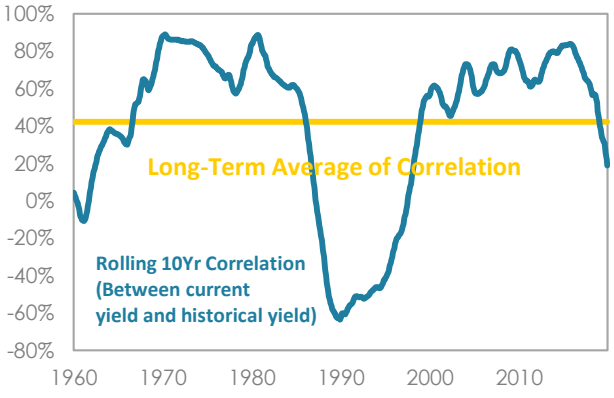

Chart 5: Rolling 10-Year Correlation: Long-Term Treasury Bond Current Yield Versus Historical Yield

Source: Robert Shiller Data

An alternative way to view this is to quantify the degree of mean reversion simply by examining the rolling correlation between current yields on long-term treasury rates and those from 10 years ago. A mean-reverting series would imply a negative correlation. But, looking at Chart 5 we observe that the correlation has been largely positive. Investors should have been betting on low yields to be followed by **even lower** (not higher) yields. Or at the very least the consistent lack of mean reversion should cause investors to question their belief in the utility of value as an input to the decision to over and underweight sovereign bonds through time. In short, positioning for mean reversion without regard to an analysis of the historical data and out-comes has proven very costly for investors.

Link Between Bond Yields and Earnings Yield

Another point we notice on Chart 3 (reproduced below) is that over the long run, the two lines track each other remarkably well. On a year-by-year basis, other factors can and do influence market valuation, resulting in deviations. ***But over the full sample, the correlation between earnings yields and interest rates is a remarkable 76%! This means that 58% (0.76^2) of the historical changes in earnings yield over the last 60 years can be explained simply by changes in long-term interest rates.***

We would argue that you don't need a complicated model to make the intuitive point that if the yields on low-risk assets such as Treasury bonds were to move lower that would, "all else being equal", lower the required rate of return on equities and push prices higher. Yet, despite the theoretical and actual link, most asset allocation models assume that long-term valuations mean revert around a stable level. If only the real world was so neat and tidy!

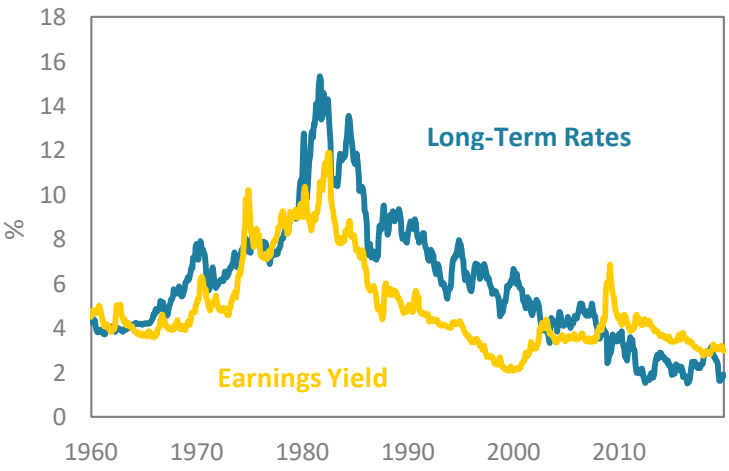

Chart 3: US Treasury Yields and S&P 500 Earnings Yield (10-Year Trailing)
Source: Robert Shiller Data

The impact of ignoring lower bond yields has been that equities have appeared rich to most value investors causing them to hold cash and miss out on significant equity market appreciation.

Link Between Bond Yields and Equity Sectors

Not only do changes in long term bond yields influence the aggregate price level of the equity markets, but they can also dramatically influence the performance of sectors vs. the market.

Chart 6 demonstrates how changes in bond yields have affected the performance of US REITs vs. the S&P 500 Index.

The blue line in Chart 6 reflects the excess performance of the MSCI US REIT Index compared to the S&P 500 Index. Blue line rising indicates REIT outperformance relative to the S&P 500 Index. The yellow line shows an inverted picture of the yield of the 10-year US Treasury bond. When the yellow line is rising, it indicates falling yields.

The correlation is 71%! This means more than 50% (0.71^2) of the day-to-day variations in REITs vs. the broad market have had nothing to do with the actual companies and are only a result of changing interest rates.

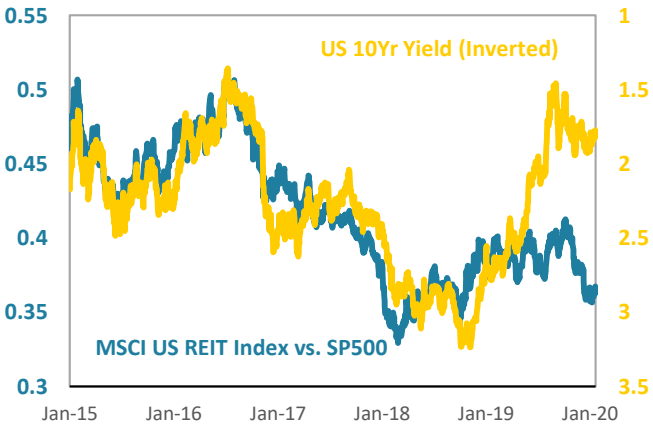

Chart 6: Changing Bond Yields: Impact on Markets and Sectors

Source: Bloomberg, MSCI

To be brief, we'll note that the explanatory power of changes in bond yields is not restricted to REITs. Other high yielding sectors e.g. utility stocks have also been significantly impacted. Finally, in a world of falling risk-free rates, it is the assets with distant but certain cash flows (bond-like) that should benefit disproportionately. It should be no surprise then that high-quality equities have significantly outperformed broad equity markets.

Is the Rally in Rates Done?

Starting in the mid-1990s when Japanese government bond (JGB) yields hit 3% investors starting shorting JGBs (chart below). The thought was that such low yields were unsustainable and surely the forces of mean reversion would drive yields higher towards the 5-6% levels in the US and Europe. Rates in Europe and Japan have indeed converged, but the convergence has been driven by European rates falling to Japanese levels. This is a **very** big deal!

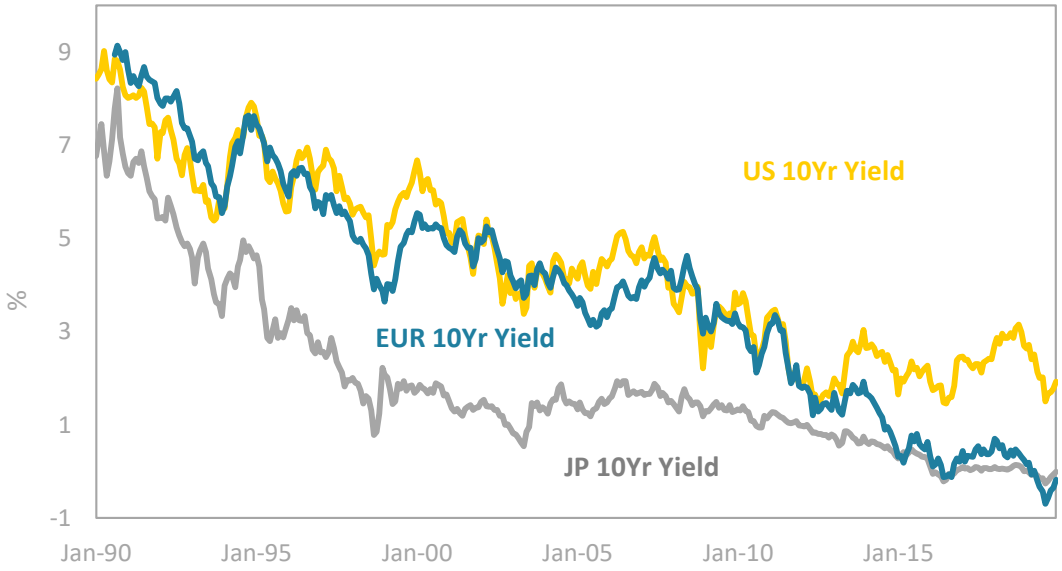

Chart 7: Japanification
Source: Bloomberg

All of investing is premised on the idea of valuing assets by discounting future cash flows using a positive discount rate. Given the recent fall in rates globally, Japan is no longer an isolated example of a major economy with near-zero long-term rates. A huge section of the developed world today has near-zero or negative rates.

Furthermore, the impact of falling rates increases as rates get to lower absolute levels. For example, let's take a hypothetical asset that is expected to pay the same nominal coupon every year for thirty years. With a starting rate of 2%, a 100-basis point drop in rates causes a 50% greater rise in present value than when rates start at 8%.

We don't believe most investors have appropriately updated their asset class forecasting models to reflect the possibility of ultra-low rates persisting for an extended period. If there is no mean reversion in bond yields, the return demanded by investors to hold risky assets should be permanently lower. Also, different assets will be impacted to varying degrees depending on duration and other factors. If these low rates were to persist (as flat yield curves imply) it will likely be **the key** investment issue of the next decade.

We want to be clear here. We are not predicting a Dow at 50,000 within the next few years. Nor are we claiming that stocks won't sell off substantially during a recession. We are simply stating that the average valuation around which equity markets oscillate in the future is possibly much higher than current models estimate. Mean reversion is likely alive and well. We will always be able to fit a mean to the data after the fact. Getting the mean right ex-ante is going to be the real challenge.

About Kaleidoscope Capital, L.P.

Kaleidoscope Capital, L.P. was founded in 2014 by Nick Nanda, Chief Investment Officer. The firm combines discretionary modern macro and systematic investment approaches to uncover opportunities across a wide range of markets and assets.

Options trading, portfolio construction, and trade structuring are particular areas of expertise for Kaleidoscope and are essential elements of risk management for the firm.

***Note:** For the valuation nerds amongst our readers, the cash flows associated with credit are unlikely to be impacted by inflation. While cash flows associated with equities (assuming companies have pricing power) are likely to grow with inflation. The correct discount rate for corporate credit is likely the 5-year nominal Treasury. While the appropriate rate for equities is a long-term TIP.

** **Data sources:** Bloomberg, MSCI, Inc., Philadelphia Fed, ECB, Robert Shiller data (http://www.econ.yale.edu/~shiller/data.htm), https://www.philadelphiafed.org/research-and-data/real-time-center/real-time-data/.

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