Strategic Global Advisors®

Factors: A Look Under the Hood

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Introduction

Year-end is a natural time to reflect on and review the past, as well as to plan for the future. In that vein, I would like to share with our clients and partners thoughts on SGA's strategies and approach, and why we are more excited today than at any time in recent memory. For the purposes of this note I will reference our flagship and longest existing strategy, International Equity Large Cap (MSCI EAFE Net Index) as the sample case.

Our conclusion is that if one believes the type of companies our process identifies makes sense – higher quality, consistent growers trading at relatively attractive valuations – we believe there has rarely been a time where the cost of owning such characteristics is more attractive than today.

Before we get to the punchline (i.e., "we believe now is the time to buy!"), let's review the history of our Alpha Model: review when it worked, evaluate when it didn't and why, and the reasons the future should be any different.

IN THIS PAPER

- A 40-year trend is no more
- SGA's Alpha Model priced near historic lows
- Quality's time in the sun?
- An excellent time for a core approach

AND...

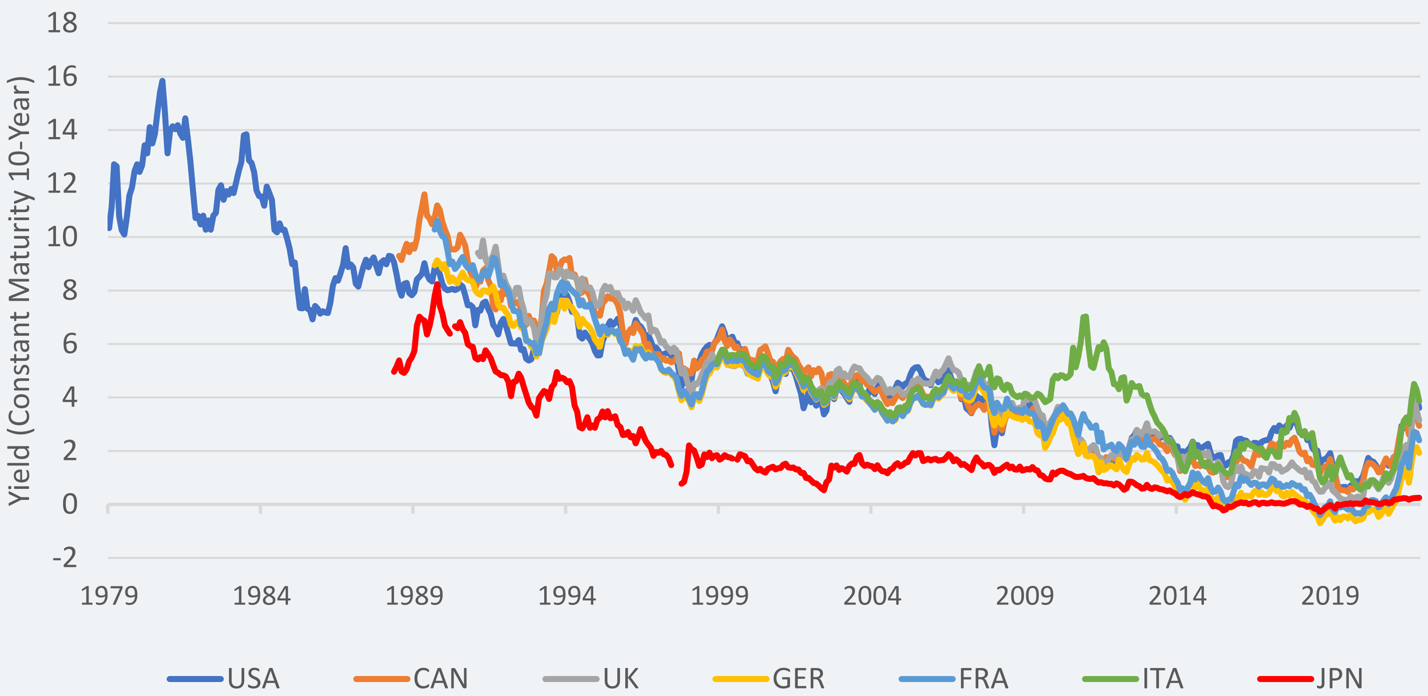
Wishing you and those close to you a very happy, healthy, and festive holiday season and a prosperous New Year! Thank you for your past support and we look forward to continuing our partnership with you into the New Year and beyond!

As a reminder, SGA's Alpha Model is comprised of 13 separate factors that identify stocks with the characteristics that we believe, over time, position them to outperform their global industry peers. These factors are grouped into four broader categories: Valuation, Growth, Quality, and Sentiment. For a factor to be added to the Model, it must not only show to have efficacy on its own, but it must also demonstrate it behaves differently than the existing factors in the Model – we value diversification. Factors in the Valuation, Growth, and Quality categories generally have a longer life span (i.e., they take longer to fully play out, approximately two years) than do those in the Sentiment category (i.e., their effectiveness tends to be shorter-term, usually under six months in nature).

Background

The world has gone through an unusual period, lasting more than 40 years, where interest rates across the globe were in nearly continual decline and leverage ratios increased. This culminated in the last few years where rates in many countries were driven to negative levels – something almost unseen in the hundreds of years of recorded history. This is often referred to as the "ZIRP" period (Zero Interest Rate Policy).

Figure 1: G-7 Sovereign Notes



Source: Bloomberg, SGA

A 40-year decline in interest rates appears to have been broken. Time to dust off the old textbooks.

Only recently have we seen interest rates begin to return toward a more normal, non-zero level, and it is in that return we believe our Model, and the stocks it identifies, are well positioned.

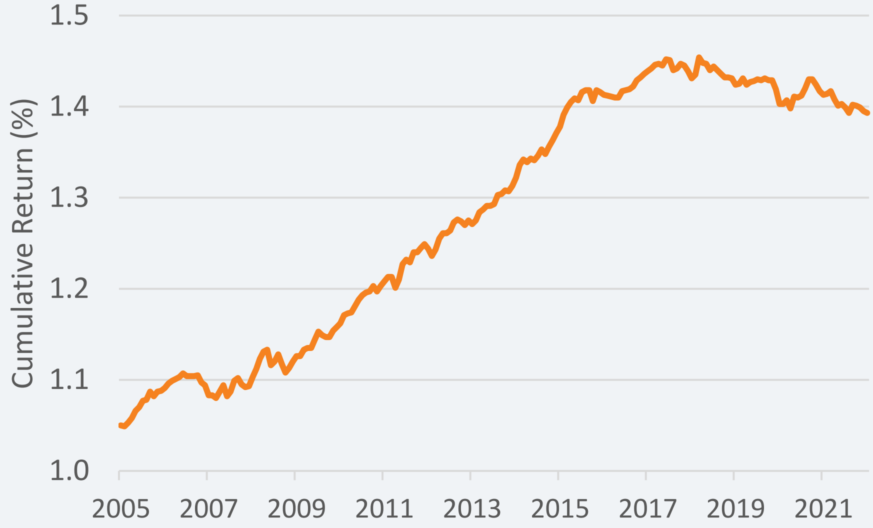
Figure 2 shows the performance of our Alpha Model since its inception in 2005. The overall Model is the compilation of the four factor groups described above.

This figure shows the Model's performance within the non-U.S. large cap developed equities universe. As can be seen, other than a drawdown during the Global Financial Crisis ("GFC") – a peak in mid-2007, trough in January 2008 and a small hiccup between March and August 2009 – the Model worked exceptionally well and consistently through May 2018. It then underperformed that year before temporarily regaining its peak in January 2019 and before again lagging until February 2021. At that point the model began again to outperform before stumbling in the fall and early 2022. Since then, it has again begun performing well.

More instructive than analyzing the aggregate Model performance, however, is to look at the contribution of the four underlying factor groups as that is when the reasons for the twists and turns at the top level become more evident.

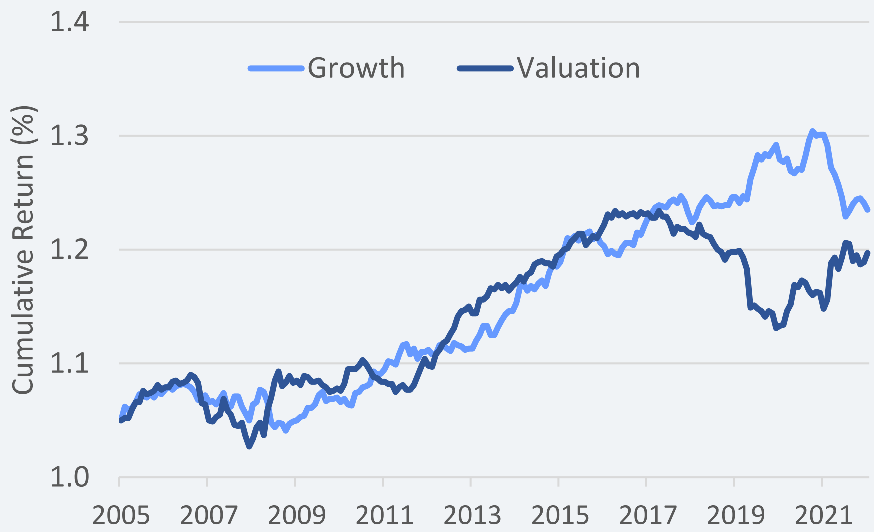
First, we will look at the Growth and Value factor groups (Figure 3).

Figure 2: Alpha Model



Source: FactSet, SGA. Analysis period: 11/30/05 through 11/30/22.
See Factor Cumulative Return Disclosure at the end of this paper.

Figure 3: Growth and Valuation Factor



Source: FactSet, SGA. Analysis period: 11/30/05 through 11/30/22.
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Most of you are well aware of the outperformance of Growth over Value stocks since the exit from the GFC. Falling interest rates supported these trends as Growth stocks typically gain a valuation boost when the present value of their future earnings becomes greater due to the lower market discount (i.e., interest) rate applied to them. The more rates fall, all else equal, the greater the Growth tailwind.

You can see the performance of our unique expressions of the Growth/Value factors over this period in Figure 3. Interestingly, and somewhat counter to the performance of generic Value factors, our expression of Value factors did as well as our Growth expression until early 2018.

As we moved into 2020, one of our toughest years, it appears that momentum took over from interest rates as the primary Growth stock driver and the mere fact that Growth had previously outperformed, drove more and more investors to specifically choose Growth over Value in spite of the increasing valuation demanded by Growth stocks – i.e., investors bought more of what had worked, irrespective of its current price.

Figure 4 shows how the AUM in non-US Growth-dedicated mandates grew substantially compared with Value-dedicated mandates during the first three quarters of 2020. This was a period many investors referred to as a "Growth at any price" market and was a period of very strong Growth performance (and similarly weak Value performance).

For the most part, from 2018 forward, our Growth and Value factor groups balanced each other as each group performed at extremes (Growth positively, Value negatively).

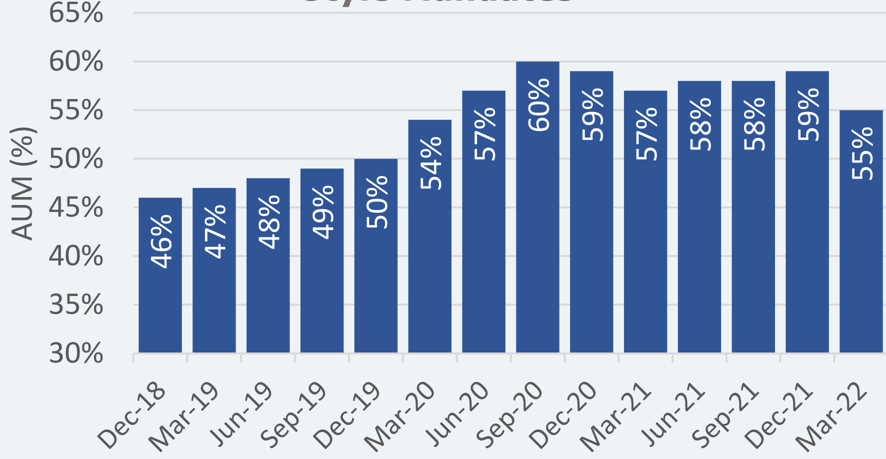
Turning to an even more interesting factor group, Quality, we can see how it too performed consistently well other than during the GFC, and then again until January 2019 (Figure 5).

> Quality likely to become a tailwind for investors

From that point, the Quality factor group demonstrated significant and consistent underperformance before finding a bottom in the middle of this year. It is our contention that Central Bank actions (e.g., bond buying, interest rate suppression) distorted the market signals normally provided by interest rates and was the prime culprit for high quality stock underperformance (and lower quality stock outperformance) during this period.

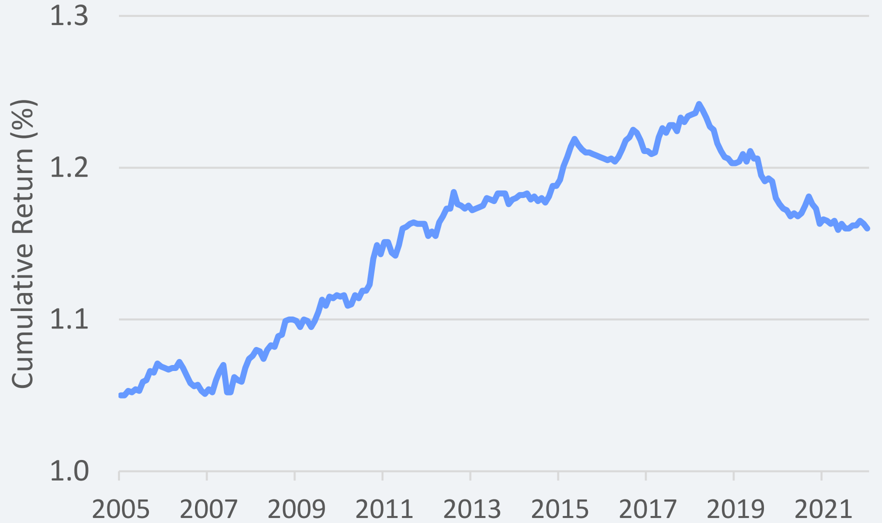
Figure 6 shows how interest rates on government bond issues over this period were driven to abnormally low and even negative levels at the time. The negative interest rate period seen in longer-term European bonds coincides almost precisely with the Quality factor underperformance.

Figure 4: AUM to Non-US Growth Style Mandates



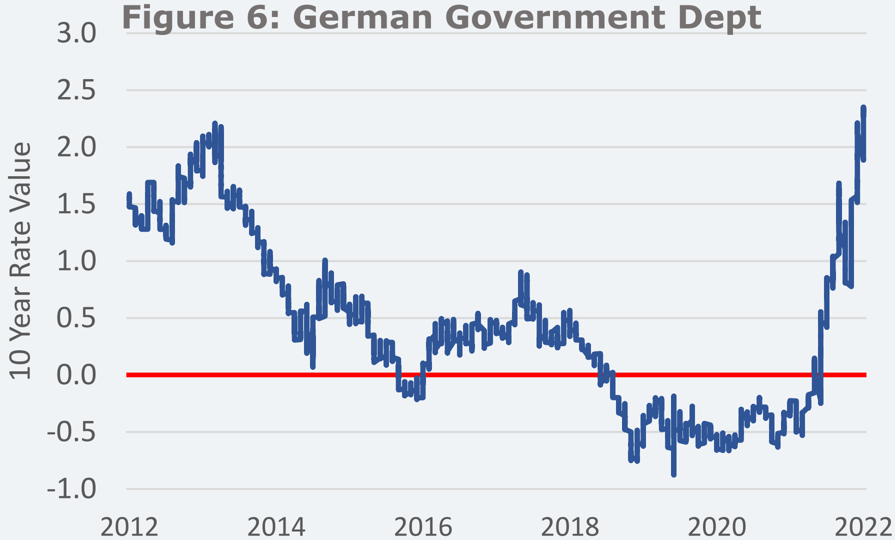
Source: eVestment, SGA

Figure 5: Quality Factor



Source: FactSet, SGA. Analysis period: 11/30/05 through 11/30/22.
See Factor Cumulative Return Disclosure at the end of this paper.

Figure 6: German Government Dept



Source: S&P Cap IQ, SGA

While all companies benefit from abundant and cheap credit, those with the poorest balance sheets, benefit the most. Where normally higher rates applied to large piles of debt eat into earnings and stretch balance sheets, during this period of "no cost credit," there was no penalty for leverage – in fact having more leverage and free credit was an advantage – until rates began to rise from late 2021 (moving positive in early 2022).

We are now entering a period where we believe the performance of our Quality factors should be more consistently a tailwind and where relative Value and consistent Growth resume a less extreme and more normal give and take.

Figure 7: Sentiment Factor

Source: FactSet, SGA. Analysis period: 11/30/05 through 11/30/22.
See Factor Cumulative Return Disclosure at the end of this paper.

Before we look at what we believe to be the current return proposition to our factor models, we should also look at the Sentiment factor group which helps to moderate the factor signals that can take longer to work (Growth, Value, and Quality) as well as explain short term reversals in performance in Figure 7.

Like the three other factor groups, Sentiment also worked well coming out of the GFC before taking on a more neutral contribution from late 2016 to early 2020 (for context, the blip seen in the fall of 2016 is most likely due to a combination of North Korea's largest nuclear test to that point, and the combined October surprises of the Donald Trump Access Hollywood video tape and Hillary Clinton's email server news). Sentiment factors then spiked substantially, becoming a leading driver in differentiating stock price movements during the COVID-19 pandemic where groups of stocks were driven more by whether they were part of the "stay at home" or "return to normal" theme than they were by valuation and growth prospects. This spike reversed sharply in November 2020 (a tough month for all SGA strategies) upon the Pfizer announcement of a COVID vaccine. That reversal, most prominent in November carried on for a couple of additional months. Sentiment then resumed a more modest positive tailwind until early 2022 when the Russian invasion of Ukraine became evident (and then a reality) and Sentiment then suffered another reversal before bottoming a couple months later in June 2022. Both events temporarily dinged largely positive trends that had been in place.

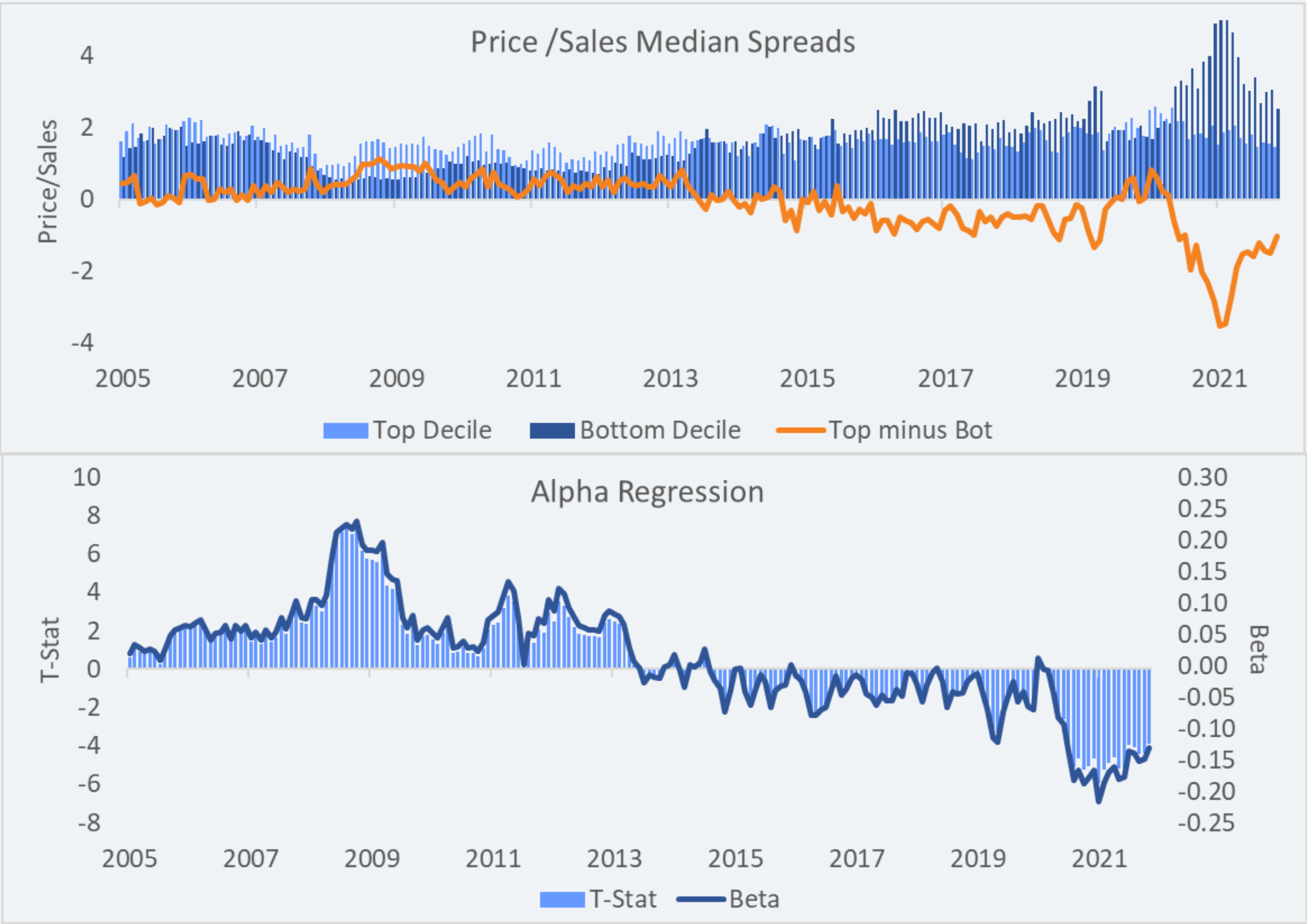
Why We Believe the Future Should Be Different

The next group of figures compares the valuations of our stock universe based on our model rankings and a Price/Sales valuation figure. The top chart in each figure shows the median Price/Sales ratio for the top decile of stocks as ranked by SGA's models and compares that to the median company valuation in the bottom decile of stocks, again as ranked by SGA's models. The orange line shows the difference between the two valuation figures.

The second figure on each page uses a regression across all stocks in the universe, so we are not just comparing the extremes at the top and bottom of the rankings. In practice, this might be the better representation of how attractive our overall Alpha Model and the various factor groups are at a given point in time.

Figure 8 and 8a shows that our overall Alpha Model has never been as cheaply priced as it is today. Thus, if you believe that high quality, consistently growing and reasonably priced stocks makes sense – it has never been less expensive to gain exposure to those factors than it is today.

Figure 8 and 8a: Alpha Model

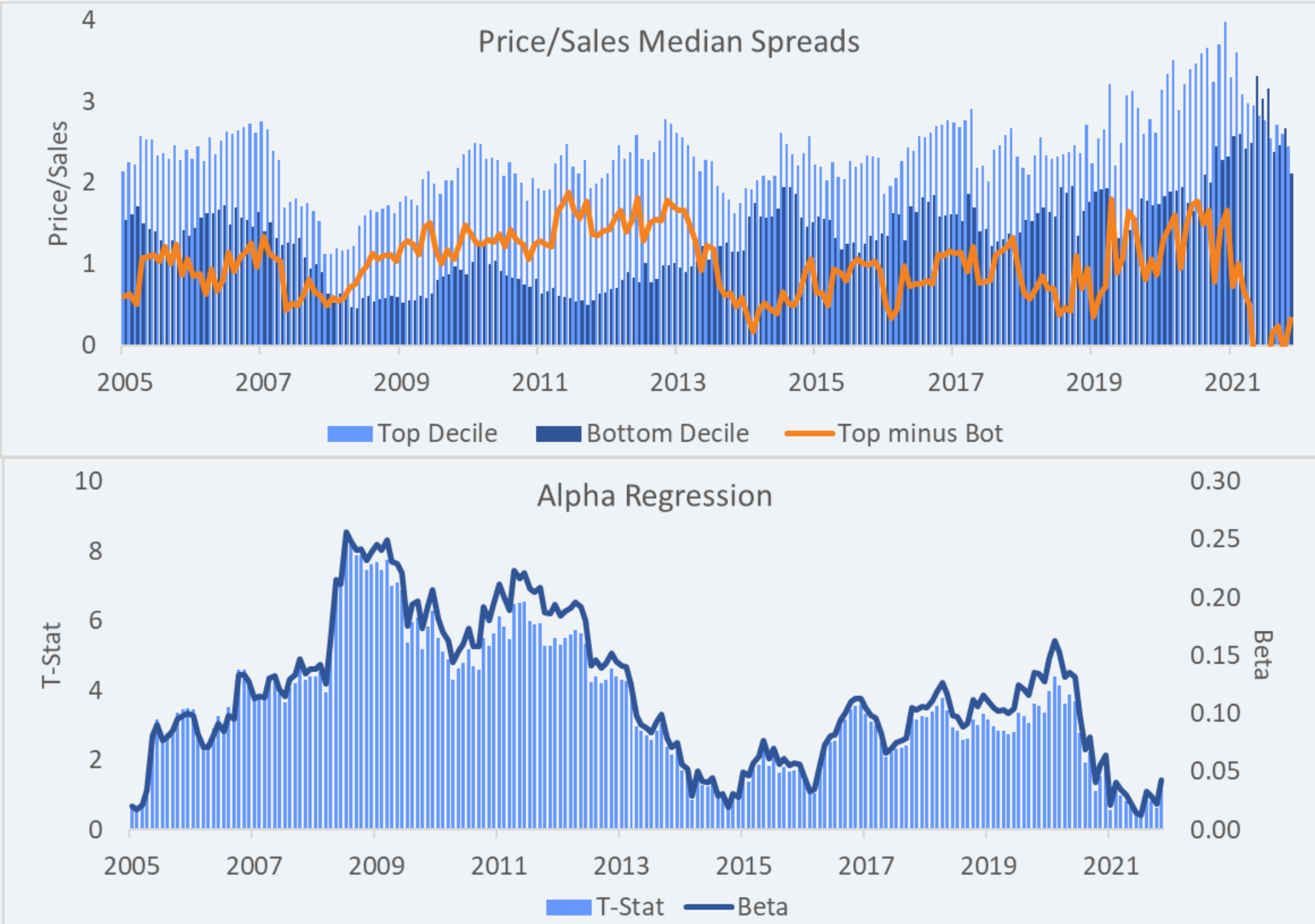


Source: FactSet, SGA. Analysis period: 11/30/05 through 9/30/22
See Alpha Model Factor Spreads Disclosure at the end of this paper.

Quality appears to be on sale

Even more interesting, we believe, is the valuation of the Quality factor group which we discussed earlier. As abnormal interest rate conditions normalize, we believe there is substantial reason for this factor to turn from a consistent (from Jan 2019) detractor to a lead contributor AND to do so at a time where one is paying a historically low premium for high quality stocks (in our Global universe, one actually pays LESS for higher quality names than lower quality peers). Such a situation has never consistently been the case before. Quality appears to be ON SALE!!! We believe this can best be seen in Figure 9a.

Figure 9 and 9a: Quality Factor



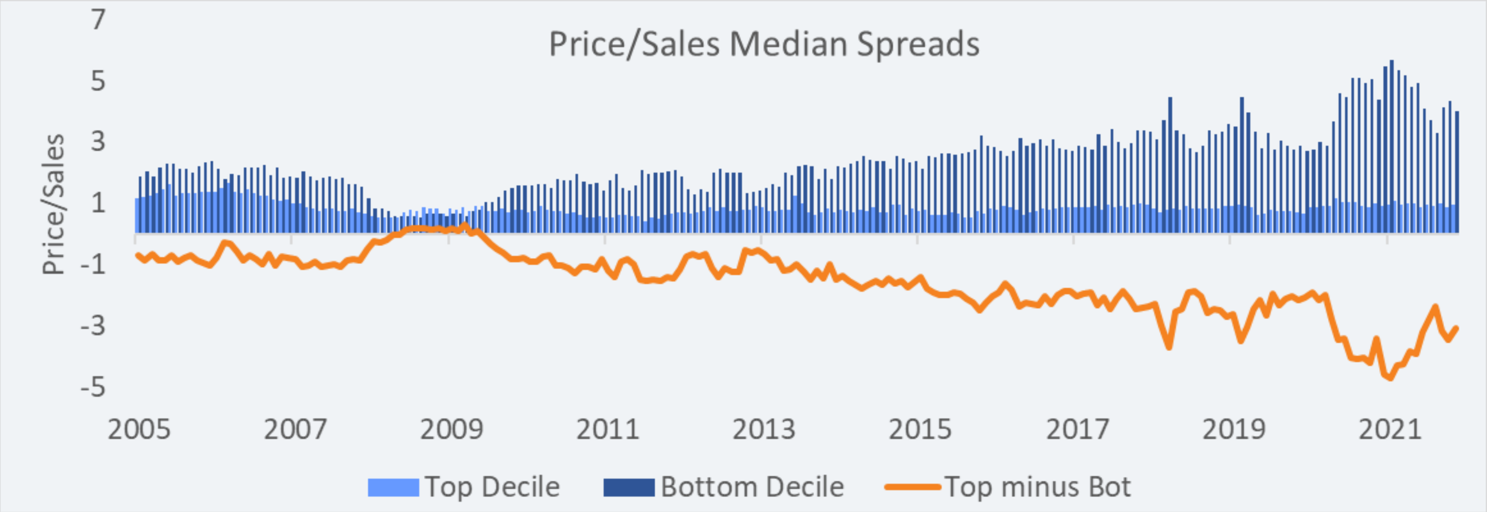
Source: FactSet, SGA. Analysis period: 11/30/05 through 9/30/22.
See Alpha Model Factor Spreads Disclosure at the end of this paper.

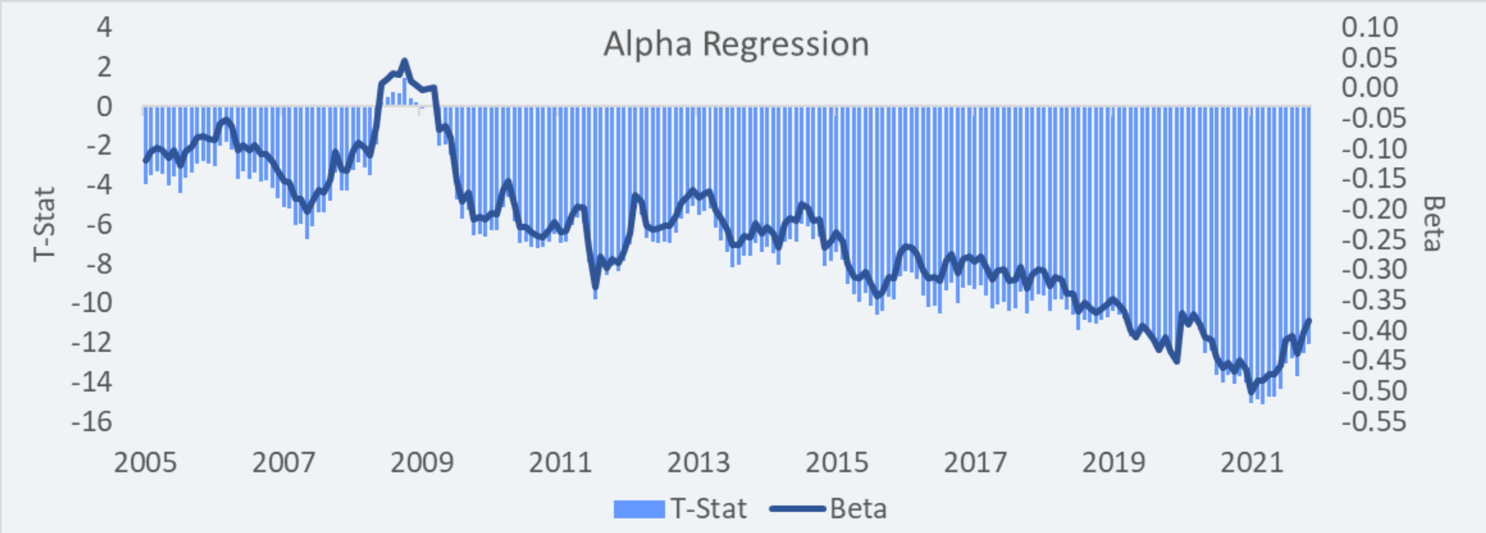
In our Global universe, one actually pays LESS for higher quality names than lower quality peers

Valuation trading at unseen levels

Like Quality factors, our expressions of Valuation (Figure 10 and 10a) are trading at here-to-fore unseen levels.

Figure 10 and 10a: Valuation Factor

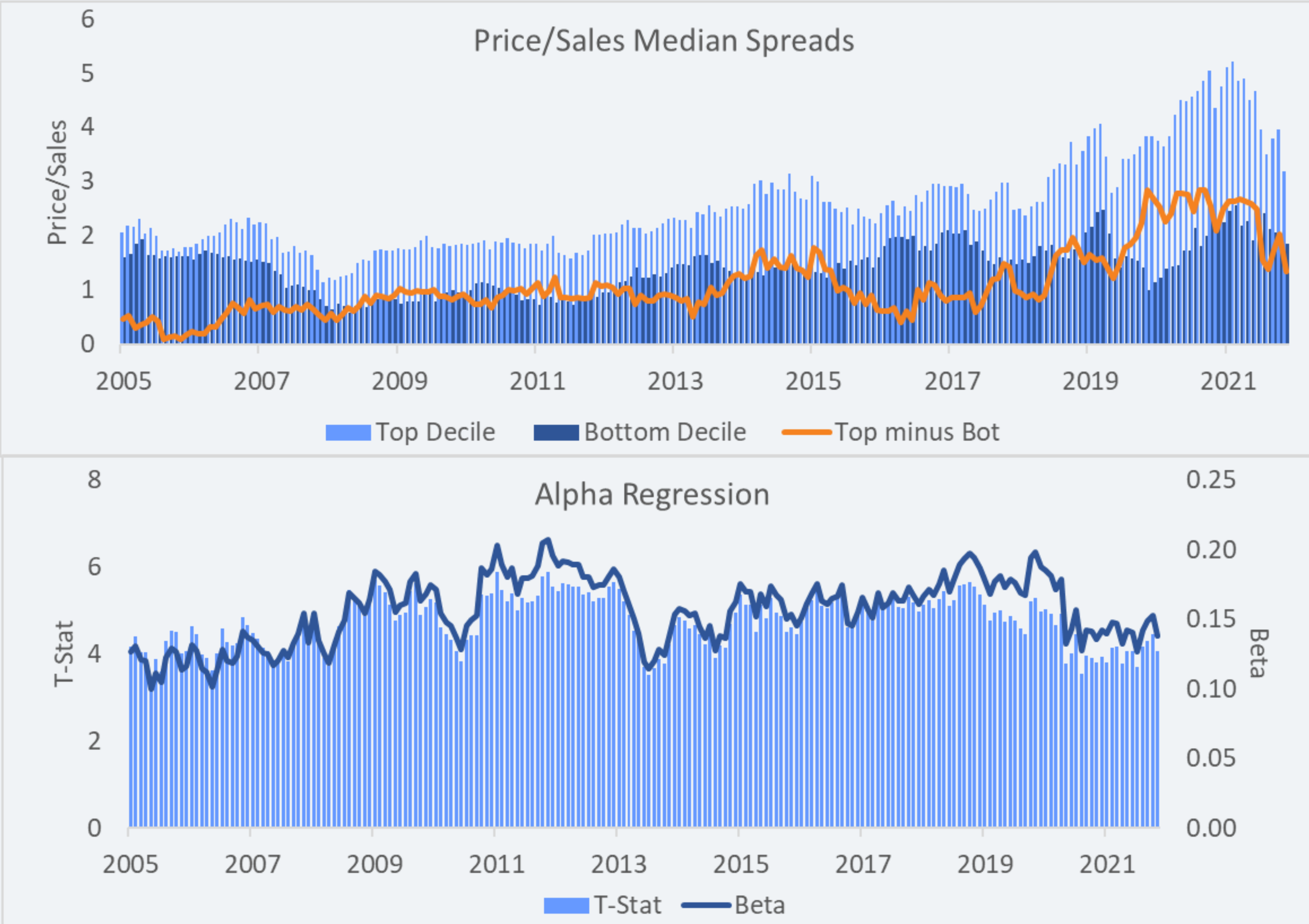




Source: FactSet, SGA. Analysis period: 11/30/05 through 9/30/22.
See Alpha Model Factor Spreads Disclosure at the end of this paper.

Growth (Figure 11 and 11a) is the only Factor group not clearly trading at historical extremes. But even here, while the top and bottom deciles show Growth to be richly priced, a more comprehensive regression across the entire universe of companies shows Growth to be trading no worse than near its historical valuation average and at levels approaching those present near the end of the GFC.

Figure 11 and 11a: Growth Factor



Source: FactSet, SGA. Analysis period: 11/30/05 through 9/30/22.
See Alpha Model Factor Spreads Disclosure at the end of this paper.

Conclusion

Every component of our Alpha Model appears to be well positioned should factor-based explanations of factor returns move toward more historical levels of pricing. The distortions of Central Bank intervention, at least for the foreseeable future, seem to be behind us. Although the potential for another inflection point or change in market leadership always exists, we believe the current environment should be quite supportive for our strategies.

If you've ever considered re-assessing your asset mix away from pure Growth or Value, now would appear to be an excellent time to do so. Please let us know if you'd like to explore any of this data more deeply with our team or if we can help you customize your asset mix.

Wishing you and those close to you a very happy, healthy, and festive holiday season and a prosperous New Year! Thank you for your past support and we look forward to continuing our partnership with you into the New Year and beyond.

Important Disclosures

This paper is meant for illustrative purposes only and is not intended as a recommendation to invest in any particular asset class or strategy. The views and opinions expressed in this paper are those of Strategic Global Advisors, LLC and should not be construed as an estimate or a promise of results that a portfolio may achieve. The materials provided in this presentation and any comments or information provided by the authors are for educational purposes only and nothing presented should be considered legal or investment advice. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

Systematic or Quantitative Process Risk

There is potential for shortfall in any investment process due to a variety of factors including, but not limited to, data and system imperfections, analyst judgment, and the complex nature of designing and implementing portfolio construction systems and other quantitative models. Such shortfalls in systematic or quantitative processes in particular pose broader risk because they may be more pervasive in nature. Furthermore, the Advisor's SGA's systems may not necessarily perform in a manner in which they have historically performed or were intended to perform. The Advisor recognizes that such shortfalls are inherent to both fundamental and systematic or quantitative processes and believes that combining both approaches improves the opportunity to reduce these shortfalls. However, these efforts may not necessarily result in the identification of profitable investments or the management of risk.

Alpha Model Factor Spreads Disclosure

Alpha Model values reflect the aggregate price to sales on SGA's historical factor category portfolios and do not reflect performance of any SGA portfolios. The referenced charts are used to illustrate the spreads between the median price to sales ratio of the highest decile ranked companies and the bottom decile ranked companies by our Alpha Model overall and within each of our four factor categories specified. SGA does not guarantee the accuracy of these estimates or methodology. SGA applies both quantitative and qualitative approaches to portfolio management, which may vary depending on market conditions.

International equity investing includes the possibility of loss.

SGA encourages clients and prospects to seek independent sources of analysis in assessing SGA's returns and process. For additional information on the calculation methodology please contact Strategic Global Advisors, LLC at 949.706.2640.

- T-Statistic = A measure of the likelihood that the actual value of the item being measured is not zero. The larger the absolute value of T, the less likely that the actual value could be zero. It is computed by dividing the average value by its standard error.
- Regression Coefficient = The coefficient that results from the univariate regression of company alpha scores (independent variable) against price to sales (dependent variable). This represents the relative cost/price of the Alpha Model, or the respective factor category, in terms of price to sales.
- The universe of securities for SGA's International Equity strategy includes approximately 2,000-2,500 companies in both developed and emerging markets that meet market relative market capitalization and internal liquidity requirements.
- Market cap cutoff was determined through time this way:
    - The top 10% of companies in the universe as measured by market cap at each given period
    - The approximate number of companies in International Equity universe varies significantly over time and in comparison to the universe used when constructing actual client portfolios
- Time period: November 2005 – September 2022
- Monthly Frequency
- Included: Developed and Emerging countries

This data in the referenced charts is to be used for illustrative purposes only and not indicative of future results.

Factor Cumulative Return Disclosure

SGA determines the pure factor returns to SGA's Risk and Alpha Factors by constructing a Factor Mimicking Portfolio ("FMP") for each alpha and risk factor. FMP's are constructed such that the portfolio's exposure (security weights multiplied by exposure, summed up) to the factor in question is 1 and has an exposure of 0 to all other factors relative to the MSCI EAFE (net) benchmark. Returns of the FMPs are calculated monthly and cumulative charts depict the cumulative results of the monthly FMP returns for a given time period. For the SGA Alpha Model and Alpha Categories, FMPs are additionally constrained to be long-only (no short positions) to better align factor performance to the portfolio opportunity set of SGA's long-only strategies. An FMP is not a real or hypothetical portfolio and is used strictly to demonstrate pure returns to SGA's Risk and Alpha Factors used in holdings-based attribution analysis.

Contact Strategic Global Advisors

Get in touch with our team to learn how you can access the international markets with our distinct integrated approach

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Brett Gallagher
President

Mr. Gallagher is President of SGA. Prior to joining the firm, he was a partner and served as Director of Research and Acquisition at Nile Capital Group, a Los Angeles-based private equity firm. Previously, he served as Deputy CIO at Artio Global Investors/Julius Baer Investment Management, Head of Investment Management Asia for JP Morgan Private Bank in Singapore, and Head of Global Equity for Bankers Trust International Private Bank. Mr. Gallagher has appeared numerous times on CNBC, Bloomberg, and Fox Business News as well as having been quoted in The Wall Street Journal. He was also a guest lecturer at Yale University. Mr. Gallagher received his BA in Economics from the University of Virginia and his MBA from The Darden Graduate School of Business. He is currently a member of the Board of Managers and Chair of the Investment Committee for the University of Virginia Alumni Association.