M.M.WARBURG & CO
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ECONOMIC SITUATION AND STRATEGY

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Stock selection: Better dogmatic or opportunistic?

The life of a portfolio manager is not always fun and games. We are not looking for sympathy – that would be inappropriate. But it does hurt a little to see the broad market beaten by stocks that good old fundamental analysis would advise against touching with a ten-foot pole. That is the situation now, though. If we analyze the performance of the broad European or US stock market, we notice that stocks are advancing that exhibit low balance sheet quality, weak profitability, high price volatility, and low earnings growth. However, that is not totally irrational. Most of those are companies that have taken a massive beating on the stock market in the last few years, but are now benefiting from an environment in which greater economic risks appear relatively unlikely given a foreseeable end of the pandemic and still ultra-accommodative monetary and fiscal policy. It makes sense that the companies benefiting from lower economic risks are mainly ones with basically shaky business models – that explains the rapid catch-up of these "ragamuffin stocks" observed in the past several weeks. But the big question is how long a situation can persist in which stocks perform that really should not be in a portfolio in the long term due to their sub-optimal attributes. Should portfolio managers remain dogmatic and rigidly stick to principles that are correct for the long haul? Or might not a little opportunism be appropriate? Ultimately, what clients pay for is good performance. Awards are seldom given for especially rigid adherence to pure theory.

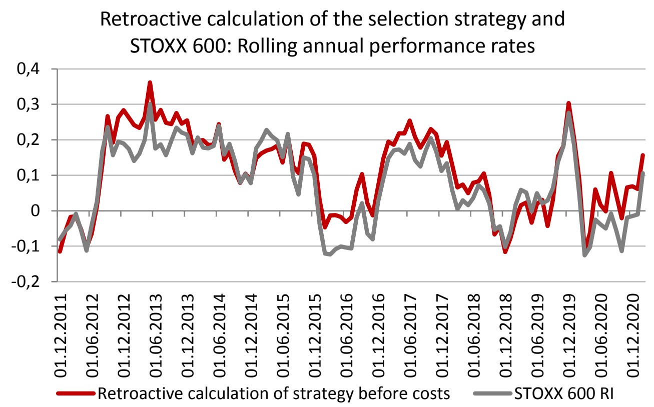
However, we should not assume that an opportunistic investment style will guarantee better performance in every instance, since the market phases in which it seems appropriate often end as suddenly as they began. People say market timing is for suckers, and there is a lot of truth in that. It is indeed very difficult to anticipate when the ideal time has come to switch from a dogmatic to an opportunistic investment style.

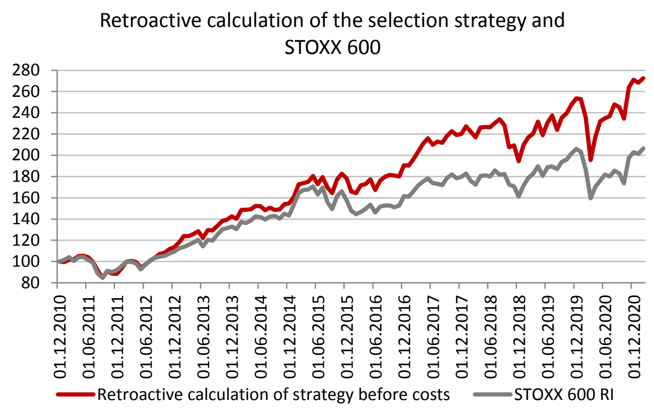
So, is there then good reason after all to bite the bullet in atypical market phases, endure the underperformance and in return benefit from the long-term outperformance that could be expected with a classic fundamentally oriented investment style geared to quality and earnings growth with fair valuation?

We have investigated this question by representing the most opportunistic investment style conceivable in a model and analyzing the resulting performance. To that end, we have "simulated" the behavior of a portfolio manager who ignores all fundamental correlations and simply buys the stocks that have the attributes that led to outperformance in the respective preceding period, regardless of whether supported by fundamental logic or not.

This is how we proceeded. By half-years from the end of 2010, we formed portfolios for 16 fundamental factors from the areas of financial quality, profitability, volatility, valuation, and growth and calculated their performance on a daily basis. We used a non-linear trend to depict the performance of these factor portfolios, determined the slope of this trend at the end point of each period and used it as the estimator for the factor return trend in the subsequent six months. In this way, we determined a half-year at a time a "factor skyline" that is based on the trends of the relatively recent past and tries to project this trend for a further six months. With this information, we then designed a portfolio by half-years that optimally corresponds to the desired factor skyline; we constrained the portfolio to be largely sector-neutral down to ICB Level 5. The portfolios consisted at all times solely of stocks that were in the STOXX 600 then. For the fundamental data, we used only analyst estimates actually available in real time. Turnover on rebalancing dates is comparatively high at about 80%. But since rebalancing only occurred in January and July, total turnover would have remained in a practicable range. No curve-fitting of the model was performed at any time. The model was programmed, and the result was taken over without a single further modification to the model. A forward-looking bias, a survivorship bias, or similar form of distortion appears impossible. A random result – driven by a few selected stocks – likewise appears impossible, since the portfolio contains about 100 equally weighted stocks at all times and the resulting statistical properties are very stable over the course of time.

The result that emerges is that relatively uniform outperformance can be achieved with this totally opportunistic approach that operates detached from economic assumptions and considerations. We see this not only in the cumulative performance, but also especially in the comparison of annual rates of the model portfolio and the STOXX 600. The model portfolio's annual rates mostly range at or above the level of the index and only seldom fall below it. The tracking error is 4.3%, and information ratio 0.7.





How should we interpret these results? We believe a possible interpretation would be that factor trends on average continue so long that even a sluggish modeling that only permits rebalancing twice a year can exploit factor trends. To a certain extent, that would refute the argument according to which trends can pivot so fast that using them systematically is impossible. For the practical context and especially for the current situation, the result can also be interpreted to mean that asset managers may venture a temporary shift to cyclical companies with little profitability and high debt. Even though these stocks certainly do not meet the traditional target criteria of portfolio managers, there are some reasons driven by macroeconomic considerations why this trend will not come immediately to an end. And history also shows that such trends can actually be utilized. We therefore conclude that even though our hearts beat for classic fundamental analysis, there seems to be no harm in a bit of opportunism.

Market Data

Stock marktes	As of 12.03.2021 14:23	Change versus 26.02.2021 -1 week	04.02.2021 -1 month	04.12.2020 -3 months	04.03.2020 -1 year	31.12.2020 YTD
Dow Jones	32486	5,0%	4,6%	7,5%	19,9%	6,1%
S&P 500	3939	3,4%	1,7%	6,5%	25,9%	4,9%
Nasdaq	13399	1,6%	-2,8%	7,5%	48,6%	4,0%
DAX	14486	5,1%	3,0%	8,9%	19,4%	5,6%
MDAX	31673	1,3%	-2,1%	7,3%	21,4%	2,8%
TecDAX	3330	-0,5%	-4,9%	6,8%	12,9%	3,7%
EuroStoxx 50	3829	5,3%	5,1%	8,2%	11,9%	7,8%
Stoxx 50	3260	4,3%	2,7%	5,5%	2,7%	4,9%
SMI (Swiss Market Index)	10850	3,1%	-0,1%	4,7%	5,8%	1,4%
Nikkei 225	29718	2,6%	4,9%	11,1%	40,8%	8,3%
Brasilien BOVESPA	114885	4,4%	-3,7%	1,0%	7,1%	-3,5%
Russland RTS	1510	7,0%	7,7%	11,3%	12,0%	8,8%
Indien BSE 30	50792	3,4%	0,4%	12,7%	32,2%	6,4%
China Shanghai Composite	3453	-1,6%	-1,4%	0,2%	14,7%	-0,6%
MSCI Welt (in €)	2806	4,5%	2,3%	8,3%	16,6%	7,2%
MSCI Emerging Markets (in €)	1358	2,9%	-1,7%	10,5%	21,9%	8,1%
Bond markets						
Bund-Future	171,64	-176	-468	-318	-626	-600
Bobl-Future	134,97	76	2	-40	-101	-21
Schatz-Future	112,09	-8	-17	-23	-33	-19
3 Monats Euribor	-0,54	2	2	1	-7	4
3M Euribor Future, Dec 2017	-0,53	-3	3	0	6	0
3 Monats $ Libor	0,19	1	0	-3	-81	-4
Fed Funds Future, Dec 2017	0,09	0	2	0	-29	0
10 year US Treasuries	1,59	14	45	62	60	68
10 year Bunds	-0,31	-2	18	24	33	27
10 year JGB	0,12	-5	6	10	26	10
10 year Swiss Government	-0,26	-5	13	18	61	23
US Treas 10Y Performance	679,58	-0,9%	-3,1%	-4,5%	-2,0%	-5,1%
Bund 10Y Performance	669,45	0,5%	-1,3%	-2,0%	-2,9%	-2,2%
REX Performance Index	494,15	0,3%	-0,7%	-1,0%	-1,5%	-1,0%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,19	-6	9	17	9	17
IBOXX BBB, €	0,67	-5	10	9	-9	12
ML US High Yield	4,91	7	8	-24	-127	-7
ML Emerging Marktes, Index	1343	-0,1%	-3,0%	-2,6%	-1,4%	-3,8%
Convertible Bonds, Exane 25	8225	1,5%	-2,0%	0,8%	6,3%	-1,2%
Commodities						
S&P Commodity Spot Index	481,35	0,9%	7,6%	23,9%	30,1%	17,6%
MG Base Metal Index	386,62	-4,3%	8,0%	8,5%	39,1%	9,0%
Crude oil Brent	69,44	5,1%	17,8%	40,7%	34,0%	33,8%
Gold	1703,41	-1,4%	-4,8%	-7,1%	3,8%	-10,2%
Silver	26,16	-0,3%	-0,1%	8,5%	52,4%	-0,8%
Aluminium	2153,75	0,2%	8,3%	6,1%	25,5%	9,1%
Copper	8932,75	-2,3%	14,1%	15,3%	57,7%	15,3%
Iron ore	171,28	3,4%	10,3%	21,0%	91,1%	9,9%
Freight rates Baltic Dry Index	1970	17,6%	48,5%	64,6%	250,5%	44,2%
Currencies						
EUR/ USD	1,1936	-1,5%	-0,5%	-1,8%	7,3%	-2,7%
EUR/ GBP	0,8582	-1,2%	-2,2%	-4,8%	-1,3%	-4,1%
EUR/ JPY	130,13	1,0%	3,1%	2,9%	8,8%	2,9%
EUR/ CHF	1,1092	1,0%	2,5%	2,5%	4,2%	2,7%
USD/ CNY	6,5050	0,4%	0,5%	-0,4%	-6,1%	-0,4%
USD/ JPY	107,98	1,3%	2,3%	3,7%	0,4%	4,6%
USD/ GBP	0,72	0,6%	-1,8%	-3,1%	-7,8%	-1,7%

Source: Refinitiv Datastream

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