Fundamentals, The First And Final Frontier

Many human endeavors have been stimulated by a prize competition. These are always something along the lines of whoever builds the fastest spaceship out of recycled beer cans wins $10 million. The federal government, ever eager to spend either your money or whatever the Federal Reserve has printed in tapered quantities over the past week, actually has a www.challenge.gov Website devoted to such contests.

In that spirit, herewith the Fundamentals Challenge: The next time the stock market takes a major beating and the President does not say, “The fundamentals of the economy are strong,” you will win a bag of the potato chips of your choice, no questions asked.

A Third Weighting Scheme

The last two months’ articles have been devoted to topics such as capitalization-weighting versus equal-weighting and to the influence of capitalization on relative performance. If we stipulate the inherent problems of capitalization-weighting and equal-weighting are they reward past performance and reward being relatively small, respectively, in how they divvy up the fund inflows, then the only way to avoid these oversimplified biases is to take size out of the weighting process altogether.

The principal approach to doing so would be instantly recognizable to anyone involved in security analysis and portfolio development prior to the introduction of capitalization-weighted indexes in the 1970s: Select stocks on the basis of their measurable financial attributes. As most of us can agree with only minor quibbling higher sales are better than lower sales, larger book value is better than lower book value, greater dividend payouts are better than lower dividend payouts and greater cash flow is better than lower cash flow, then we are on our way toward the principles of fundamental weighting.

These factors focus on the textbook definition of a stock’s value, the ability to produce and expand returns to shareholders both in the form of dividend-based income and buyback-based capital distributions. They also have the advantage of not being as subject as earnings to accounting decisions of when to recognize income and expenses. In a famous phrase, “Earnings are an opinion; dividends are a fact.” This could be amended to say, “Dividends and buybacks are facts.”

This ignores the continuous and figuratively bloody methodological fights index developers seem to have as a matter of course. Some methods include stock buybacks along with dividend payouts on the sound theory both represent returns to the investor; others penalize greater sales if they are achieved via higher debt/equity ratios. Others exclude book value or modify cash flow to the point where only the potion retained after dividends and share buybacks is included. Fundamental indexes can be compartmentalized further into investing styles such as value or growth.

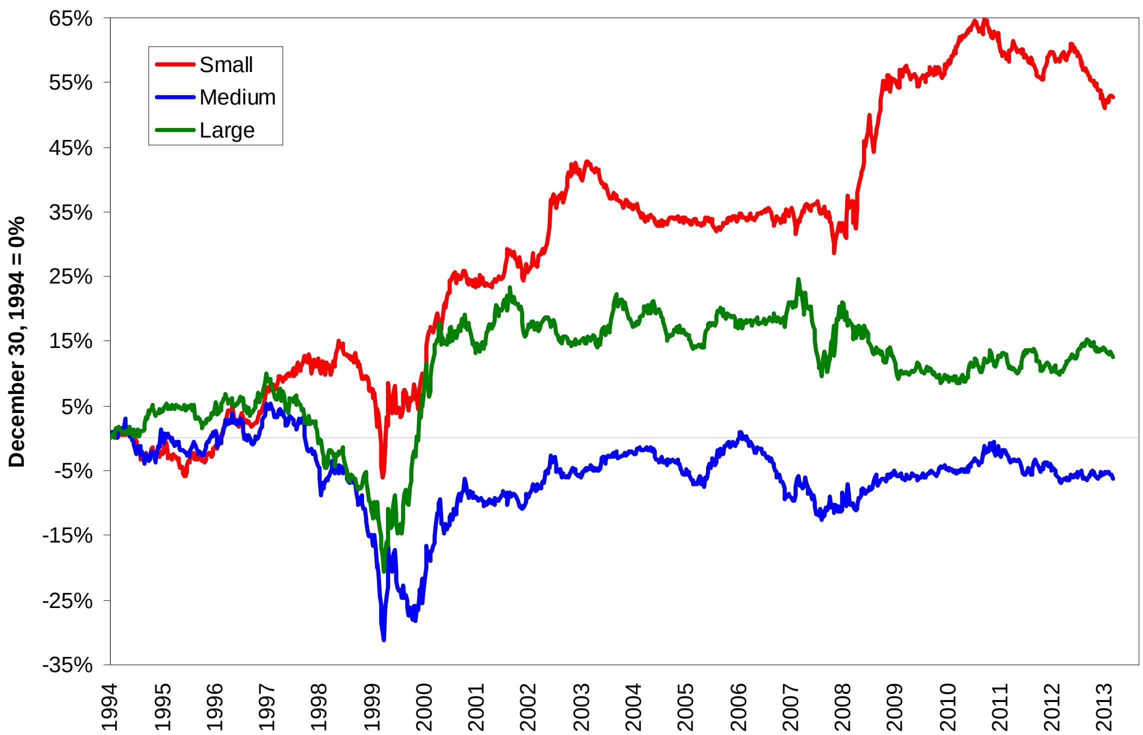
These financial variables are the comfort food of the investing world. A focus on them will lead you to miss the high-flying and quick-crashing tech stocks of the bygone dotcom era or they may overemphasize firms whose existing fundamentals over a typical five-year averaging period have been solid but whose prospects are deteriorating. The oil giants of the late 1970s and early 1980s all had great five-year fundamentals before they got walloped in the middle part of the 1980s, and a similar fate awaited mainframe computer giant IBM as personal computers came to the fore. Nothing is perfect, is it?

As an aside, the broader question of whether share buybacks are a sign of weakness as the company does not have a more compelling use for cash than to return it to shareholders and possibly to enrich option-incentivized management will be sidestepped here.

Performance Comparison

Once all of these discussions come out of the proverbial ivory tower, the one question most investors have is performance. Let’s compare the total returns for three “core” fundamental indexes produced by Research Affiliates against their capitalization-weighted counterparts produced by Standard & Poor’s. To refresh from last month, the S&P 1500 Supercomposite is divided along capitalization lines into the large-capitalization S&P 500, the middle-capitalization S&P 400 and the small-capitalization S&P 600.

Incremental Performance Of Fundamental Indexes

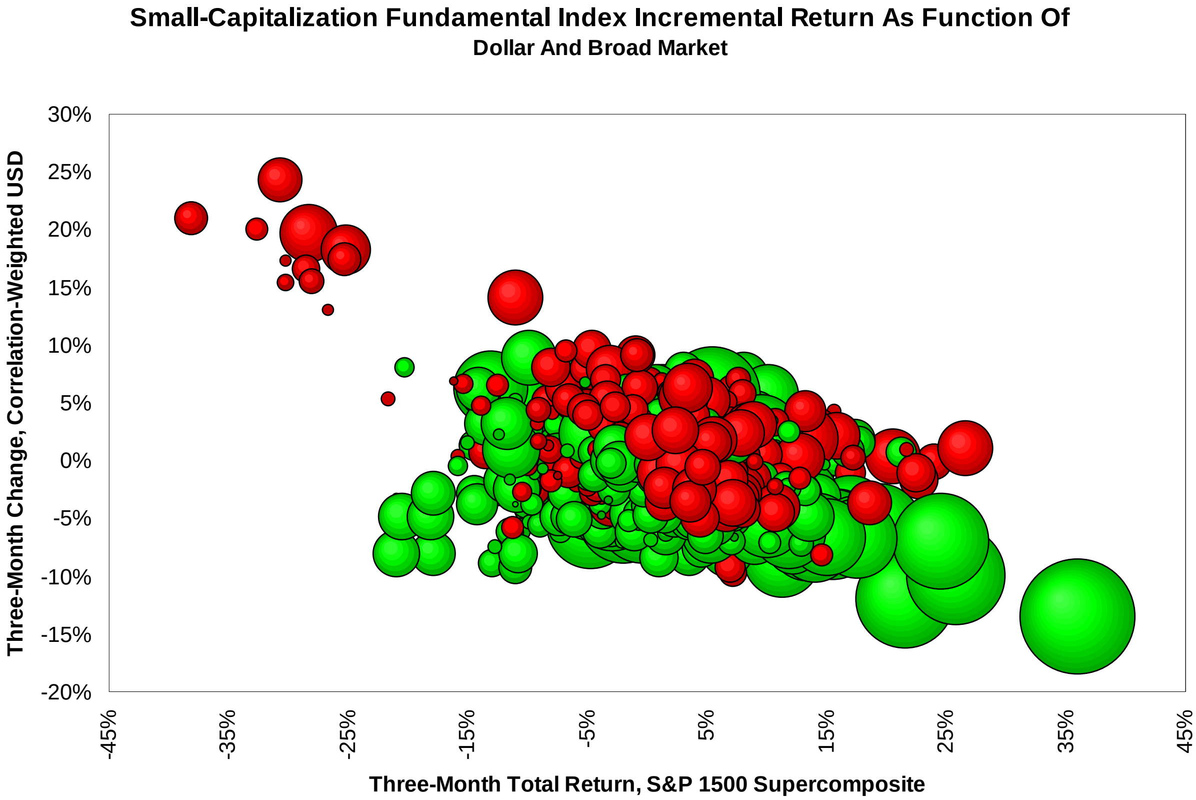


Two differences stand out immediately. First, while the fundamental series for both the large- and especially for the small-capitalization indexes have outperformed continuously since the bursting of the dotcom bubble in 2000, the middle-capitalization index has struggled on a relative basis since then. As noted last month, the middle-capitalization index has enjoyed an odd and completely non-fundamental advantage for years: Hedge funds buy the issues likely to move into the much larger S&P 500 in anticipation they will rise for no reason other than index funds then must buy them.

Second, the small-capitalization fundamental index outperformed after both major bear markets of this era, especially the 2008 financial crisis. Investors instinctively flee to the perceived safety of large-capitalization issues during times of crisis; apparently they flee from smaller issues as well. This leaves the door open for what used to be called stock-pickers to find unloved and oversold bargains amongst small-capitalization issues.

Focus On Small Capitalization

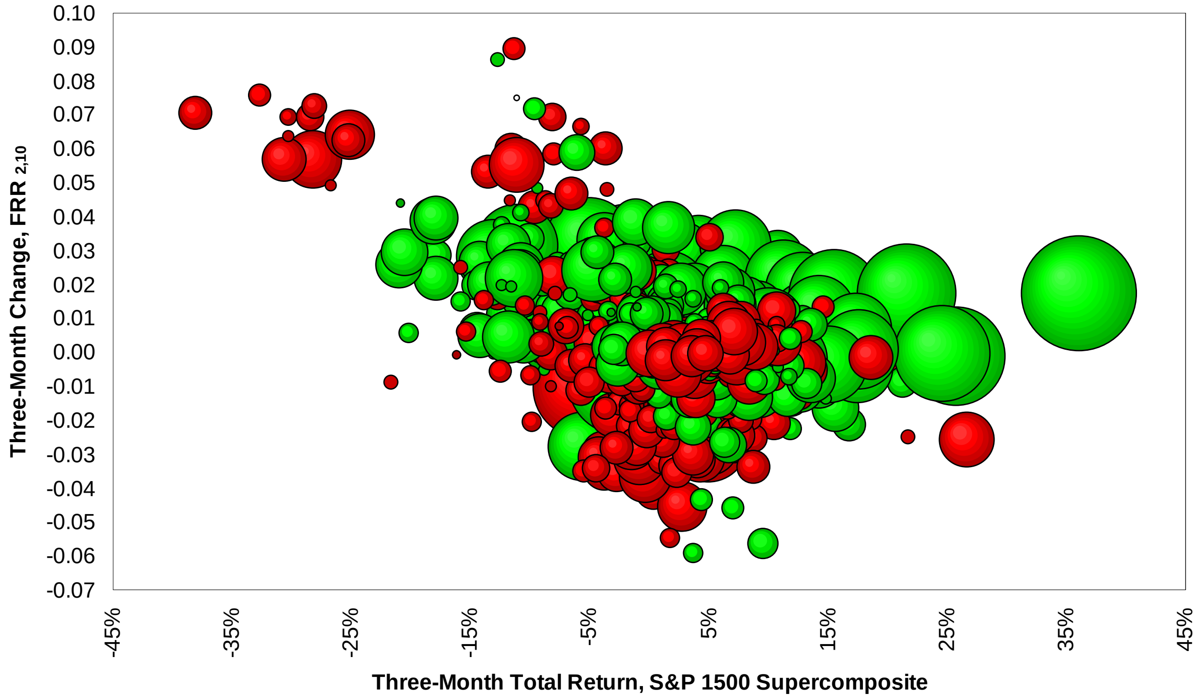
The history of the small-capitalization index' incremental performance suggests it is quite sensitive to broad market conditions. Interestingly, it appears to be sensitive to changes in the dollar as well. Let's map the three-month incremental return of the small-capitalization fundamental index as a function of three-month returns on the broad S&P 1500 Supercomposite and the *Bloomberg* correlation-weighted dollar index. Fundamental index outperformance is depicted with green bubbles, S&P 600 outperformance is depicted with red bubbles; the diameter of the bubbles corresponds to the absolute magnitude of the performance differential.



The fundamental index outperforms most strongly in the southeast corner of the map and vice-versa. Its greatest weekly bursts of outperformance did not come during bearish periods, but rather after bullish ones; this suggests the capitalization-weighted index led the way with a burst of indiscriminate buying followed by more discerning allocation into the fundamental index. The opposite appears true as well: After investors shed stocks en masse, the fundamental index was sold further. The dominant pattern in the middle of the chart is for a strong dollar to redound to the benefit of the capitalization-weighted index as opposed to the fundamental index. This, apparently, is one fundamental the fundamental analysts have ignored.

A second fundamental is changes in the Treasury yield curve as measured by the forward rate ratio between two and ten years ($FRR_{2,10}$). This is the rate at which we can lock in borrowing for eight years starting two years from now, divided by the ten-year rate itself. The more this ratio exceeds 1.00, the steeper the yield curve is; an inverted yield curve as an $FRR_{2,10}$ less than 1.00. If we map the incremental returns for the fundamental index as a function of three-month returns for both the broad market and the yield curve, we see two zones of fundamental index underperformance at both extremes for changes in the yield curve. It matters not if the $FRR_{2,10}$ steepened by more than 0.04 or flattened by more than -0.02, once the Federal Reserve starts slamming the yield curve about, the small-capitalization fundamental index starts underperforming.

Small-Capitalization Fundamental Index Incremental Return As Function Of
Yield Curve And Broad Market



The two illustrations above highlight the inherent drawback for all fundamental analysis: It must rely on past data as future data do not exist. Markets either are not or should not be scorecards for past performance; they should reflect at-risk forward assessments. Once external variable such as the dollar or policy variables such as the yield curve enter the equation, the neat assumption of fundamental weighting's advantage over capitalization-weighting starts to teeter, and this is for the strongly outperforming small-capitalization fundamental index.

We can conclude with regard to all discussions of weighting schemes, "Let the debate continue," if for no other reason it will. Forever.