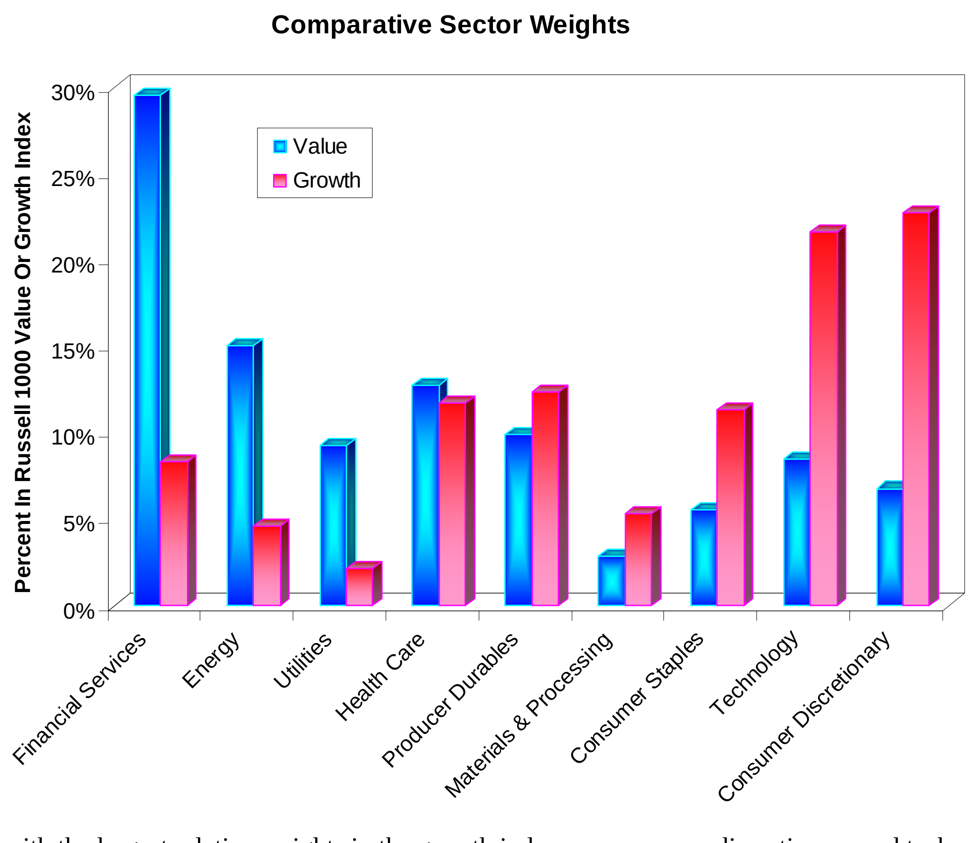
Style Is Always In Fashion With The Russell 1000

Traders like to think of themselves as independent thinkers and lone wolves out on the investment landscape, but when the shape of the investment landscape is defined by the collective actions of others, you have to run with the herd. Also known as trend-following, this has been an accepted part of futures trading for years. Equity traders and investors have to play the game a little bit differently as most institutional investors have to follow charters defining their risk parameters and industry exposure. If you look at the prospectus for something with "value" in its name, you should not have to guess whether the manager favors stocks with low price-to-book ratios and above-average dividend yields or not.

While these investment managers have to hew to their charters, plus or minus, their investors do not. As various types of investments move into and out of favor, flows of funds follow in long-running trends. Sometimes these propel growth stocks in a given sector higher, as happened during the technology bubble of the late 1990s; sometimes they push the value stocks in a given sector lower, as happened to the large-capitalization financial stocks during the 2008 financial crisis and its aftermath. In all cases these changing investment fashions are reflected in the divergent behavior of style indices such as the Russell 1000 Value and Growth indices. Let's look at how value vs. growth investment trends have moved over time for these large-capitalization issues, what their economic sector dependencies have been and how you can use some readily available market indicators to trade futures on them.

Sector Distribution

Value and growth differ from each other on more attributes than price-to-book and dividend yield; they have profound differences in their sector exposure. The largest sector exposure in the value index, by far, is financial services. The other three sectors where value outweighs growth are energy, utilities and health care. Two of these sectors, financial services and utilities will be singled out for factor analysis below.



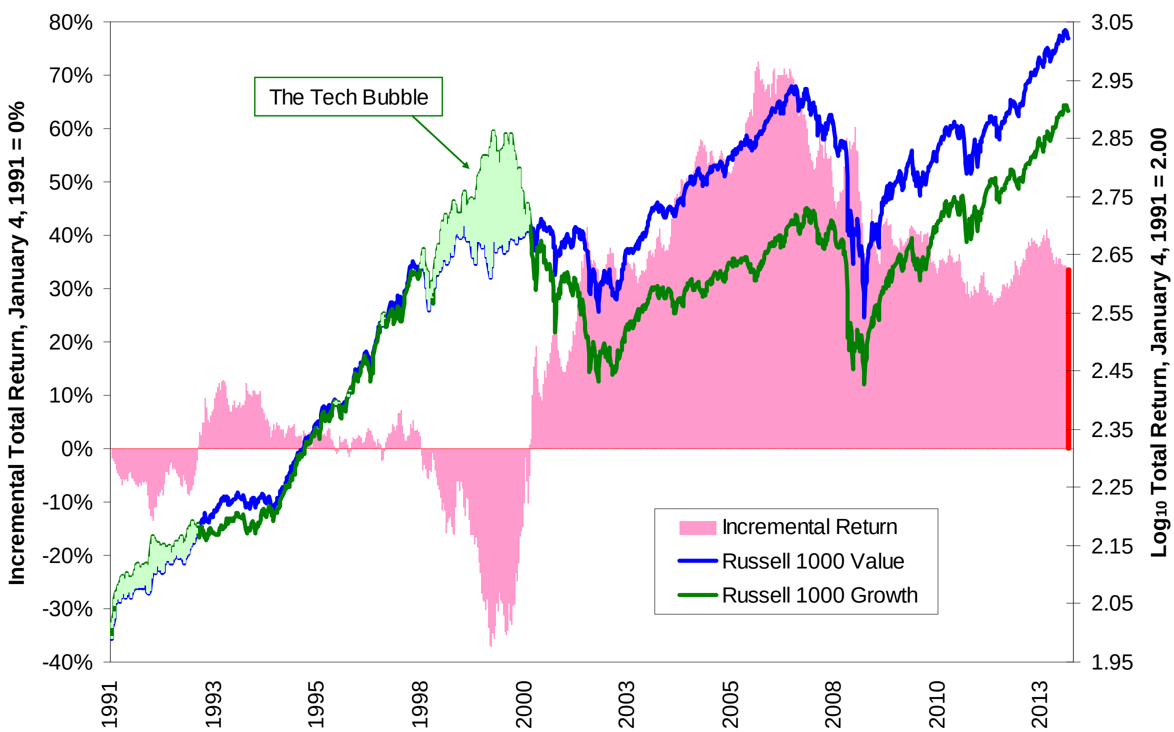
The two sectors with the largest relative weights in the growth index are consumer discretionary and technology. Neither should be surprising given their respective leverages to consumer and business spending. Both of these sectors have high volatility levels and tend to surrender gains quickly during market downturns.

In homage to the old Wall Street adage, "It is a market of stocks, not a stock market," we can say, "It is a set of sectors, not just a single value or growth index."

Value And Growth

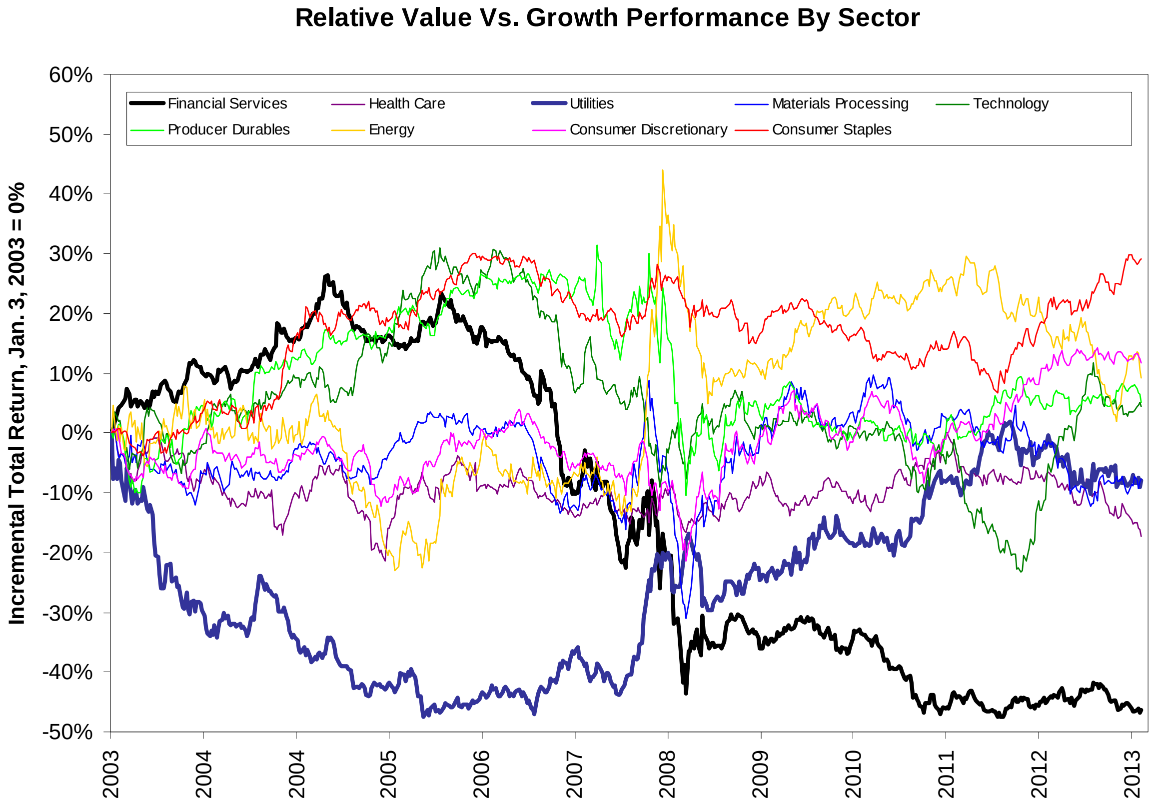
Names can be deceiving. You might think value-oriented investors are more income-oriented and are willing to trade return for less risk. However, the total return for the value index has been consistently higher that the total return for the growth index since the bursting of the technology bubble. Much of this outperformance has been retained since 2001 through the bull market lasting into October 2007, the horrific bust lasting into March 2009 and the subsequent charge to new nominal highs extending into January 2014. The downturn in the relative outperformance of the value index during the 2007-2009 bear market suggests the financial sector was in large part responsible.

Large-Capitalization Value Has Maintained Advantage



Relative Sector Returns

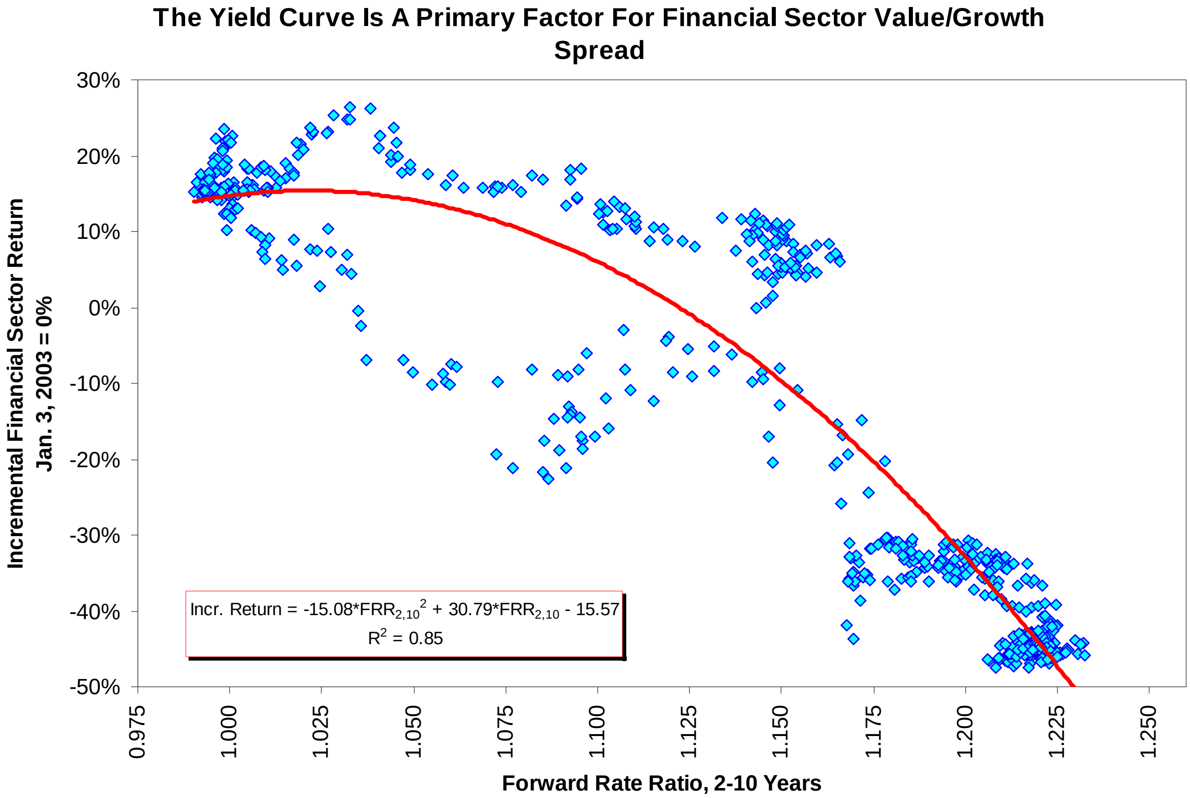
Now let's take the incremental total return for each sector's value index to its growth index with all data reindexed to the start of 2003. Some of the paths are rather unremarkable, such as the ones for health care and both the consumer staples and consumer discretionary sectors. Three of them, those for financials, utilities and energy, have both a high degree of variance and pronounced trends. While the energy sector will not be discussed in detail below as its value versus growth path has been buffeted about by such a large number of market factors as to be unwieldy, both the financial and utility sectors, highlighted with heavier lines, lend themselves to factor analysis.



Incremental Financial Sector Return

While it may seem hard to recall today after living through five years of near-zero percent interest rates and multiple rounds of Federal Reserve quantitative easing, the U.S. did go through a period of seventeen consecutive 25 basis-point increases in the target federal funds rate between June 2004 and August 2006. This period of tightening led to an inversion in the U.S. yield curve for much of the period between late 2005 and mid-2007. We can measure this inversion by the forward rate ratio between two- and ten-year Treasuries ($FRR_{2,10}$). 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 has an $FRR_{2,10}$ less than 1.00.

If we map the incremental total return for the financial value index to the financial growth index as a function of this yield curve measure, a very clear and logical relationship emerges. The more the Federal Reserve stepped on the monetary accelerator and steepened the yield curve, the more the financial value stocks underperformed their growth brethren. Many of the financial value stocks are banks, life insurance firms and mortgage lenders who might on the surface be thought to benefit from a steep yield curve. However, as interest rates were forced lower, the absolute level of carry declined even as the yield curve was steep. In addition, banks are all too aware of the no-free lunch principle; their rescue in 2008 involved an implicit put option from the public accompanied by an equally implicit short call option on their future gains. Anyone following the parade of Dodd-Frank regulations and various lawsuits against mortgage lenders can see this short call option on performance unfolding before their eyes.

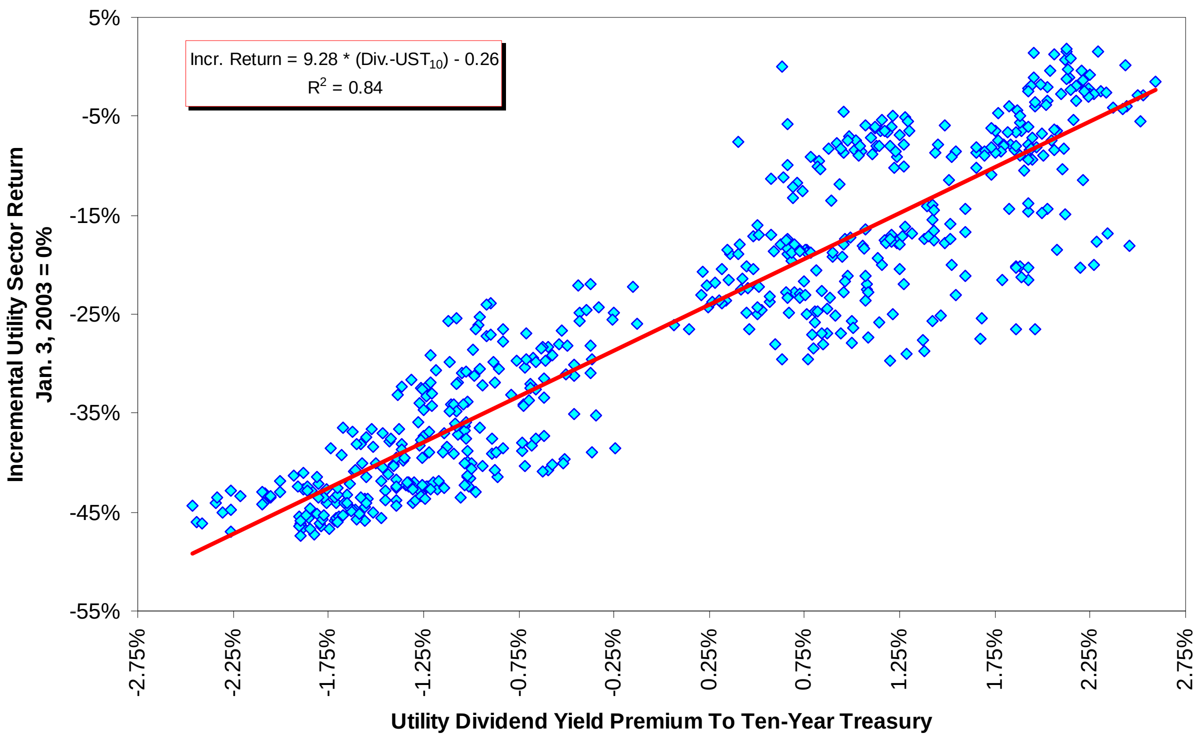


Incremental Utility Sector Return

Now let's turn to the utility sector. There was a time when these stocks were considered to be similar to instruments such as preferred stock, REITs and investment-grade corporate bonds in their interest rate sensitivity. Much of that changed during the deregulation of the industry in the 1990s and the rise of merchant power traders, many of whom have departed the scene ingloriously. The sector has been reacquiring its interest rate sensitivity in recent years.

Let's map the incremental total return of the utility value index to the utility growth index as a function of the sector's dividend yield premium to ten-year Treasuries. Here again, the relationship is simple, direct and logical. As the dividend yield spread increases, value stocks in the utility sector outperform and vice-versa. This is equivalent to saying yield-hungry investors flocked into the more staid utility dividend payers when real Treasury yields were being forced to multi-decade lows. The implication, of course, is the process can repeat in reverse if and when ten-year Treasury yields rise.

Dividend Yield Is A Primary Factor For Utility Sector Value/Growth Spread



Think Sectors. Think Factors

The key to trading futures on the Russell 1000 style index is to move beyond the technical analysis of their spread even though these spreads, like all stock index spreads, fall into the "unrelated" category and can form persistent trends (see "Think Before You Spread: Should One Size Fit All?" April 2001). You want to take the very different economic sector weights of the two indices into account, look at how the key sectors such as financial in the value index or technology in the growth index are performing and then think about the factors and even individual stocks affecting those sectors are moving.