BROMPTON FUNDS

Brompton Insights

December 2020

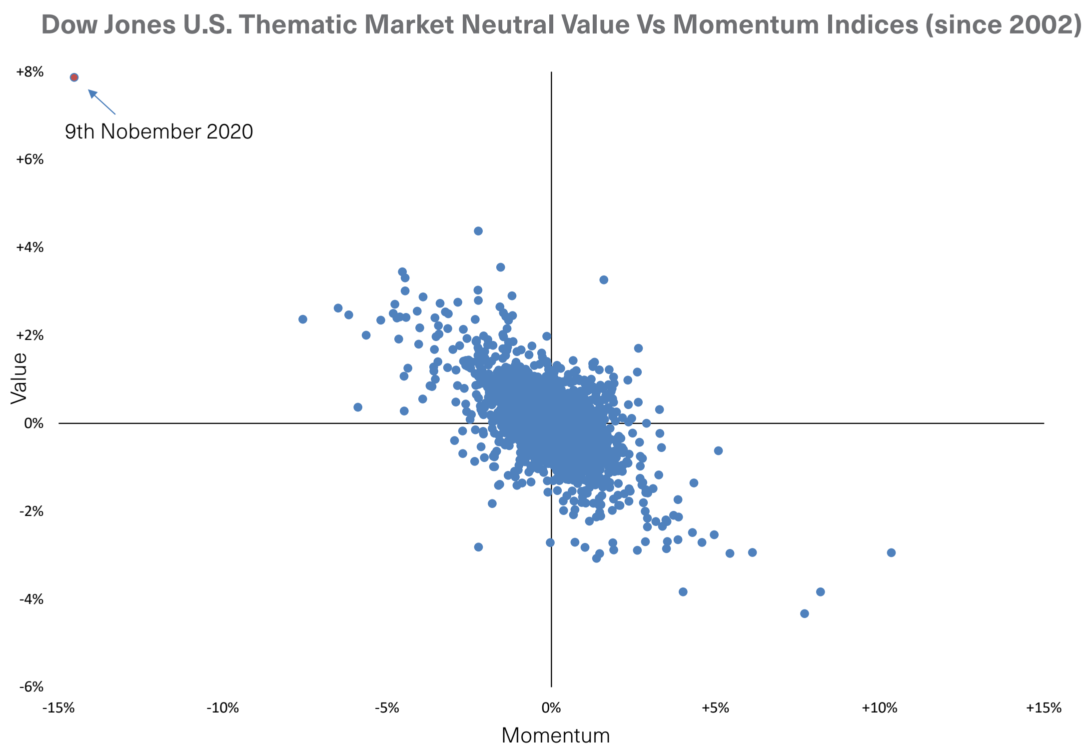
The Great Rotation – A Case for Actively Managed Investments

Key insights in this report:

- Equity markets are becoming more volatile with major market moves occurring with increasing frequency
- Higher volatility tends to drive reduced market liquidity, and this is a relationship that has grown stronger with the recent proliferation of volatility-targeting strategies used by certain investors
- When significant events occur, such as the US election or the recent vaccine news from Pfizer and Moderna, volatility tends to compress as these events are no longer uncertain, which in turn drives underlying rotations in the market as liquidity improves
- Managing portfolios in this environment has become increasingly complex and investors should consider actively managed funds that look at many factors when making investment decisions

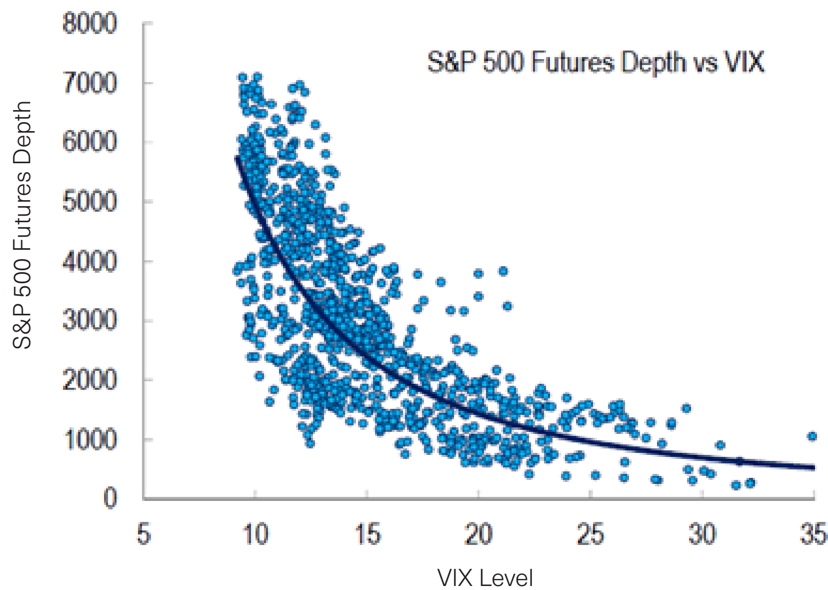
There is an old saying "we cannot direct the wind, but we can adjust the sails". This holds true for actively managed portfolios where adjustments are dynamically made to generate alpha while managing risk. To make adjustments, one needs to anticipate the directional change and act accordingly. This year we witnessed the largest rotation from momentum to value, a 15.5 sigma[1] move down in momentum stocks with a 12.75 sigma move up in value. To put this in perspective a 15-sigma event is something that should happen every one quindecillion[2] years (200 times older than the age of the universe or basically a zero probability of occurring). Over the past 12 months we have seen six rotations from momentum into value that exceeded 6-sigma. While the magnitude and frequency of these moves suggests they are unlikely to happen again, empirically the distribution of market returns does not fit a conventional normal distribution. In fact, market returns have a distribution consisting of fatter tails i.e. extreme events occur more frequently given endogenous risk. As a result, we believe these rotations are likely to occur more frequently than anticipated.

Dow Jones U.S. Thematic Market Neutral Value Vs Momentum Indices (since 2002)



Source: S&P Dow Jones Indices, November 25, 2020.

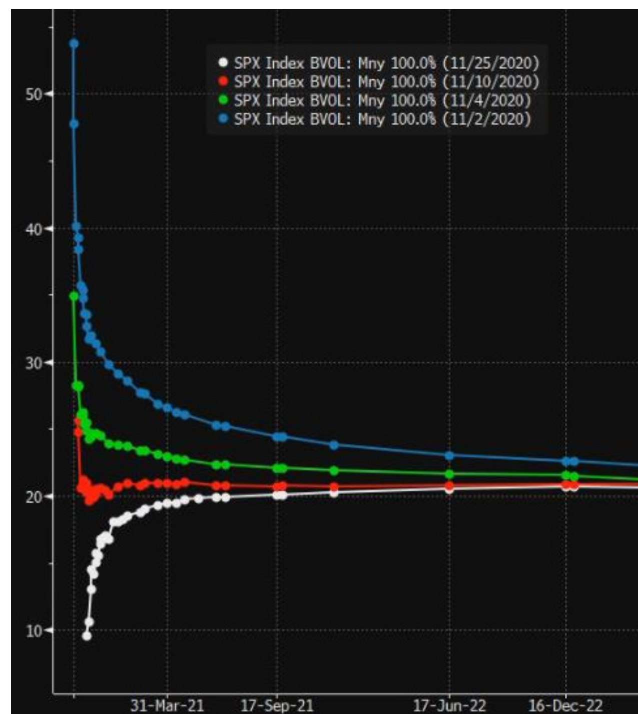
The underlying force that drives these market rotations is based on the moves in implied volatility.[3] The figure below shows that liquidity is negatively correlated with volatility in an exponential fashion i.e. market liquidity (as measured by the futures depth[4]) falls as volatility increases and vice versa. The proliferation of volatility-targeting strategies and products that help investors hedge risks and exposures are partly responsible for strengthening this liquidity-volatility relationship and recently up to 80% of liquidity variations were explained by volatility according to JP Morgan.



Source: J.P. Morgan, April 8, 2019.

Heading into the US elections, implied volatility was elevated at the front end of the curve given concerns of a contested election outcome. This is illustrated in the figure below, which showed a downward sloping term structure in implied volatility of the S&P 500. Post elections when a winner was declared along with positive vaccine news from Pfizer drove a massive volatility compression, particularly in the front of the curve. As we illustrated above, declining volatility improves market liquidity. But rather than rising tides lifting all boats, a market rotation from growth to value emerged. This was attributed to the level of dispersion trading on the S&P 500 i.e. selling index volatility (when it is elevated) and buying cheaper volatility of the index constituents. Given the idiosyncratic (unsystematic) risk and level of dispersion inherent with index constituents along with volatility compression pinning realized volatility, there is a rotation within the index, when one group moves up (stocks with cheaper volatility such as value and cyclicals) the other group (growth and momentum) moves down i.e. a rotation to value from growth. Over the last few weeks, we saw additional compression on the front end of the term structure in implied volatility of the S&P 500 which drove mini market rotations but not as powerful as the initial move.

S&P 500 Implied Volatility Term Structure (Annual Implied Volatility vs Time)



Source: Bloomberg, November 25, 2020.

Market rotations are proof that an actively managed approach is a prudent investment strategy. Actively managed portfolios typically take a multi-factor discretionary approach in generating active returns and managing risk. Managing factor exposures such as momentum, value, size and volatility is a complex undertaking for the average investor. Stock picking within these factors as well as styles (defensive/cyclical) under market regimes that are constantly in flux is even more complicated. For example, there is a difference between value stocks (sustainable cash flows at an attractive price) and structurally broken stories, which are often referred to as value traps, implying that they are cheap for a reason, in that the upside potential is muted. As a result, not all value stocks will see a sustainable bid after these market rotations. In addition, not all momentum stocks warrant a premium valuation and those with structural moats, first mover advantages and innovative disruptors are likely to experience less valuation compression during rotations.

The question on everyone's mind is whether the rotation into value is durable. Given the dynamics of the term structure of implied volatility of the S&P 500 and proliferation of volatility targeting strategies, we believe these market rotations will happen from time to time. We believe the durability of the rotation into value is dependent on the level of fiscal stimulus, the level of reflation in the economy post pandemic and the absence of exogenous shocks as these are factors are likely to reduce the dispersion between growth and value.

Brompton's Approach

All of Brompton's equity income mandates are actively managed. They are currently positioned with a barbell approach with a combination of long-term secular growth companies and companies trading below their intrinsic value.

Brompton Global Dividend Growth ETF (BDIV)

Brompton North American Financials Dividend ETF (BFIN, BFIN.U)

Brompton Global Real Assets Dividend ETF (BREA)

Brompton European Dividend Growth ETF (EDGF)

Brompton Global Healthcare Income & Growth ETF (HIG, HIG.U)

Brompton Tech Leaders Income ETF (TLF, TLF.U)

[1] Sigma (σ) is the Greek symbol used to represent standard deviation.

[2] Quindecillion – 1 followed by 48 zeros.

[3] Implied volatility is the market's forecast of a likely movement in a security's price. Implied volatility is often used to price options contracts: High implied volatility results in options with higher premiums and vice versa.

[4] Market depth is measured as the average number of futures contracts on the top 5 levels of the limit order book intraday, averaged across the bid and offer.

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