fLAB

It´s All About Asset Allocation

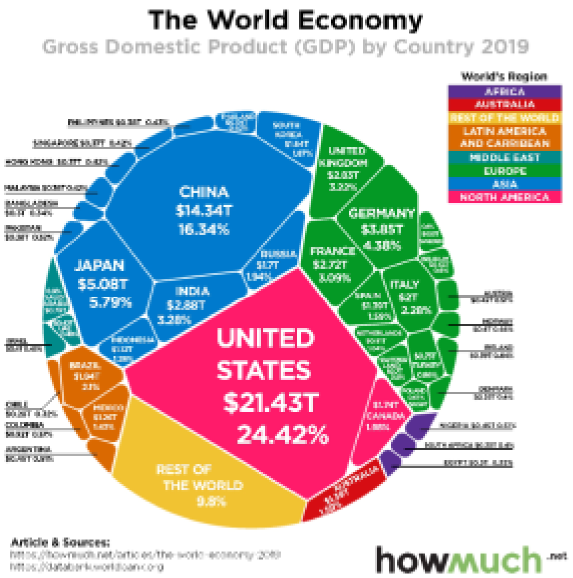
December 2024, Newsletter#98

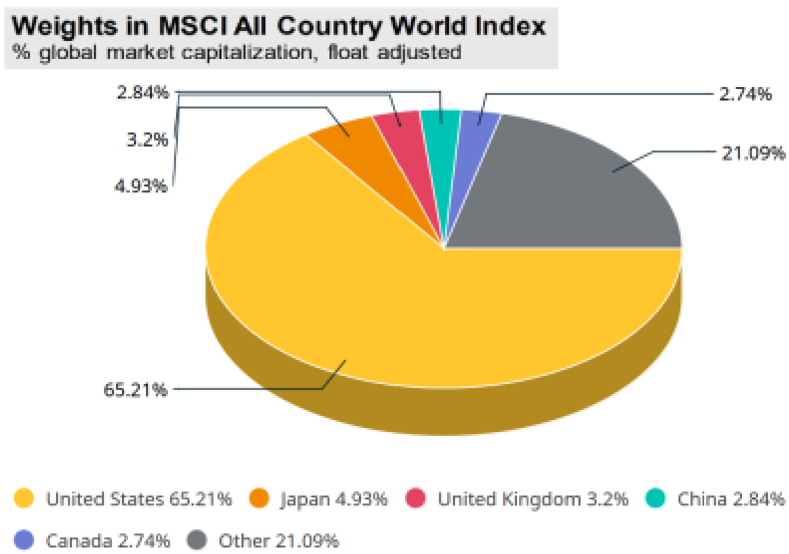
As we continue to prepare the launch of fLAB Equity, our new 2025 fund that will attempt to beat the World Stock Market by investing dynamically in variable style factors, let me share with you some of the issues we have been working on. They may deserve, each one of them, a larger space than this newsletter. In fact, there are three that occupy my few and scattered neurons these days:

1. When we talk about beating the World Stock Market, we generally think of the MSCI index, either the World Index or the All Country World Index. As you know, the first includes developed countries and the second also adds emerging countries. **Emerging markets now account for 9.98% of the ACWI.** The weight of emerging markets in the MSCI ACWI index has changed significantly over the last three decades. In the 1990s, the share of emerging markets was very low, representing less than 5% of the index. However, during the boom of emerging economies in the 2000s, driven by the growth of countries such as China, India and Brazil, this percentage grew significantly to peaks of 15%.

At the same time, if we compare the various countries based on their weight in the GDP and global stock market capitalization, the contrasts are extreme. The bullish supercycle of the US equity market has led it to have 65% of the entire global stock market with less than a quarter of the GDP. On the other hand, the 2 mega economies, China and India, account for 19.6% of the world GDP but only 5% of the world stock market.

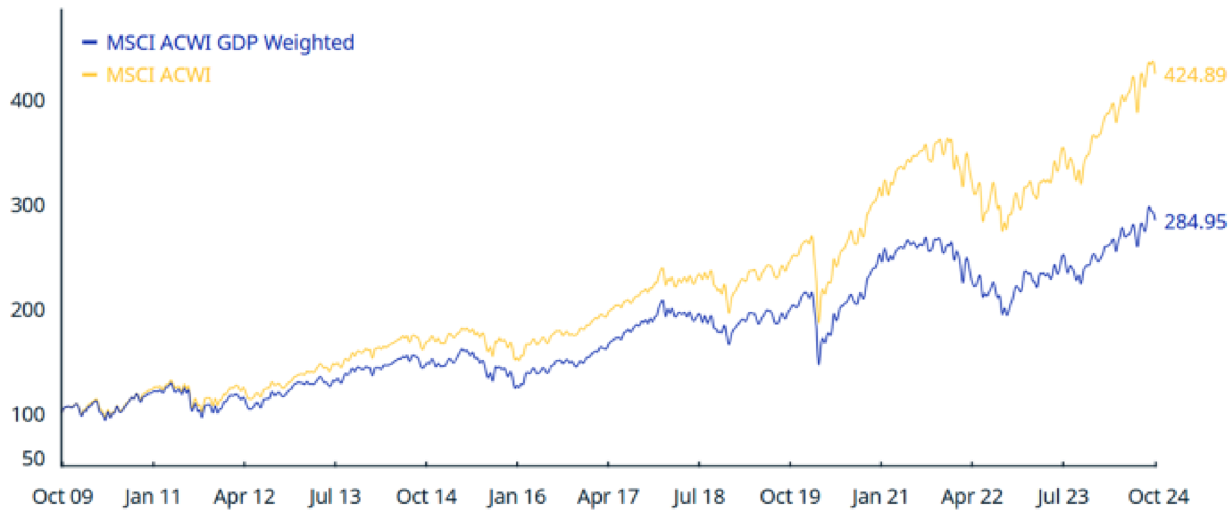
The data is revealing, and for that simple reason alone, whether it is called market opportunity, pure tactics or reversion to the mean, no portfolio that aims to beat or simply have exposure to the global market can do without investing a percentage in Emerging Markets.





As a curiosity, MSCI publishes a very interesting index, the MSCI ACWI GDP Weighted, based on a weighting scheme derived from the economic size of each country (using GDP data) rather than the size of its stock market. Over time, GDP data tend to have more stability than stock market prices. It is not surprising that it does not outperform the traditional ACWI, especially given its lower exposure to the US successful market.

CUMULATIVE INDEX PERFORMANCE — GROSS RETURNS (USD) (OCT 2009 – OCT 2024)



INDEX PERFORMANCE — GROSS RETURNS (%) (OCT 31, 2024)

					ANNUALIZED			
	1 Mo	3 Mo	1 Yr	YTD	3 Yr	5 Yr	10 Yr	Since Jun 30, 2000
MSCI ACWI GDP Weighted	-3.92	3.84	27.48	13.38	2.59	7.46	6.72	5.78
MSCI ACWI	-2.21	2.67	33.40	16.44	6.01	11.61	9.62	6.36

2. **Having a good idea is dangerous, especially if you only have one**. In Finance, this is lethal. I still remember in the early 90s, how some local european equity managers refused to include foreign shares in their equity portfolios, lest their pure national portfolios be contaminated. The gradual opening to other markets took away our foolishness and the Internet democratized access to knowledge. That is why I find the Value investing Fan Club increasingly anachronistic. Let it be clear that I have excellent friends, fund management professionals, who have spent their entire lives looking for undervalued companies, that is, companies that are quoted below their intrinsic value, which is the price that the market would assign to that share under normal conditions.
That and nothing else is the founding principle of Value investing.

This presents 3 problems: The most obvious is that when a company is cheap it is usually for a good reason. And it can remain cheap longer than you are solvent (hello Keynes!).

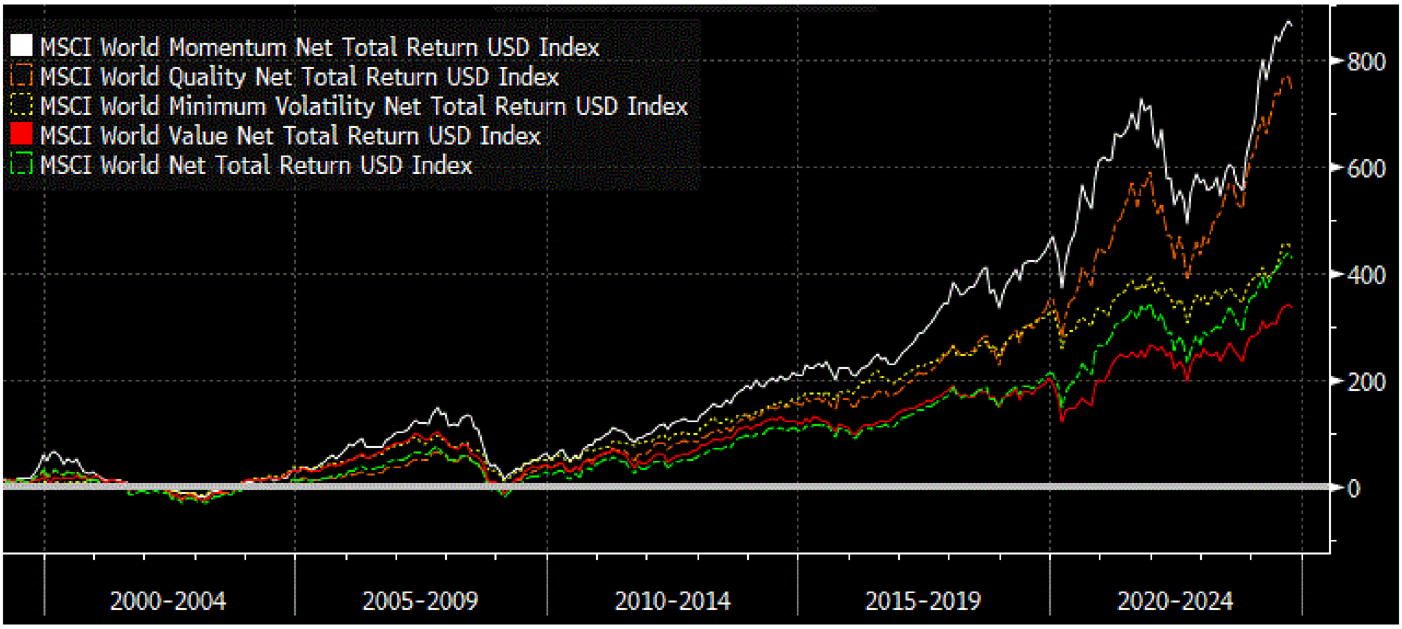
The second is that we, fund managers, are not Warren Buffet.

However, it is the third problem that has me stunned: **the denial of reality and the opportunity cost of investing only under a value philosophy**. The academic world is in general agreement in identifying 6 sources or factors of profitability in the stock markets: value, momentum, size, volatility, quality and dividends.
So, just as in the 90s I had colleagues who only bought local shares, today we have apostles of Value who defend it as the only possible and correct strategy to win in the equity market.

But Morningstar data don´t lie: Value is the investment factor with the worst Sharpe Ratio in the last 15 years:

Name	Total Ret 1 Yr (Mo-End) EUR	Total Ret Annlzd 3 Yr (Mo-End) EUR	Total Ret Annlzd 5 Yr (Mo-End) EUR	Total Ret Annlzd 10 Yr (Mo-End) EUR	Total Ret Annlzd 15 Yr (Mo-End) EUR	Total Ret Annlzd 20 Yr (Mo-End) EUR	Sharpe Ratio 15 Yr (Mo-End EUR
MSCI World Quality NR USD	27,35	17,90	16,66	16,97	11,70	8,81	0,68
MSCI World Momentum NR USD	21,24	14,63	16,94	17,17	11,00	9,36	0,61
MSCI World High Dividend Yield NR USD	22,27	6,83	7,07	10,43	5,68	5,69	0,27
MSCI World Minimum Vol (USD) NR USD	14,31	7,88	7,93	11,84	7,80	6,73	0,52
MSCI World Value NR USD	33,21	6,78	7,90	11,19	5,47	5,20	0,26
MSCI World Small Cap NR USD	41,89	10,96	11,77	14,60	8,97	9,52	0,42
MSCI World NR USD	30,34	13,22	13,04	14,34	8,11	6,81	0,42

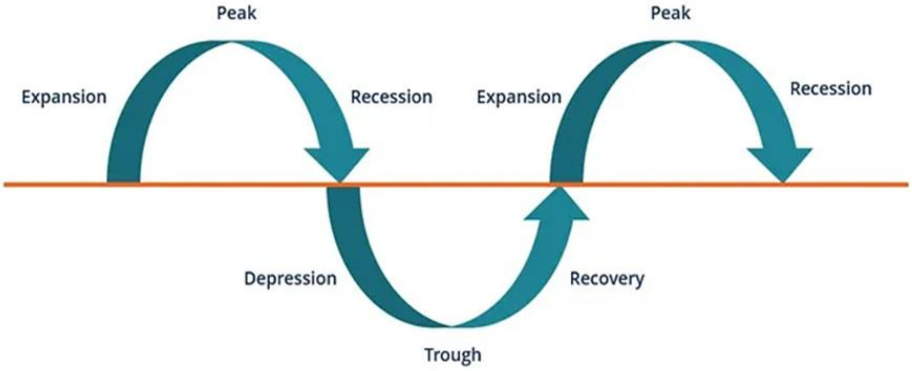
And much more visual and painful is the comparison of the 4 most established factor strategies, the MSCI World Factors. Having been only in Value is like having been in the US markets ignoring Mag7 in the last 5 years.



3. **How could one invest dynamically through factors in the global stock markets? Well, that is the million-dollar question.** Looking at the chart above, who wouldn't have liked to be fully invested in a Momentum or Quality portfolio? Well, this question is tricky, as well as recognizing that since 2009 we have been experiencing a powerful secular bullish cycle that has conditioned the results. However, in the last two years and for the launch of fLAB Equity, **finding a systematic investment model that was adaptive**, that is, that invested in those stocks that had the best relationship with those 4 factors at any given time, took up most of my research. In the end, we have managed to identify the 3 variables that define the greater or lesser weighting that should be given to the 4 factors (we have named it the 3M Factor Model: Macro+Momentum+Mkt Sentiment):

a) Macro Cycle

Theory suggests that systematic factor returns should be linked to changing economic conditions. Positive long-term factor returns have often been associated with compensation for taking macroeconomic risks. For example, during a downturn, which might be characterized by deteriorating economic conditions but still positive economic growth, a combination of defensive factors might be more appropriate than a combination of cyclical factors. Conversely, during an expansion phase, a combination of cyclical factors might be preferred.



b) Momentum of the Different Factors

Relatively few studies on adaptive factor allocation have considered the effect of momentum on the factors themselves. Momentum indicators are based on historical total returns over the past 12, 6, and 1 month for each of the 4 factors. Among all simulations with data since 1986 in the MSCI study, the best performing momentum-based simulated portfolio for the MSCI ACWI index was the 6-month Momentum.

c) Market sentiment

The quantitative crisis of 2007 and the global financial crisis of 2008, characterized by extreme volatility, are stark reminders of times when some factor strategies, such as Value, experienced significant losses. Losses in Momentum strategies, on the other hand, have coincided with changing volatility environments. Market measures, such as the CBOE Volatility Index (VIX) or option-adjusted spreads (OAS) in credit markets, have been found to be statistically significant leading indicators of factor performance.

Today, with November closing data, using these 3 parameters (3M Factor Model) for the 3 main geographic areas, we would allocate factors as follows:

	Quality	Momentum	Low Vol	Value	
MACRO	40	30	20	10	
MOMENTUM	30	40	20	10	
MKT SENTIMENT	25	25	25	25	USA
	31,67	31,67	21,67	15,00	fLAB Factor

	Quality	Momentum	Low Vol	Value	
MACRO	35	20	30	15	
MOMENTUM	10	30	40	20	
MKT SENTIMENT	20	30	20	30	Europe
	21,67	26,67	30,00	21,67	fLAB Factor

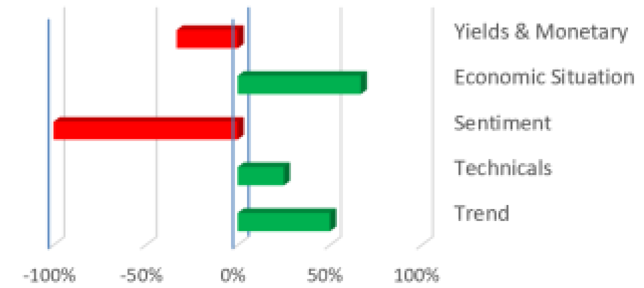
	Quality	Momentum	Low Vol	Value	
MACRO	35	35	15	15	
MOMENTUM	40	30	20	10	
MKT SENTIMENT	25	25	25	25	Japan
	33,33	30,00	20,00	16,67	fLAB Factor

I hope that my musings, which will hopefully lead us to the launch of fLAB Equity, around the end of January 2025, have been of interest to you.

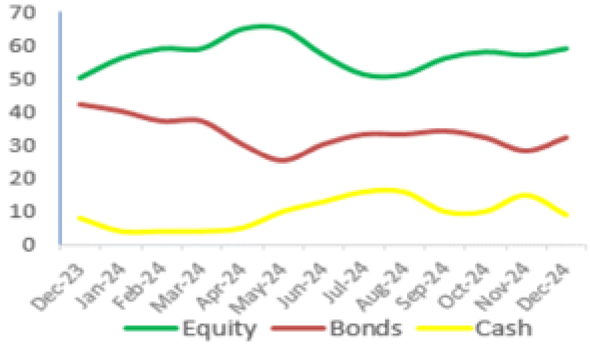
Oh, I say goodbye not without remembering the December Asset Allocation of fLAB Core:

fLAB Core Asset Allocation Model		Dec-24	Benchmark
	Stocks	59%	55%
	Bonds	32%	35%
	Cash	9%	10%

Equity vs. Bonds Relative Strength by Betalphing 5 Indicators



red (bond & cash preference) green (equity preference)



Equity Regional Allocation vs MSCI World AC			
US & Pacific ex-Jap	*OW*	*Japan & UK*	*UW*
Benchmark (US 63%, Eur 12%, Emerg Mk 10.5%, Jap 5.5%, UK 3.5%, Pacific 2.8%, Can 2.7)			

US Sector Allocation			
Health Care, Utilities, Energy	*OW*	*Materials & Comm Services*	*UW*

Government Bond Allocation vs Barclays Global Government Bond Index			
Eurozone & UK	*OW*	*Japan*	*UW*
Benchmark (US 55%, Eurozone 25%, Japan 14%, UK 6%)			