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A FAMILY OFFICE

VIEWS FROM THE BRICK

RISE OF THE FACTORS

Stock picking is sexy. It's what gets talked about at cocktail parties and happy hour. There are secret Slack channels dedicated to it. "I got a tip about this company that's going to be the next Amazon, want to hear about it?" What isn't getting tossed around too often are braggadocios comments about well crafted factor exposures within a portfolio. But one of these carries a more significant impact on a portfolio's return whether you know it or not. We'll give you a hint, it's in the title.

MEET ME IN THE MIDDLE

We've shared our thoughts on the Active vs Passive debate with you in the past. Our beliefs that the answer to that question isn't binary lies deeply in the idea of factor based investing. Just about 25 years ago, arguably the most disruptive innovation in the world of finance made its way to U.S. markets. The first S&P 500 indexed fund was launched in the ETF wrapper, forever changing how investors access the market. What ensued was an all out assault on the Efficient Market Hypothesis (EMH) with two very strong opinions. Those who (birthed) and believed the concept, let's say their home base is in Chicago; and those who thought inefficiencies could routinely be exploited within markets, we'll plant them in Connecticut. The civil war between the Midwest-Coast and East Coast has been an ugly one.

But us free thinkers (call us Switzerland?) have been able to play devil's advocate a bit and have decided to side with our own rationale. As time has gone on, the passive side of the argument has been winning hand over fist when measured by flows. Of course, they've been working with a very favorable environment. The beta rally which has taken place since the GFC is a perfect storm for these vehicles that are purely beta in exposure. This is like Brazil hosting a World Cup and playing every game in their home country in front of sold out, biased crowds. Except, Brazil eventually ~~lost~~ got smoked when that was the actual scenario. We don't think passive investments are immune to this outcome either. Tides change. Star players get hurt. So then if you can see the side in both arguments, how do you get involved? As innovation within the ETF space continues to bring new options to investors at low costs, it has become increasingly easier to carry "Smart Beta" exposures within the portfolio. Enter factor investing.

THE 5 HORSEMEN

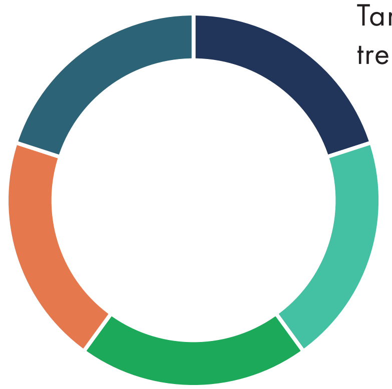
For starters, let's quickly cover the five factors investors have probably unknowingly been carrying exposures to since the dawn of markets:

Value

Seeks to identify alpha for stocks that are trading at prices below their fundamental value

Volatility

Empirical data shows stocks with low volatility earn greater risk-adjusted returns than highly volatile assets. Targeting this factor has been a popular trend in recent years.



Size

Pertains to the market cap of the underling stocks held within a portfolio. Historically, smaller companies have provided higher returns with albeit higher volatility.

Quality

Quality carries both quantitative and qualitative metrics. Quality is defined by low debt, stable earnings, consistent asset growth, and strong corporate governance.

Momentum

The trend is your friend is somewhat of a mantra within pockets of investing. Momentum plays off this, under the premise that stocks which have been in favor in recent periods will continue to be rewarded by investors.

WHAT'S YOUR SIGN?

You can think of factors like astrology signs for stocks. You might have owned shares of specific stocks to this point and thought the performance was strictly because of the company you chose. "You're special" you whisper as you admire your E*TRADE account at night. But in reality, a few simple regression models could have shown that the return of that stock was attributable to certain characteristics your investment was predisposed to. All you actually did was select a few stocks that embody the factors outlined above. Each factor will behave differently in different market environments, the same way personalities of certain astrological signs seems to fit certain descriptions. This is where the active management argument can take one giant step towards the center.

IT'S WHAT'S ON THE INSIDE THAT COUNTS

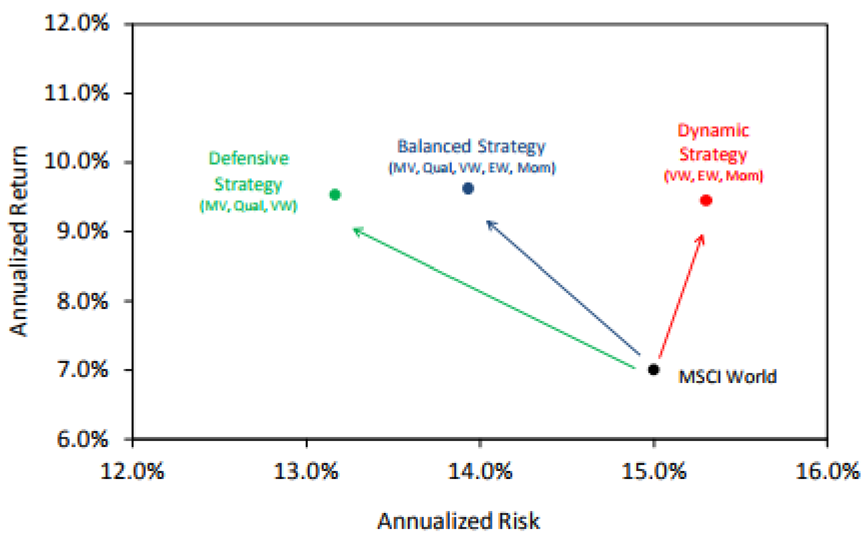
Pick a market and its broad index measure. (FWIW once you pick a market, you've made a very active decision. Devil's advocate, remember?) For illustration purposes we'll take the S&P 500. If you want to gain exposure to this market, you now have more options than you used to. The options that factors now present to investors are a compelling one. If you have an issue with being attached to the index for better or for worse, but don't quite trust stock picking, you can now create a mindful exposure to this index (and many others) with certain factor tilts. Typically, the S&P 500 carries inherent bias towards size and momentum given the market cap weighting. Rethinking this universe with a multi-factor weighting approach can grant you your S&P exposure, with active factor selection. Passive investing argument, that'll be one giant step toward the middle for you as well. Where does that bring us? Pittsburgh?

SOURCE: All performance as of December 30, 2016 unless otherwise noted. This presentation is solely for informational purposes and should not be taken as investment advice. For further information, please contact one of our investment adviser representatives.

If Chicago is the home of the EMH and the core of passive investments, and Connecticut the land of exploiting inefficiencies, I guess we claim the land of Pittsburgh as the city of ~~champions~~ compromise. With the advancements in technology, ETFs have continued to disrupt the investing world for the last 25 years. The wrapper has acted as a vehicle for innovation, which only benefits the end investor in our eyes. Now, not all ETFs are created equally and due diligence is still required. But it's easier than ever for a portfolio to carry cheap and smart beta in ways they couldn't before.

NO FREE LUNCH

At this point you're probably starting to think ahead and figure out that if factors are the thing that makes stocks tick, then you can try to pick them the way you would stocks. You're not wrong in your assumption, but we'd advised against that practice. Timing markets is colossally hard. Timing factors isn't any easier. Rotation within factors is quite similar to the rotation within styles and sectors we've spoken to clients about. Just like stocks, bonds, sectors, countries, or any other financial instrument, equity factors and the strategies based on them can become cheap or expensive. You can determine a factor is rich or cheap and subsequentially determine whether an expected return is below or above the broad market.



The point of using (and understanding) selective factor exposures within a portfolio isn't to introduce a new way to trade within a long term portfolio. What the introduction of factor aware exposures within ETFs has done is grant long-term investors the ability to rethink their "core" equity exposures. A mindful mix of factor exposures and tilts has shown to provide a more attractive risk/return profile than the broader true passive index fund approach[1].

SOURCE: [1]Data and graph provided by MSCI research. Time period for performance measure spans 1988-2013 This This presentation is solely for informational purposes and should not be taken as investment advice. For further information, please contact one of our investment adviser representatives.

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