The Regime Shifts From Momentum to Quality

Making short term market predictions is a fool's errand, and consequently we don't do it. Investing for the long run is hard enough without being confused by all the pundits on cable TV. But underneath the visible noise of market direction an interesting shift is taking place.

We tend to own stocks that are less exciting than most on a day to day basis. Typically these are companies that have at least a decent prospect of generating long term capital gains rather than the more highly taxed short term gains that result from rapid moves. This approach worked reasonably well last year but when the S&P500 is up 32% it's unlikely that the slow and steady approach will do as well, and it modestly lagged. The bias of investors towards growth over quality dates back to about July the way we measure it.

Over the past month we noticed that the prevailing relationship was shifting, and that low beta, or low volatility stocks were beginning to outperform (noted in our April newsletter). It seemed to coincide with the satiation of so many investors keen to get into the market before the opportunity was missed (although this last piece of evidence is highly qualitative). Some of the worst performers (Facebook, Netflix, Tesla) are of course some of the previously most loved names.

Mike Cembalest at JPMorgan Asset Management writes intelligently about many aspects of investing. Most recently he put numbers on this phenomenon by noting that on a **market cap weighted** basis valuations were at a fairly modest 55th percentile P/E of trailing earnings (using data going back to 1983), whereas the **median** stock's equivalent P/E was at the 80th percentile. Since larger cap stocks tend to be more stable than mid-caps, it’s a neat way of capturing their relative valuation difference.

Recent market moves have been in the direction of narrowing this gap. We’ve seen this in the our own investment strategies. Generally such regime changes last at least several months, so while we don’t know where the market’s going over the next few weeks, it does appear to be a decent bet that the recent bias away from high growth will continue a good while longer.