Disciplined Equities

Market Update

Market overview

Global equities finished the third quarter in positive territory, with U.S. equities leading the charge behind a 7.7% gain in the S&P 500®. U.S. stock returns were driven mostly by continued strength in corporate earnings, backed by growing cash flows and expanding margins. Within the U.S., health care led the rally with a 14% gain, followed by industrials and technology. Conversely, materials, energy and real estate lagged, finishing the period with modest losses.

Momentum leads

Momentum factors continued their strong year, after recovering from a brief reversal in June. With many consistent themes driving market returns over the last 12 months (i.e. beta, quality, growth), previous winners continued to outpace previous losers, resulting in strong returns for momentum.

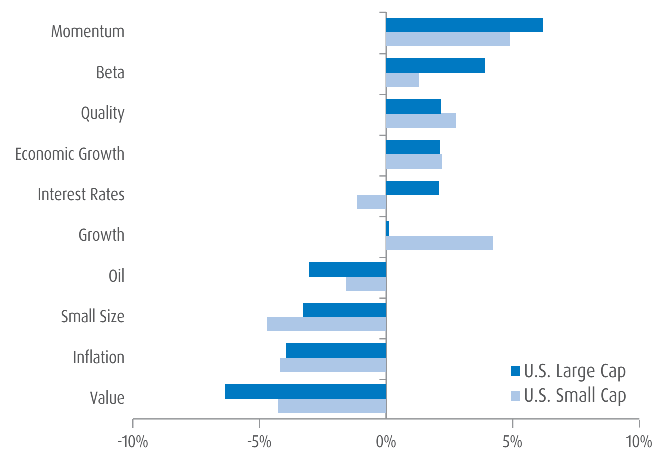
Quality in favor

As tensions mounted over a strong dollar and the potential impact from trade wars, investors preferred higher-quality companies with greater profitability. Longer term, quality factors have been some of the best performers in the U.S. market.

Growth vs. value

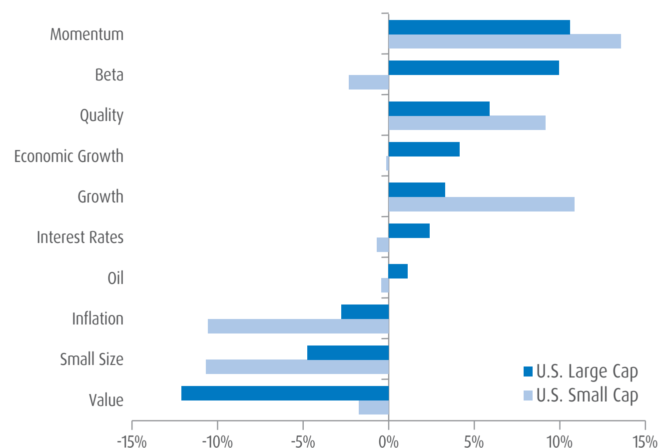
After weakness in July, growth factors recovered in August, ending yet another quarter in positive territory. While performance of growth in the large-cap universe was less positive compared to previous quarters, value continued to struggle mightily, marking an exceptionally difficult 12-month period.

Factor performance — most recent quarter



Source: FactSet, Axioma, Russell and BMO Global Asset Management

Factor performance — trailing one year

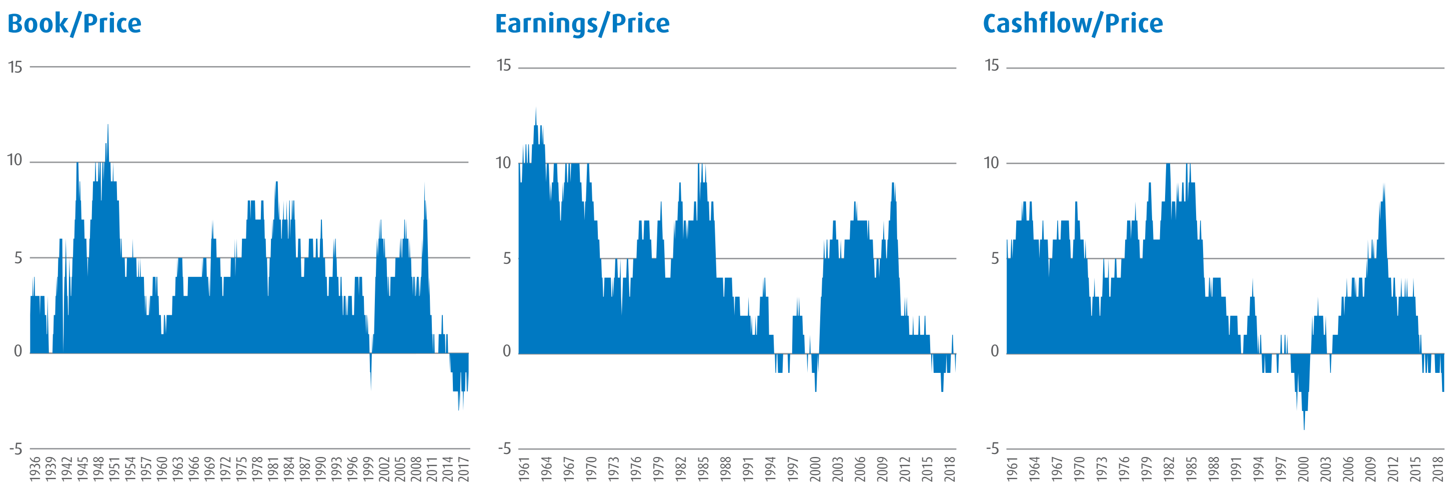


Source: FactSet, Axioma, Russell and BMO Global Asset Management

Third quarter observation

The benefits of value investing have been well documented in financial literature. Research has shown that over the long run, stocks with cheaper valuations have outperformed those that are more expensive. However, while valuation factors typically offer a positive return over full market cycles, there have been limited extended periods in which valuation factors underperformed, the current market environment included. In fact, the underperformance of value investing over the last ten years is comparable only to the 1990s tech bubble (chart 1).

Chart 1 | Rolling 10-year annualized returns of standard valuation factors



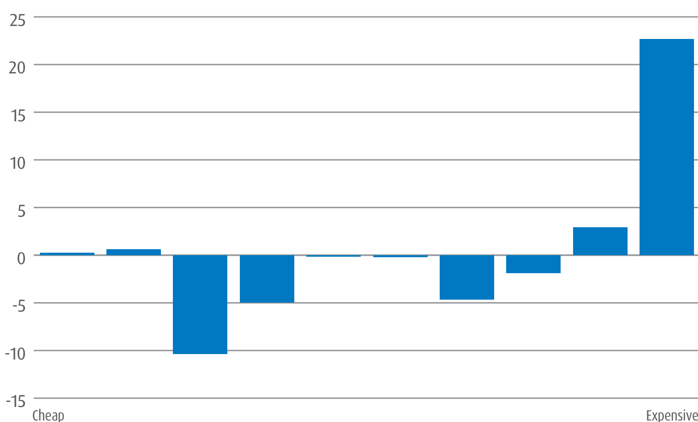
As of June 30, 2018. Sources: BMO Global Asset Management,. Ken French Data Library. Book/Price returns reflect the "High Minus Low (HML)" factor from the Fama-French three factor model. Underlying data 7/1926 - 5/2018 for Book/Price, 7/1951-4/2018 for Earnings/Price, and 7/1951-5/2018 for Cashflow/Price based on data availability.

What makes the current market environment even more extraordinary is the degree of leadership by the most expensive segment of the U.S. stock market. When dissecting the year-to-date performance of the Russell 1000® and Russell 2000® universes based on deciles of valuation, we found that the most expensive decile of companies have by and large been the best-performing segment of the U.S. market. Within the U.S. large-cap market specifically, the most expensive ten percent of stocks have outperformed the cap-weighted benchmark by more than 23% this year, while all other deciles have been flat-to-negative (chart 2). We see a similar pattern within U.S. small-cap. Although value has underperformed in the past, the extreme nature of outperformance by only the most expensive segment of the U.S. market is unusual, and likely unsustainable.

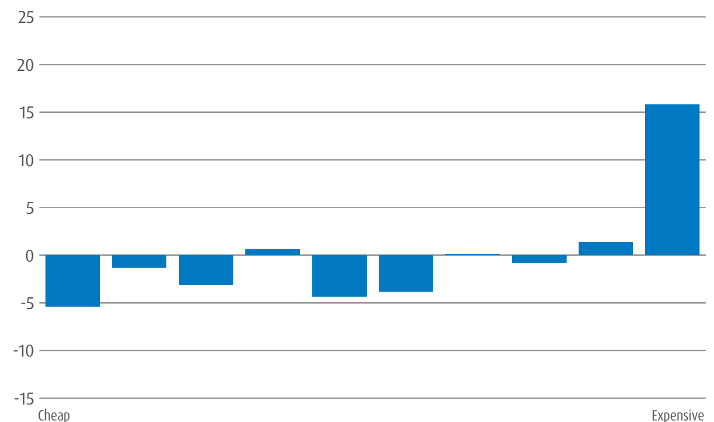
From a value investor's standpoint, it is important to focus on the long-term and resist the temptation to believe that "this time is different." It is also important to have conviction in your process to help participate in recoveries when cycles eventually reverse course. Our research shows companies that have strong fundamental characteristics with attractive valuations and positive investor sentiment tend to outperform over the long-run, and have positioned our clients' portfolios to help extract excess returns from potential mispricings in the market.

Chart 2 | December, 2017 - September, 2018

Russell 1000® valuation decile performance



Russell 2000® valuation decile performance



Sources: BMO Global Asset Management, FTSE Russell and Factset

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Past performance is not necessarily a guide to future performance.

The S&P 500® Index is a capitalization-weighted index of 500 large-cap U.S. stocks.

The Russell 1000® Index is an index of approximately 1,000 of the largest companies in the U.S. equity market.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe.

Investments cannot be made in an index.

Beta is a measure of a portfolio's volatility. Statistically, beta is the covariance of the portfolio in relation to the market. A beta of 1.00 implies perfect historical correlation of movement with the market. A higher beta manager will rise and fall more rapidly than the market, whereas a lower beta manager will rise and fall slower.

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