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Why invest in equity markets?

For a variety of reasons many investors prefer to target higher portfolio returns by concentrating a large portion of their wealth in stocks. This is rational where investors are averse to leveraging a diversified portfolio, or where accounts are leverage constrained, as over the long-term investors in equities should expect to earn a meaningful premium over bonds. In fact per Figure 1., global equity markets have delivered a premium of about 5% per year over government bonds since 1925. Of course, this excess return is simply compensation for assuming about 14.5% in annualized excess volatility, and periodic losses of 50% or more.

Figure 1. Cumulative Global Equity Risk Premium (1925-2015).

Source: ReSolve Asset Management. Data from Global Financial Data. Results are for illustration only.*

Improving equity returns through Relative Momentum

Relative momentum is the idea that investments with strong recent performance will continue to do well over the next little while. This concept has been validated across virtually all markets everywhere as a way to identify which assets are likely to deliver the best returns over the next few weeks or months. The most intuitive way to demonstrate the power of relative momentum is to show the performance of portfolios that constantly rotate into the strongest global asset classes, as we’ve plotted in Figure 2.
Thought

“The most widely observed and persistent source of excess returns in markets is ‘momentum’, which describes how assets that have had the strongest returns in the recent past are more likely to produce the strongest returns in the near future. This effect is observed virtually everywhere assets exchange hands in markets, including wine, art, homes, commodities, and of course stocks and bonds.”

Figure 2. Asset class momentum portfolios formed on top quantiles (1995-2015).

Through visual inspection, it’s clear that by constantly rotating into assets with the strongest trend strength, there is potential to earn higher long-term returns.

The RTE strategy employs relative strength momentum to identify which regional stock markets, including U.S., European, Japanese, or Emerging markets, are exhibiting the strongest trends. ReSolve’s approach improves on traditional momentum methodologies by applying a proprietary statistical technique that zeroes-in on the unique character of each stock index, while ignoring the market forces that cause them to move together. The historical results show a more stable portfolio that is more resilient to market noise.

Cutting off the Tails

Relative momentum works well to identify the strongest markets, but it is not very helpful at identifying the best equity markets around the world if equity markets in general are in crisis. To deal with this market duality the RTE strategy exploits a second well-known momentum method, sometimes called ‘time-series’ or ‘absolute’ momentum, which helps to identify when global equity markets are rolling over into a bear market. Figure 3. shows the aggregated distribution of monthly returns for a portfolio of U.S., international, and emerging market equity indexes from 1995 – 2015, over all monthly periods (dark blue), and only in months after markets have signaled positive absolute momentum.
“[From] 1960 through June 2010 ... the average investor encountered severe rolling quarterly losses 5.3x more frequently on average than they would have expected. Viewed over the course of an average decade, investors would have expected about 6.5 such tail events, whereas actual S&P 500 performance consisted of 34.”

Welton Investment Corporation

A few points are clear from visual inspection. First, note that average returns are higher when indexes have positive momentum – 0.93% per month versus 0.55% over all months. Of equal importance however, there are far fewer returns in the left tail of the distribution – that is, ‘black-swan’ type negative returns – when assets are in positive trends. This is consistent with what is observed in the finance literature: stronger returns with lower peak-to-trough losses from absolute momentum.

Some may find it difficult to understand why the profile of returns described in Figure 3. above is meaningful. Figure 4. should provide clarity. To demonstrate the power of absolute momentum over a longer period, this case study utilizes returns to U.S. large capitalization stocks since 1927. The chart shows the cumulative returns to the U.S. stock index in months after markets have signaled a positive trend (dark blue), versus when markets have signaled a negative trend (light blue). Note that average returns to U.S. stocks in months subsequent to a positive trend signal have averaged over 13% per year, while returns after negative trend signals have provided less than 2% per year.
Figure 4. Cumulative returns to U.S. large cap stock index in months subsequent to positive or negative momentum signals, 1927 – 2015.

While Figure 4. shows that returns to stocks are higher when they are in a positive trend, it’s critical to understand that the strategy earns it’s high returns mostly by avoiding large losses. This is clearly illustrated in Figure 5., which quantifies the returns to the absolute momentum strategy relative to a buy and hold approach for U.S. stocks over the most challenging periods of the past 90 years. Specifically, the chart and table highlight the maximum drawdowns experienced by both strategies during the worst maximum drawdowns for U.S. stocks since 1927.

Equity Risk Premium

“Historically, the market risk premium represents the difference between what an investor expects to earn on an equity portfolio and the risk-free rate of return. This risk premium has, over the last century, oscillated between an average of 3.5% and 5.5% (Shiller Data). “

* Past results are not necessarily indicative of future results. It is expected that the simulated performance presented in this document will vary as a result of both improvements to our simulation methodology and the underlying data sets used for simulation. Please review the disclosures at the end for more information.
“For every 50% decline in portfolio returns one has to make 100% to break back to even. As such, succeeding at equity investing is less about blowing the lights out during the good years and more about not losing what you have during the bad years.”

Figure 5. Drawdowns to buy and hold and absolute momentum strategy, U.S. large capitalization stocks, 1927 – 2015.

<table>
<thead>
<tr>
<th>Event</th>
<th>From</th>
<th>To</th>
<th>Buy &amp; Hold</th>
<th>Momentum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Great Depression</td>
<td>Sep 1929</td>
<td>Jun 1932</td>
<td>-82%</td>
<td>-29%</td>
</tr>
<tr>
<td>Global Financial Crisis</td>
<td>Nov 2007</td>
<td>Feb 2009</td>
<td>-48%</td>
<td>-6%</td>
</tr>
<tr>
<td>Tech Wreck</td>
<td>Sep 2000</td>
<td>Sep 2002</td>
<td>-44%</td>
<td>-17%</td>
</tr>
<tr>
<td>Mid 1970s</td>
<td>Jan 1973</td>
<td>Sep 1974</td>
<td>-43%</td>
<td>-22%</td>
</tr>
<tr>
<td>Late 1960s</td>
<td>Dec 1968</td>
<td>Jun 1970</td>
<td>-27%</td>
<td>-13%</td>
</tr>
</tbody>
</table>

Source: ReSolve Asset Management. Data from CSI. Results are for illustration only.*

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Summary

Investors can seek higher returns by increasing exposure to diversified portfolios using leverage. However, this solution is often confounded by leverage aversion or regulatory constraints. The alternative is to concentrate portfolios in higher risk asset classes, like equities. The equity-centric solution is expected to deliver higher returns over the long term to compensate for the extra risk, but this poses problems for investors who can't tolerate 30%-50% losses. The RTE strategy was engineered exclusively to address this challenge. By constantly seeking the world’s strongest stock markets, the strategy aims to profit from growth anomalies in every corner of the globe. And by taking advantage of absolute momentum, the goal is to preserve more of those gains by avoiding catastrophic losses.

How does it compare?

For statistics on how the full implementation of this strategy stacks up to other types of markets and portfolio construction methodologies please sign up to our free exclusive content portal. Inside you will find performance simulations, exclusive whitepapers, and other research to help you better understand our investment methods and philosophy and help you invest better.
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General information regarding the simulation process. The systematic model used historical price data from Exchange Traded Funds (“ETFs”) representing the underlying asset classes in which it trades. Where ETF data was not available in earlier years, direct market data was used to create the trading signals. The hypothetical results shown are based on extensive models and calculations that are available for any potential investor to review before making a decision to invest.

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