Market Navigation Insights

Do traditional factor and style indexes create a false market narrative?

May 24th, 2023
Significant Growth v Value rotation – what does this reflect?

Source: Wilshire, Data as at 31 March 2023
How are Style indices constructed?

**Value:**

(Equal Weight)
- Forecast Earnings Yield
- Book to Price
- Cash flow yield

**Growth:**

(Equal Weight)
- Long Term EBITDA growth
- Long Term revenue growth
- Forecast EPS growth

How much genuine ‘Factor Premia’ do they capture?
A key problem is the capture of significant unintentional exposures ...

Large sector exposure skews (as at year end 2022)

Source: Wilshire, Data as at 31 December 2022
...resulting in distorted sector weighted performance distributions

Source: Wilshire, Data as at 31 December 2022
Stock concentration exposure ...

Weight and Contribution to 2022 Return of Top 10 Largest Stocks by Market Cap

<table>
<thead>
<tr>
<th>Growth</th>
<th>Weight</th>
<th>Cont</th>
</tr>
</thead>
<tbody>
<tr>
<td>Microsoft Corp.</td>
<td>10.1</td>
<td>-2.8</td>
</tr>
<tr>
<td>Apple Inc.</td>
<td>9.3</td>
<td>-2.5</td>
</tr>
<tr>
<td>Amazon.com Inc.</td>
<td>4.9</td>
<td>-2.4</td>
</tr>
<tr>
<td>Alphabet Inc Cl-C</td>
<td>3.1</td>
<td>-1.2</td>
</tr>
<tr>
<td>Alphabet Inc Cl-C</td>
<td>3.0</td>
<td>-1.1</td>
</tr>
<tr>
<td>NVIDIA Corp.</td>
<td>2.3</td>
<td>-1.2</td>
</tr>
<tr>
<td>Tesla Mtrs Inc</td>
<td>2.1</td>
<td>-1.4</td>
</tr>
<tr>
<td>MasterCard Inc.</td>
<td>2.0</td>
<td>-0.1</td>
</tr>
<tr>
<td>UnitedHealth Group Inc.</td>
<td>1.6</td>
<td>0.1</td>
</tr>
<tr>
<td>Eli Lilly &amp; Co.</td>
<td>1.6</td>
<td>0.6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>40.1</strong></td>
<td><strong>-12.0</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Value</th>
<th>Weight</th>
<th>Cont</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apple Inc.</td>
<td>4.0</td>
<td>-1.0</td>
</tr>
<tr>
<td>Exxon Mobil Corp.</td>
<td>2.7</td>
<td>2.4</td>
</tr>
<tr>
<td>Johnson &amp; Johnson</td>
<td>2.5</td>
<td>0.1</td>
</tr>
<tr>
<td>Berkshire Hathaway Inc</td>
<td>2.4</td>
<td>0.1</td>
</tr>
<tr>
<td>JPMorgan Chase &amp; Co.</td>
<td>2.3</td>
<td>-0.3</td>
</tr>
<tr>
<td>Procter &amp; Gamble Co.</td>
<td>2.1</td>
<td>-0.1</td>
</tr>
<tr>
<td>Chevron Corp.</td>
<td>2.1</td>
<td>1.2</td>
</tr>
<tr>
<td>Pfizer Inc.</td>
<td>1.7</td>
<td>-0.2</td>
</tr>
<tr>
<td>Merck &amp; Co. Inc.</td>
<td>1.7</td>
<td>0.8</td>
</tr>
<tr>
<td>Coca-Cola Co.</td>
<td>1.6</td>
<td>0.2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>22.9</strong></td>
<td><strong>3.2</strong></td>
</tr>
</tbody>
</table>

Source: Wilshire, Data as at 31 December 2022
... and macro indicator & long duration equity sensitivity

These ‘off target exposures’ dilute intended factor premia exposure

Source: Wilshire, Refinitiv and FactSet, Data as at 31 March 2023
‘Pure factors’ paint a different picture – via minimization of ‘off target’ exposures

• Methodology designed to focus on factor premia and the minimization of off target exposures
• Via sector neutral and ‘multiple tilt’ approach:

  **Quality** is defined as an equally weighted composite of:
  • ROE
  • Accruals Ratio (Net income – FCF)/Total assets
  • Debt to Equity Ratio

  **Value** is defined as an equally weighted composite of:
  • Earnings Yield,
  • Sales to Price Ratio,
  • Cash Flow Yield
  • Book to Price Ratio
Pure factors have delivered very different return profiles to Style indices

2022 Total Returns (%)

Q1 2023 Total Returns (%)

Not as much Growth/Value rotation via the prism of ‘Pure Factors’

Source: Wilshire, Data as at 31 March 2023
Why the difference? Minimizing ‘off target’ active exposures

**Value:**

Value Style vs Pure Value-2022 Average Active Exposure

Value Style vs Pure Value-Q1 2023 Average Active Exposure

Source: Wilshire, Data as at 31 March 2023
Resulting in very different return drivers and characteristics

Source: Wilshire, Data as at 31 March 2023
The same story comparing Growth v Pure Quality active exposures

Growth v Pure Quality:

Source: Wilshire, Data as at 31 March 2023
Growth vs Quality factor performance attribution

Source: Wilshire, Data as at 31 March 2023
Traditional factors & style indices capture numerous off target exposures

- Sector
- Stock concentration
- Macro – long duration
- Other factors

These minimize factor premia signalling and create a false narrative of exaggerated rotation

Pure Factors are designed to apply precision to Factor Premia capture enhancing multi-factor application
More information

Subscribe and download here: http://www.wilshire.com/

Pure Factors Methodology

Research Papers
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