

<https://blog.en.erste-am.com/2017/07/26/style-management-in-practice-part-2/>

## Style management in practice: part 2

Harald Egger

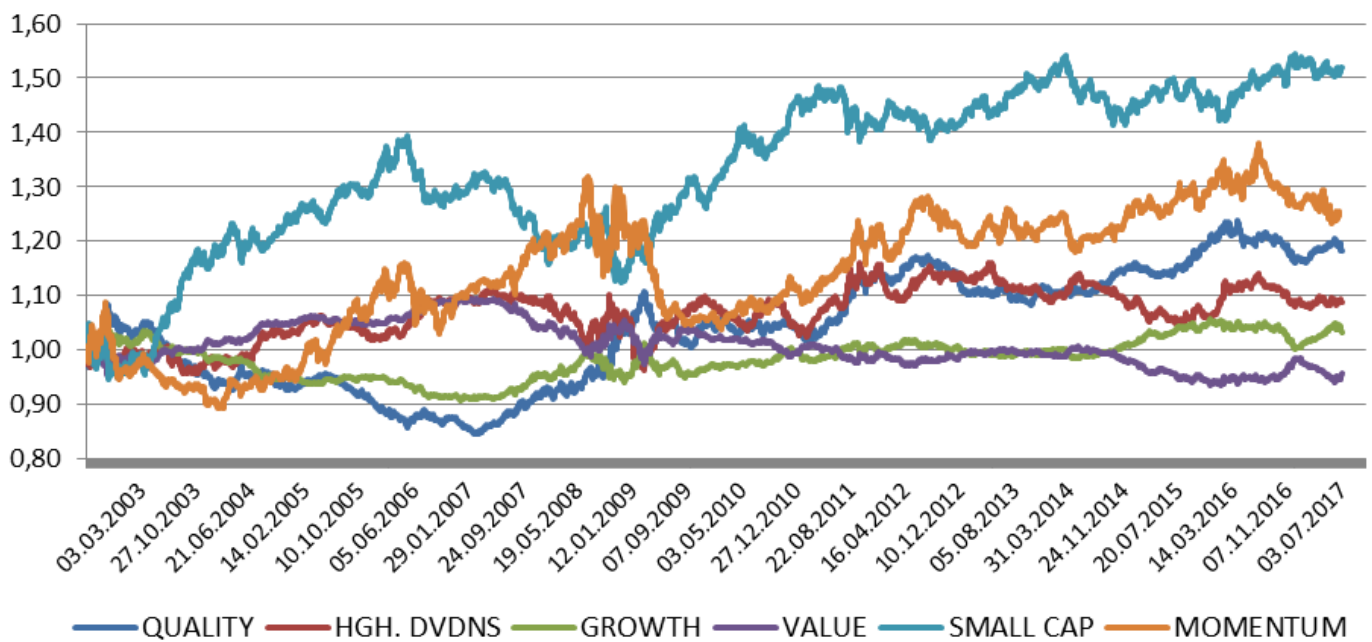


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Having defined and explained various management styles in equity management in part 1, we will now have a look at the specific styles and their return/risk ratio over time.

# Relative Performance der verschiedenen Aktienstrategie-Stile

(Indexiert auf 1,00)



Sources: Erste AM; Bloomberg; the return and risk ratios do not take fees, duties, or taxes into account. Past performance is no reliable indicator of future development.

Looking at the performance of the different styles, we find the following:

1. The performance of the various styles may differ a lot.
2. Small caps outperformed the market significantly over the observation period (50%, which equals 2.74% p.a.).
3. Momentum was a successful strategy, but also underwent three phases of clear underperformance.
4. In 2007, a trend reversal took place. Since then, value shares have underperformed the overall market, whereas quality and growth shares have outperformed it.

The underperformance of value comes as a surprise, given what Fama/French established in their famous 1992 paper (which everyone in this field will come across sooner or later). According to the paper, small caps and value are two factors that could explain outperformance. Until the early 1990s, that was indeed the case, but apparently outperformance phases do not have to be of a sustainable nature.

The analysis of the value segment over a longer period of time (from 1991 onwards) reveals different phases.

## Phase 1 (1991-1994): yield curve turning steeper

Value outperforms growth significantly

## Phase 2 (1994-1999): the birth of the Internet

Boom phase of growth with TMT bubble at the end

Commodity prices fall

Yield curve flattening

## Phase 3 (1999-2007): emerging markets (BRIC) catching up - commodity boom

Strong phase of value; quality and growth were underperformers and had "fallen out of fashion"

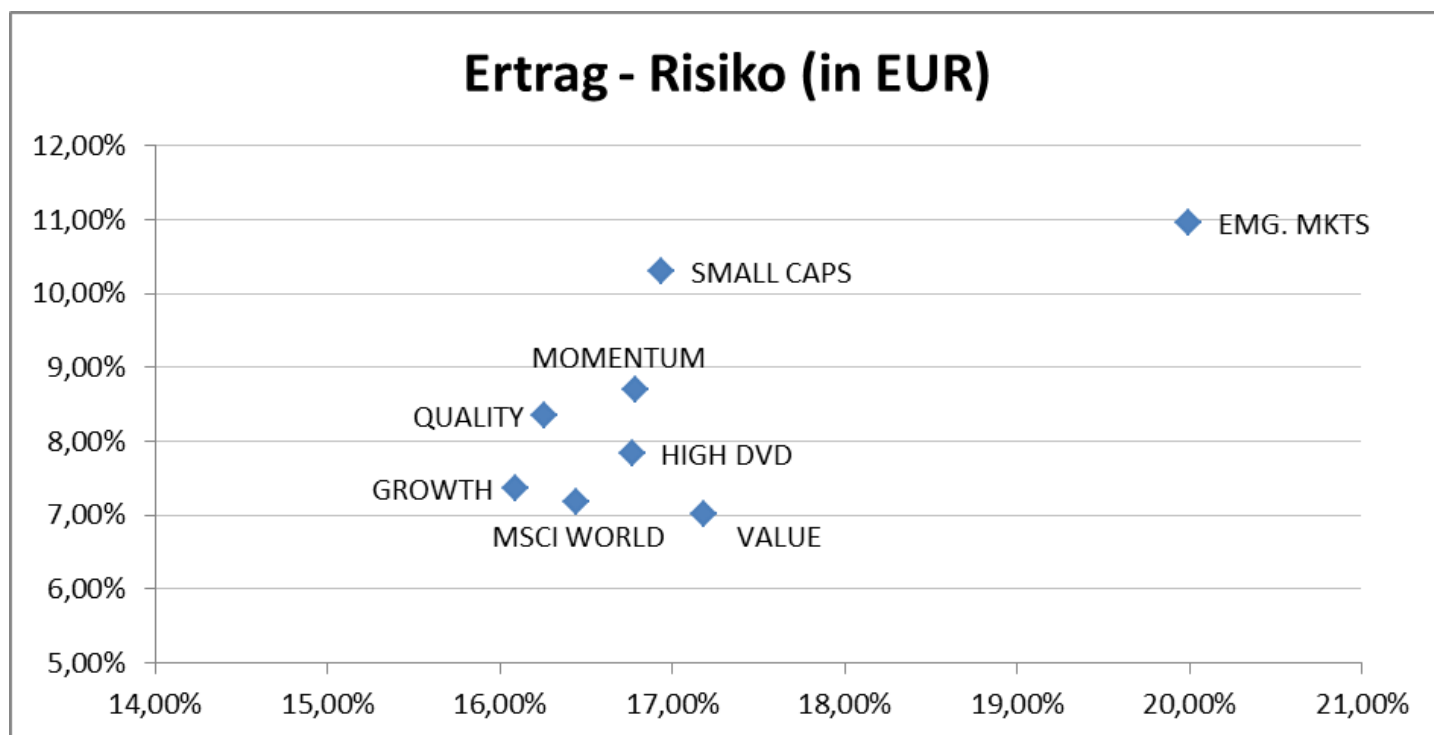
Commodity prices doubling

#### **Phase 4 (2007 to date): “After the financial crisis”, deflation, interest rates are falling continuously**

Value is the weakest style of all.

An important finding is the fact that one style may outperform the rest over a long period of time while being among the absolute losers in a different phase.

#### **Return/risk ratio (2002-2017):**



Sources: Erste AM; Bloomberg; the return and risk ratios do not take fees, duties, or taxes into account. Ratios based on weekly data.

Past performance is no reliable indicator of future development.

The chart above shows the return over the past 15 years in relation to the risk (as measured by volatility). These are our findings:

Small caps and emerging markets have yielded the highest rate of return. However, the significantly higher rate of return for the emerging markets is “bought” by significantly higher risk.

In terms of return, value and growth shares were neck to neck for a while, although the risk of growth shares was lower, which made them the better choice.

Quality shares were ideal in this context, as they generated a higher return at lower risk.

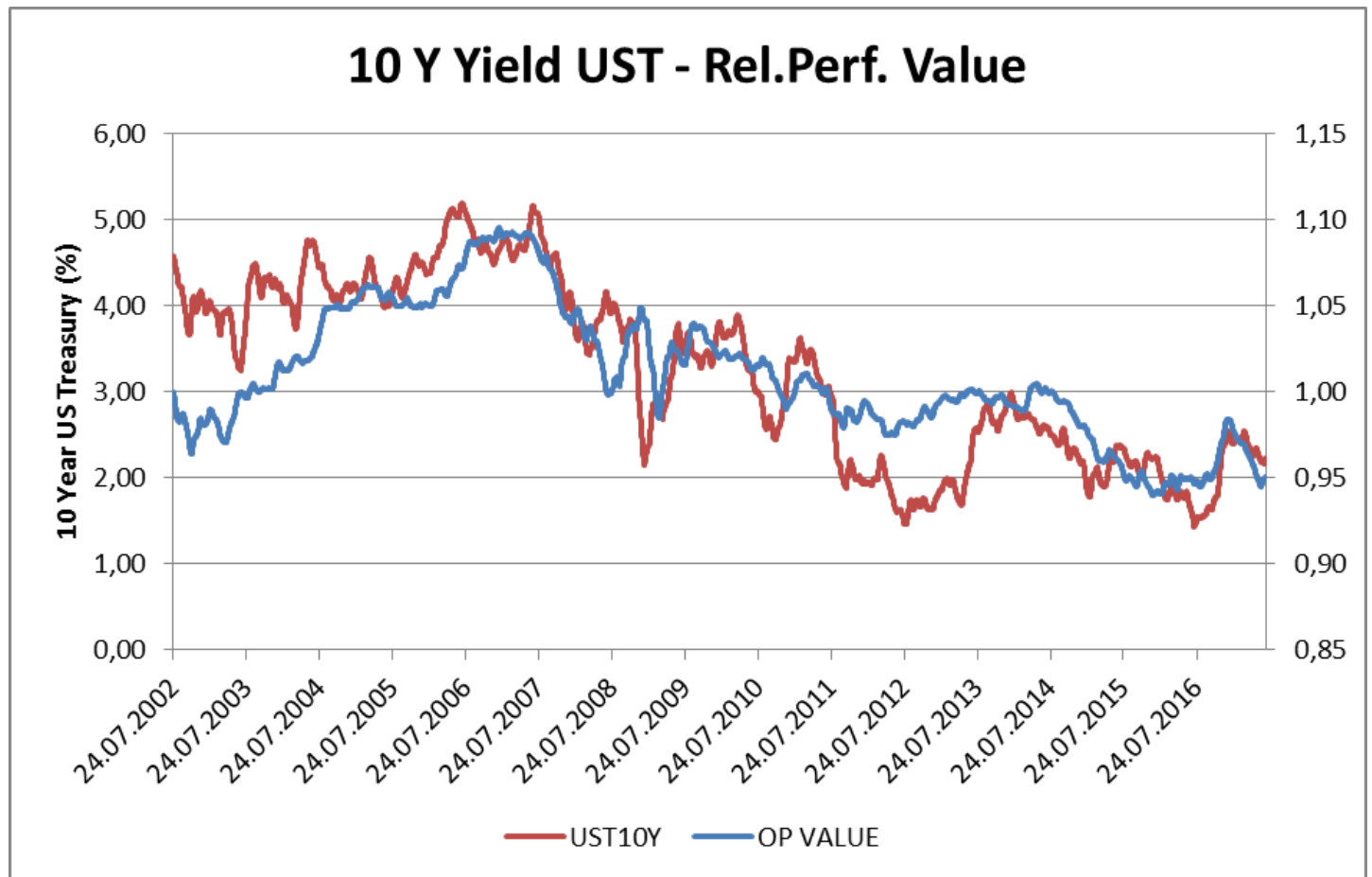
Betting on the winners of the past was no bad strategy either, since it would have generated an outperformance of 2% at slightly higher risk.

High-dividend shares also achieved a higher rate of return, although the return/risk profile was not ideal.

However, this is the picture of the past 15 years; it is by no means clear that the coming 15 years will look the same. Many value shares contain a higher degree of risk than the overall market. But in what cases will the investor be compensated for the higher risk?

#### **What drives the outperformance of value and style in general?**

A strong correlation between US Treasuries and the value style has existed over the past 15 years. This may on the one hand be due to the fact that the value segment currently contains a lot of financial companies (i.e. financials). Financials benefit from a steeper yield curve, so when the 10Y yields are rising, the value segment will be outperforming the other market segments, and vice versa. Since 2007, the 10Y yields have fallen from 5% to slightly above 1%. In such a scenario, falling yields would always go along with underperforming value shares. Conversely, growth and quality would outperform the market amid falling interest rates.



Sources: Erste AM; Bloomberg; the return and risk ratios do not take fees, duties, or taxes into account.  
Past performance is no reliable indicator of future development.

The yields also describe very well the development over the past months. The drastic increase in interest rates from July 2016 onwards heralded a phase of value outperformance, but in the wake of the decline of yields in 2017, said outperformance has quickly come to an end.

The timing of styles is generally difficult, given that the correlation with external factors is unstable. The correlation between value and 10Y yields has not always been as high as today. But the following statement still holds:

For value to outperform, at least one of the following conditions should be prevalent:

- Long-term yields are rising
- Short-term yields are not rising, but the yield curve is turning steeper
- Commodity prices are rising drastically

Quality and growth shares, on the other hand, outperform the overall market if

- Interest rates are falling
- The yield curve is flattening
- Commodity prices are falling

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Harald Egger is Chief Analyst and has worked at Erste Asset Management since 2001. Previously he worked for four years as a fund manager and analyst for AXA Investment Management in London. He headed the equity segment within Erste Asset Management and was CIO until April 2013. He has been employed in the finance industry since 1992.