FIRST QUADRANT

FQ INSIGHT:

The Reluctant Equity Market

November 2014

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In the first nine months of the year, even as the US equity market continued to notch gains following a year of high returns in 2013, the market seemed to lack conviction. We had the impression that investors were not in equities because of strong enthusiasm for the asset class, but because the other possibilities looked worse – especially government bonds. What gave the impression that investors were lukewarm about equities were the returns of a number of the segments within the market. Wherever we looked, from sector returns to company size, factor returns and investor sentiment, the overall impression was of risk averse equity investors. The recovery of the US economy from the financial crisis has been weak compared to previous crises, and the strong equity market return from 2009-2013 raised the market to levels somewhere between fully valued and overvalued. At the beginning of the year, 10 year US Treasury bond yields, around 3%, were expected to rise as the Federal Reserve reduced its program of bond-buying, started to map out rises in short-term rates and the economy finally achieved lift-off. Instead, the same sense of unease overhanging the equity market affected Treasurys, too, and long-term interest rates declined sharply.

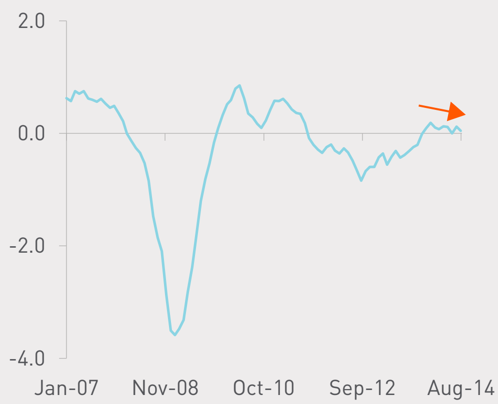
At its highest level, the S&P 500 Index reached 2011 on September 18 this year[1], which yielded a return of 8.8% YTD. Finally, after almost nine months during which the broad market held up despite defensive rotations within the market, the market took a sharp negative turn and the S&P 500 Index bottomed out on October 15 with a reading of 1862 (-7.4% from its September peak). The so-called "investor fear gauge" CBOE Volatility Index (VIX)[2] jumped above 25 briefly before the market rebounded. As we write now the equity market has bounced back strongly, recovering most of the heavy loss since mid September. Despite the rapid recovery from the correction, we continue to believe that investors are skeptical about the near- and medium-term prospects for equities.

There have been plenty of reasons to be cautious this year, from tepid economic news out of China and Europe to ongoing geopolitical crises in Ukraine and the Middle East and worries about US interest rate hikes. Our proprietary global economic composite indicator started to decline from the beginning of the year after steady improvement (from depressed levels) in 2013.

Our investor sentiment indicator is signaling low sentiment[3]. One component of this indicator, dividend premium -- which is defined as the log difference of the average market-to-book ratios of dividend payers and nonpayers -- jumped suddenly at the beginning of the year. Since dividend premium measures the valuation difference between dividend payers and

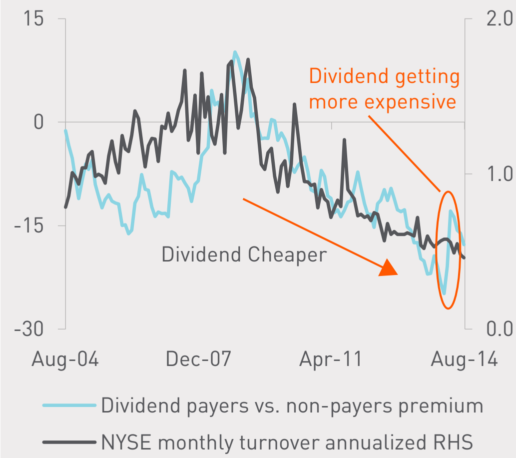
Past performance is no guarantee of future results. Potential for profit is accompanied by possibility of loss.

EXHIBIT 01: GLOBAL ECONOMIC COMPOSITE INDICATOR (JANUARY 2007 - AUGUST 2014)



Source: JP Morgan, the Federal Reserve, OECD, the Banca d'Italia, and First Quadrant, L.P.

EXHIBIT 02: DIVIDEND PAYERS VS NON-PAYERS (AUGUST 2004 - AUGUST 2014)



Note: Dividend payers vs. non-payers premium is defined as the difference of the log of average P/B ratios of dividend payers and nonpayers among the Russell 3000 universe.

Sources: Russell, Compustat, MarketQA, NYSE, and First Quadrant, L.P.

nonpayers, an increasing dividend premium means that dividend payers became more expensive relative to nonpayers, as a result of investors' preference for dividends as safe and steady income. We also use NYSE turnover as a gauge of investor sentiment. The following chart shows trading activity is still decreasing, which demonstrates the recent market rally was with lower investor participation – hardly a robust endorsement.

Another indicator, equity mutual fund flow activity, also suggests that investor sentiment is subdued. The following chart (Exhibit 03, next page), published by Nomura, shows that net purchases of global equity mutual funds are at very low levels compared with historical inflows.

There is further evidence of investor risk aversion from the performance of equity factors, which show investors' preference for quality, stable income and defensive stocks, and their aversion to risky and cyclical stocks. Companies with high default risk and high volatility performed relatively poorly. The following table shows some of the factor and index performances.

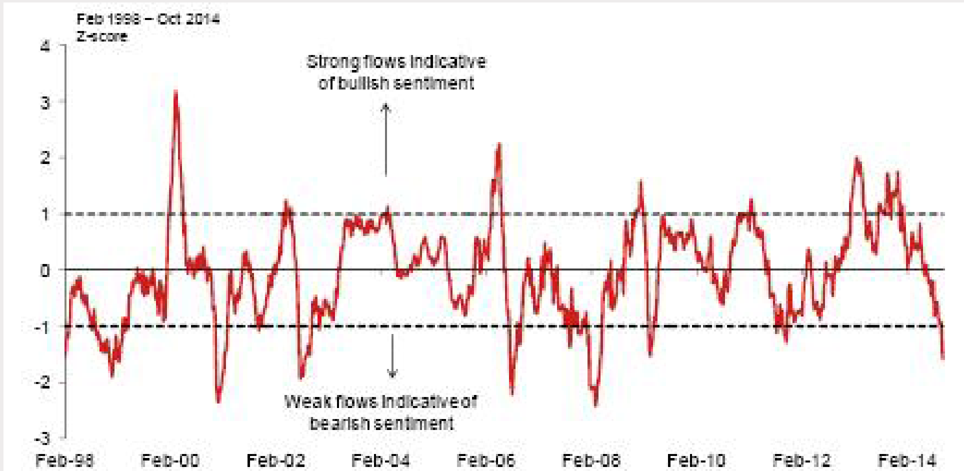
TABLE 01 - RUSSELL INDEX RETURNS AND NOMURA FACTOR RETURNS (YTD)

Russell Index				Nomura Quant Factors		
FR1000	FR2000	FR3000 Value	FR3000 Growth	Dividend yield	Default Risk	Volatility
10.61%	1.90%	9.80%	10.01%	3.00%	-5.30%	-1.20%

Sources: Russell and Nomura.

Russell 1000 Index[4] outperformed Russell 2000 Index by about 8.71% this year. During uncertain times large cap is preferred over small cap because large cap stocks are safer to own. The dividend yield factor, which buys stocks with high dividend yields and sells stocks with low yields, was one of the best performing factors this year. In recent years, dividend yield from stocks has been used as an income supplement to the low yield of Treasurys. Interestingly, Value and Growth indices performed similarly,

EXHIBIT 03: GLOBAL MUTUAL FUND ACTIVITY INDICATOR (FEBRUARY 1998 - OCTOBER 2014)



*Mutual fund net inflows are based on US net purchases of all equity mutual funds as well as net purchases of European, Japanese and Global Emerging market funds. US and Global emerging market flows are measured as the 12-week moving average of flows expressed as a percentage of US and GEM market capitalisation, while European and Japanese figures are measured in relation to reported assets under management. Return series is 12-week forward local currency return of Datastream World Index. ** Z-score is measured in standard deviation and is a rolling 2-year average. Japanese data prior to July 2005 is based on retail flows as a % a Japanese market cap. Source: AMG, EPFR, Datastream, FTSE, Nomura strategy research

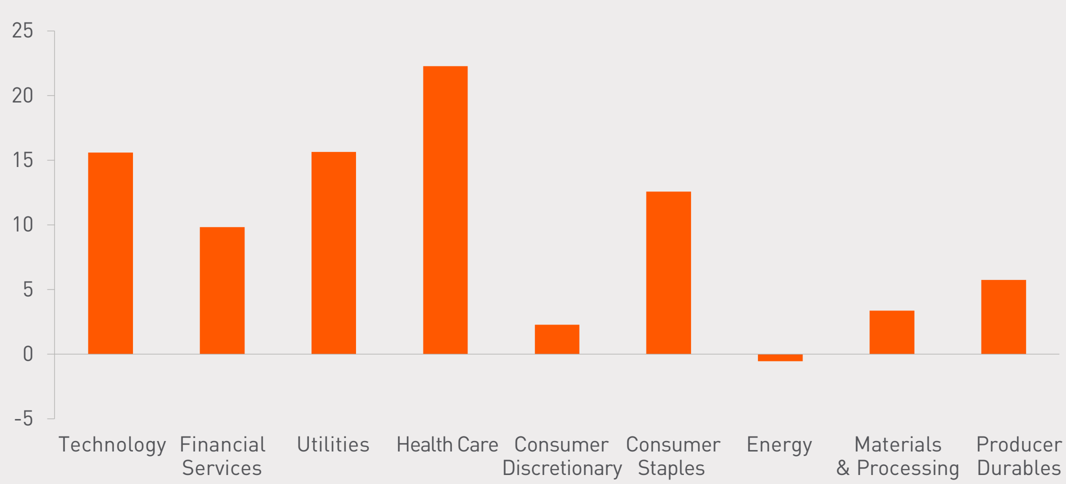
without clear leadership of one or the other, which shows that investors were indecisive on which style tilt to take.

So far this year, defensive sectors generally outperformed cyclical sectors, with the Health Care sector being the best performing sector and the Energy, Consumer Discretionary and Materials sectors on the bottom of the performance ranks.

Summary

In this note, we have attempted to provide context and an explanation for some of the rotations within the equity market this year. The

EXHIBIT 04: RUSSELL US SECTOR RETURNS (YTD)



Source: Russell

US equity market has rallied over the last five years, other assets are far from cheap, interest rates are expected to rise and macroeconomic news outside the U.S. has uneven. As a result, investors have been approaching equities cautiously, by being selective and conservative. Over the near-term, we do not see the drivers that would signal a continuation of the bull market returns of 2013. However, given that our long-term strategic view is that we are in a resilient state (see "The Current Resilient Market Environment: October 2014 and History") a full blown bear market drop of -20% or more is unlikely though a substantial correction in the -10% to -15% range is highly possible.

Our multi-factor approach has a substantial weight in defensive factors and also employs pro-cyclical factors, overlayed with top-down tactical risk allocation and industry rotation. Currently, portfolios are neutral on most tactical positions, with the exception of a moderate overweight to price momentum. If risks increase for a sustained period, most likely we would reduce value exposure and underweight small stocks; and boost exposures to growth and solvency. Please see our recent insight piece on "How Should We Position Portfolios When Volatility Rises?" for a more detailed discussion.

Reference

Baker Malcolm. and Jeffery Wurgler, 2006, Investor Sentiment and the Cross-Section of Stock Returns, Journal of Finance 62 , 1645–1680.

Endnotes

[1]As of end of October. Sources: S&P 500 - http://us.spindices.com/indices/equity/sp-500, Bloomberg

[2]Sources: CBOE VIX - https://www.cboe.com/micro/vix/historical.aspx, Bloomberg.

[3]The sentiment indicator follows the methodology of Baker and Wurgler (2006).

[4]Sources: Russell 1000 - https://www.russell.com/indexes/americas/indexes/daily-values.page?, Bloomberg.

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