

EYE ON THE MARKET

by **Peter Greenberger, CFA, CFP®**
 Director, Mutual Fund Research & Marketing
 Member of Raymond James Investment Strategy Committee

✉ **Thomas Ganey**
 Research Analyst, Mutual Fund Research & Marketing

COMMENTARY ON SPECIFIC MARKET ISSUES AND ACTIONABLE IDEAS TO CONSIDER



Over the last few years, the concepts of momentum and low-volatility investing have gained recognition in the financial industry. This is due in part to the reflection that certain individual securities have enjoyed meaningful appreciation in value while the broad equity market remained subdued over the last year. Conversely, commodities and the emerging markets continued to experience declining prices, as the underlying fundamentals and sentiment of both asset classes deteriorated. Both of the aforementioned examples illustrate the idea of momentum, where security prices are more likely to keep moving in the same direction than to change directions.

During this same period, volatility returned to the broad market place, and those investors who overestimated their risk tolerance were likely surprised by the performance gyrations in their portfolios. Given this, investment strategies that aim to dampen the highs and lows are garnering attention.

CAPTURING THE MOMENT! UM?

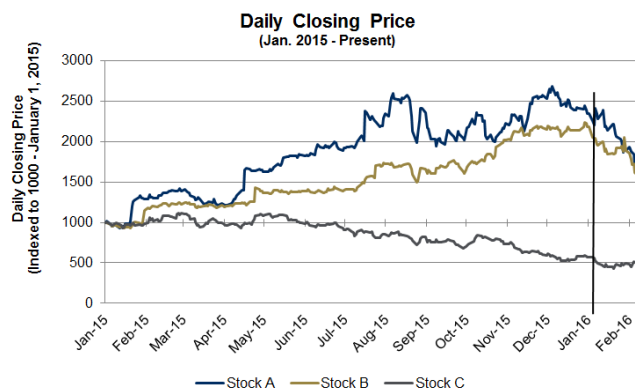
Research published in *The Journal of Portfolio Management*¹ notes that:

“Momentum is the phenomenon that securities that have performed well relative to peers (winners) on

average continue to outperform, and securities that have performed poorly (losers) tend to underperform.”

The research also notes that the principal of momentum was observable across more than 40 countries, over a dozen asset classes, and over 200 years of market data. Momentum can be evaluated using a wide range of metrics including price, earnings, and valuations. As Chart 1 displays, Stock A and Stock B experienced positive momentum throughout 2015, while Stock C suffered from negative momentum over the same period.

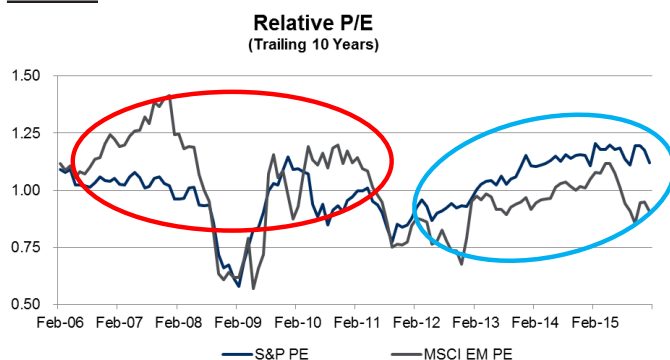
Chart 1



Source: Morningstar Direct. For illustrative purposes only. Not an investment recommendation.

¹ C. Asness, A. Frazzini, R. Israel, & T. Moskowitz. “Fact, Fiction, and Momentum Investing.” *The Journal of Portfolio Management*. Special 40th Anniversary Issue.

While both Stock A and Stock B have since experienced a trend reversal, it is possible for positive momentum of their underlying fundamentals to continue over longer periods of time because of how each drives future growth of its business. It is worth noting that momentum and investor sentiment are not to be confused. The authors of the research article note that momentum, both positive and negative, can occur over protracted periods of time. On the other hand, investor sentiment can vary by the day.

Chart 2

Source: Morningstar Direct. The MSCI Emerging Markets Index is a market capitalization-weighted index of stocks from 26 emerging markets that only includes issues that may be traded by foreign investors. The S&P 500 Index is a market-capitalization weighted index of 500 stocks, and is generally considered representative of the U.S. stock market.

Chart 2 highlights that momentum can be persistent for extended periods of time, should be considered on a relative basis, and can be evaluated on more than just individual stocks. As the chart indicates for the period of February 2006 through February 2011, as denoted by the red circle, the price to earnings ratio ("P/E") of the MSCI Emerging Market Equity Index was generally higher than the P/E for the S&P 500, except following the financial crisis. Since the latter half of 2011, the P/E ratio for the emerging market equity index has been below that of the S&P 500, as highlighted in the blue circle. Both periods of momentum can be tied to long-term fundamental factors. This included rapid growth within emerging market economies leading to relatively higher P/E ratios during the earlier period, while a decline in commodity prices, a rising U.S. dollar, and other factors have led to a lower relative P/E ratio since 2011. Will these trends reverse? They may as trends shift when long-term fundamentals change, as has been the case in previous economic cycles.

LESS IS MORE

It is perfectly understandable that an investor would want to capture as much of upside and little to any of downside momentum. To that end, Eye on the Market ("EotM") urges the consideration of strategies that limit the overall exposure to market volatility, particularly as volatility, as measured by the Chicago Board Options Exchange ("CBOE") Volatility Index ("VIX"), has increased, as noted on Chart 3, since the start of 2015.

Chart 3

Source: Morningstar and Raymond James. The Chicago Board Options Exchange ("CBOE") Volatility Index ("VIX") is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. An index cannot be invested in directly.

This matters, as the investor is likely to become more risk averse, and possibly exit the market during periods of heightened volatility, particularly when the volatility is to the downside. Emotional decision-making during uncertain times can have significantly negative impacts on the portfolio and make it less likely to reach long-term financial goals. While easier said than done, sticking with a long-term strategic allocation and financial plan can lessen the likelihood of locking in significant losses in value.

EotM examined the volatility, as measured by standard deviation, as well as the total and risk-adjusted returns of the individual constituents of the S&P 500 over the ten-year period of February 2006 to January 2016 (standard deviation is a risk statistic used to measure the amount of volatility of the return observations around the portfolio's average return). The analysis ranked the overall level of volatility of each stock over the ten-year period into quartiles, ranging from the 1st quartile exhibiting the lowest level of average annualized volatility, to the 4th quartile exhibiting the highest level.

"...investment strategies that aim to dampen the highs and lows are garnering attention."

Table 1

S&P 500 Index Ten Year Period (February 1, 2006 - January 31, 2016) Average				
Quartile	Annualized Volatility	Annualized Return (%)	Cumulative Return (%)	Sharpe Ratio
1	18.60	10.00	189.66	0.55
2	25.77	9.04	175.84	0.42
3	32.15	6.42	153.32	0.31
4	45.85	4.19	194.55	0.27
S&P 500	15.77	6.48	87.41	0.42

Source: Morningstar and Raymond James. The Sharpe Ratio is a measure of a Fund's reward per unit of risk. The higher the Sharpe ratio, the better the portfolio's risk-adjusted performance. An index cannot be directly invested in.

Table 1 indicates that, over this discrete period, the lower-volatility quartiles generated higher annualized and risk-adjusted returns, as measured by the Sharpe Ratio, generating an annualized total return of 10%, while those that had the highest volatility (4th quartile) generated an annualized total return of just over 4%. While idiosyncratic factors drive volatility levels, those companies that are prone to deeper declines will have to generate higher than average returns to remain relatively competitive with less-volatile peers. This trend may persist in a similar manner over the course of time, but as most investors know, past performance is no indication of future results.

FLEETING OR TIMELESS?

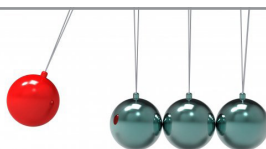
It is very tempting to get caught up in the latest new idea or invest in the next "hot" industry, but over the course of time the positive results of this type of strategy will be short-lived as a new technology takes over. Research has demonstrated that over longer periods of time both momentum-based and low-volatility strategies can generate attractive results. EotM encourages investors to take a thoughtful and patient approach that compliments the investment objectives, goals, and risk tolerances, and considers how momentum and/or low volatility strategies may affect his plan.

SO MANY CHOICES, WHAT TO DO

EotM would like to provide investors with a one-stop solution that provides both the best characteristics of momentum investing coupled with low volatility characteristics. Unfortunately, a single solution may not be best, as the two strategies traditionally take different skill sets to execute on a consistent, sustainable and repeatable basis. Hope should not be lost, as there are a variety of ways that an investor can allocate to both momentum and low-volatility strategies. Regardless of the approach that an investor ultimately takes, he should remain cognizant that there is no single one size fits all solution.

SIDE NOTE

The benefits of positive momentum exist outside of the world of finance, whether it is an album continuously topping the charts, a movie preserving its run of leading the box office, or a sports team maintaining a winning streak. Typically, the positive momentum is coupled with the fact that the artist, actor, or athlete consistently performs at a high level, not high one day, low the next, and so on. This in turn has led to fans following musicians such as the Beatles for over 50 years, the Star Wars series nearly 40 years, and teams such as the Green Bay Packers and New York Yankees for even longer.



Investors should carefully consider the investment objectives, risks, charges and expenses of mutual funds and ETFs before investing. The prospectus contains this and other information about mutual funds and ETFs. The prospectus is available by contacting the fund family and should be read carefully before investing.

The views expressed in this newsletter are subject to change, and no forecasts can be guaranteed. Information contained in this report was received from sources believed to be reliable, but accuracy is not guaranteed. Material is provided for informational purposes only and does not constitute recommendations, investment advice or an indication of trading intent. Investing always involves risk and you may incur a profit or loss. No investment strategy can guarantee success.

Past performance does not guarantee future results. There is no assurance these trends will continue.

RAYMOND JAMES®

Raymond James & Associates, Inc. member New York Stock Exchange/SIPC. Raymond James Financial Services, Inc., member FINRA/SIPC.
Investment products are not deposits, not FDIC/NCUA insured, not insured by any government agency, not back guaranteed, subject to risk and may lose value