Using Value, Momentum and Quality as an Active Approach to Investing

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What is a truly active approach?

A strategy that purposely deviates from the traditional, market-cap-weighted indexes.

If You Want to Beat the Market, Don’t Invest Like an Index Fund

Vanguard S&P 500 ETF (VOO)

Also available as an Admiral™ Shares mutual fund.

Overview | Price & Performance | Portfolio & Management | Fees | Distributions | News & Reviews

Product summary

- Invests in stocks in the S&P 500 Index, representing 500 of the largest U.S. companies.
- Goal is to closely track the index’s return, which is considered a gauge of overall U.S. stock returns.
- Offers high potential for investment growth; share value rises and falls more sharply than that of funds holding bonds.
- More appropriate for long-term goals where your money’s growth is essential.

View prospectus and reports

ETF facts

Asset class	Domestic Stock - General
Category	Large Blend
IOV ticker symbol	VOO.IV
Expense ratio as of 04/28/2020	0.03%
CUSIP	922908363
ETF advisor	Vanguard Equity Index Group

Source: Vanguard.

The median R-squared for no-load, actively managed domestic equity funds is 91%.

In other words, 91% of their return can be explained by movement in the S&P 500 index as opposed to their strategy.

The Money Manager's Dilemma

Investment Success

(Long-term)

vs.

Career Risk

(Short-term)

Two Big Advantages Individual Investors Have

- Never having to report performance
- The ability to invest in exchange-traded stocks of all sizes

Keys to Active Investing

- Base the approach on research about what has worked historically
- Have a systematic, well-defined manner of applying it
- Be willing to sacrifice shorter-term underperformance for long-term outperformance

VMQ Stocks is a good an example of a systematic, active approach.

Two Cornerstones

Value Beats Growth

Source: Kenneth French Data Library, lowest and highest 30% book-to-market equal-weight portfolios, data from 1952 to 2019.

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High Valuations

=

High Expectations

=

More Room for Disappointment

Valuation Considerations

- Academic research uses relative (e.g., cheapest 40%); always finds stocks
- Absolute limits (e.g., price-to-book ratio below 3.0, price-earnings ratio below 20.0) prevent paying up, but can be restrictive
- Some stocks are cheap for a reason

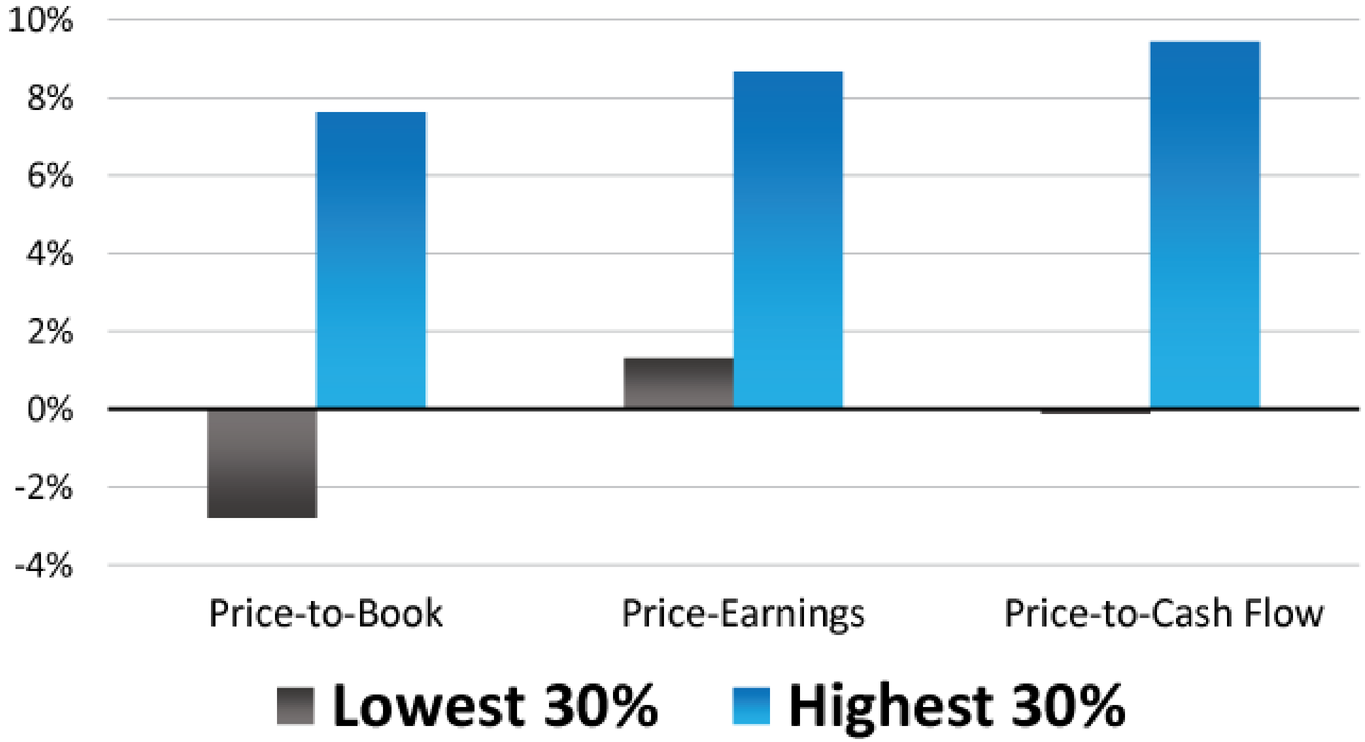
Combine Value Measures

- Price to sales
- Price to earnings
- Enterprise value to EBITDA
- Shareholder yield
- Price to book value
- Price to free cash flow

VMQ Value Score

- Must have valid ratio for at least two of the six ratios
- Two-step process:
  - First, the percentage rankings for all valid ratios is calculated
  - Second, a stock's average valuation rank is compared against the average rank of all other stocks
- Put another way, stocks are ranked based on how their composite valuation compares to all other stocks

Value Droughts Can Occur



Source: Kenneth French Data Library, lowest and highest 30% 12-month price returns for equal-weight portfolios, data from 2017 to 2019.

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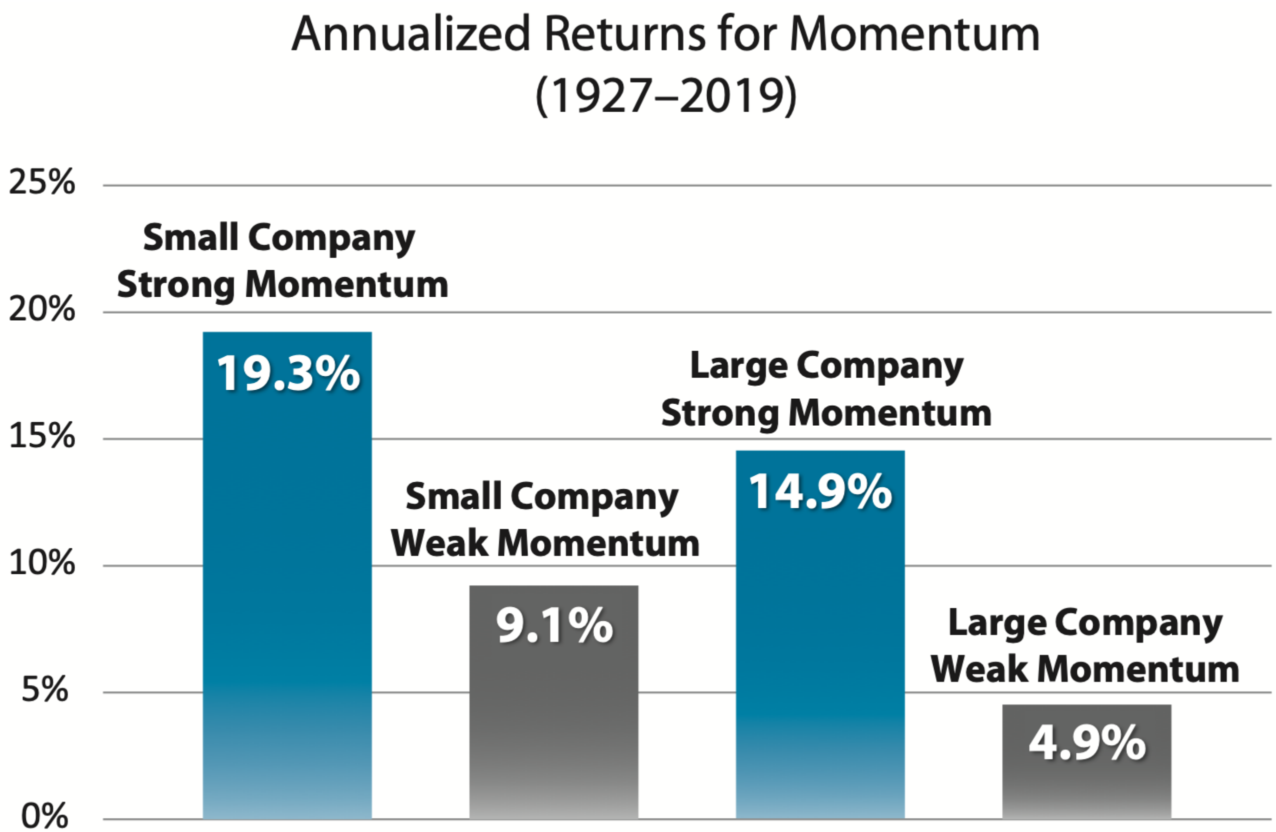
The fear of incurring periods of underperformance is one of the reasons factor premiums, including the excess long-term return from favoring value, continue to exist.

Momentum: Investors Prefer Winners



Source: Kenneth French Data Library, lowest and highest 30% 12-month price momentum for equal-weight portfolios, data from 1927 to 2019.

Momentum Considerations

- Stocks with relative strength rankings of 60% or higher tend to outperform
- Look at longer periods of 13 weeks or longer; can be mean-reverting over 4-week periods
- Momentum strategies have more turnover, and therefore are more costly

Weighted Four-Quarter Relative Strength Rank

- 40% weight to most recent quarterly relative strength rank
- 20% weight to relative strength rank of each of previous three quarters
- Fared better than other momentum indicators, including 26-week and 50/50 26-week/52-week relative strength ranks

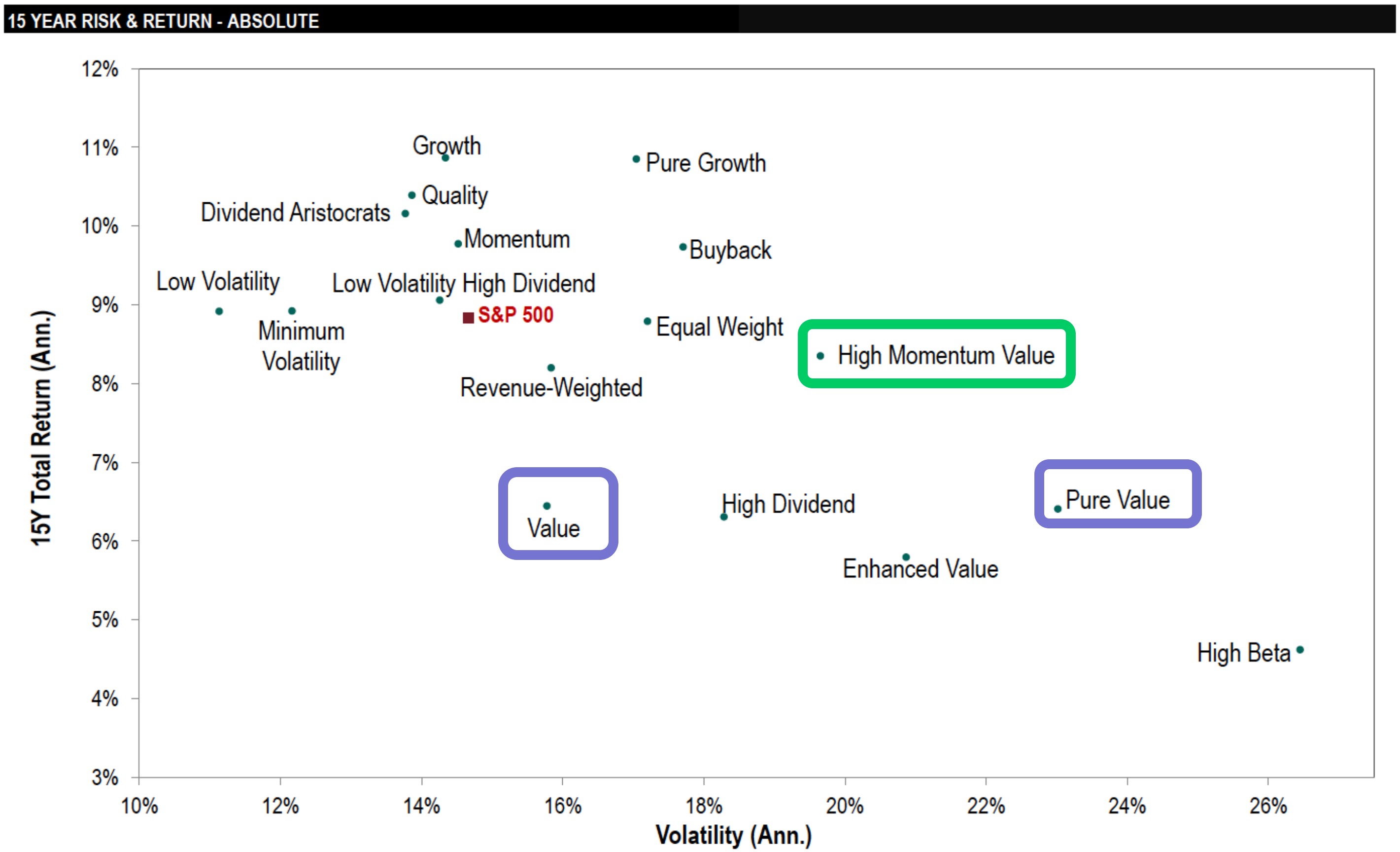
Five Worst Momentum Crashes

Rank	Month	Market Returns 2 Years Prior (%)	Winners vs. Losers (%)	Overall Market (%)
1	Aug 1932	(67.8)	(74.4)	36.5
2	Jul 1932	(74.9)	(61.0)	33.6
3	Jan 2001	10.7	(49.2)	3.7
4	Apr 2009	(40.6)	(45.5)	10.2
5	Sep 1939	(21.5)	(43.8)	17.0

Source: "Momentum Crashes," Kent Daniel and Tobias J. Moskowitz; National Bureau of Economic Research; August 2014.

The combination of a low valuation and good relative price momentum indicates that other investors view the stock as a bargain too.

Momentum Has Helped During Value Drought



Source: "Index Dashboard: S&P 500 Factor-Indices," S&P Dow Jones Indices, June 2020.

Merely looking for low value and strong momentum identifies many stocks.

The list can be narrowed down by requiring other attractive traits.

VMQ Quality Grade ranks on how many of VMQ’s five quality tests a stock passes relative to all other stocks.

Quality Traits

- Lower level of accruals
- Improving asset turnover
- Buying back shares
- Dividend growth
- Positive earnings estimate revisions

Additional Restrictions

- Profitable over 12 months and last year and forecast to stay profitable
- Price at or above $4
- Exchange-listed
- Not China- or Russia-based
- Not an ADR or an ADS
- Not in financial sector or a REIT

Putting It All Together

- Value Grade of A or B (low valuation)
- Momentum Grade of A or B (strong momentum)
- Quality Grade of A or B (good quality)

Sell Rules

- Value Grade worsens to F
- Momentum Grade worsens to F
- Quality Grade worsens to F
- Company stops being profitable on a trailing 12-month basis

VMQ Stocks

Welcome to VMQ Stocks

Commentary:

An Updated Look at Value, Plus the June Monthly Review

JUNE 26, 2020

I spent time this week updating historical returns for various indexes and factors. Some of the work was for The AAII Way project I've been working on. Some of it has been for VMQ Stocks.

It's useful to stop and look at the historical data every now and then to maintain perspective. The day-to-day fluctuations and 24/7 news flow make it easy to lose sight of the forest for all of the trees. I'll start with a macro look and then dig down into the value factor.

Large-cap domestic stocks have been the stars over the past decade. The S&P 500 index realized a 13.6% return from 2010–2019, versus 12.7% for mid-cap stocks and 11.8% for small-cap stocks. Year to date, large-cap stocks continue to lead. The S&P 500 had a year-to-date return of –4.5% as of yesterday. This is far above the –15% year-to-date return for the S&P MidCap 400 index and the –14.7% return for the Russell 2000 index. (The year-to-date numbers are through yesterday's close.)

Recent Portfolio Alerts

Portfolio Additions

Company (Ticker)	Alert Date	Sector: Industry
There are no recent portfolio Additions.		

Portfolio Deletions

Company (Ticker)	Alert Date	Sector: Industry
There are no recent portfolio Deletions.		

» Click here to see historical alerts

VMQ Model Portfolio Weekly Scoreboard

Green up arrows and red down arrows show the daily change in the Value Grade, Momentum Grade or Quality Score.

Value Grade

Company (Ticker)	New Grade	Date of Change
No Value Grade changes within the last week.		

(www.VMQStocks.com)

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Recent Addition

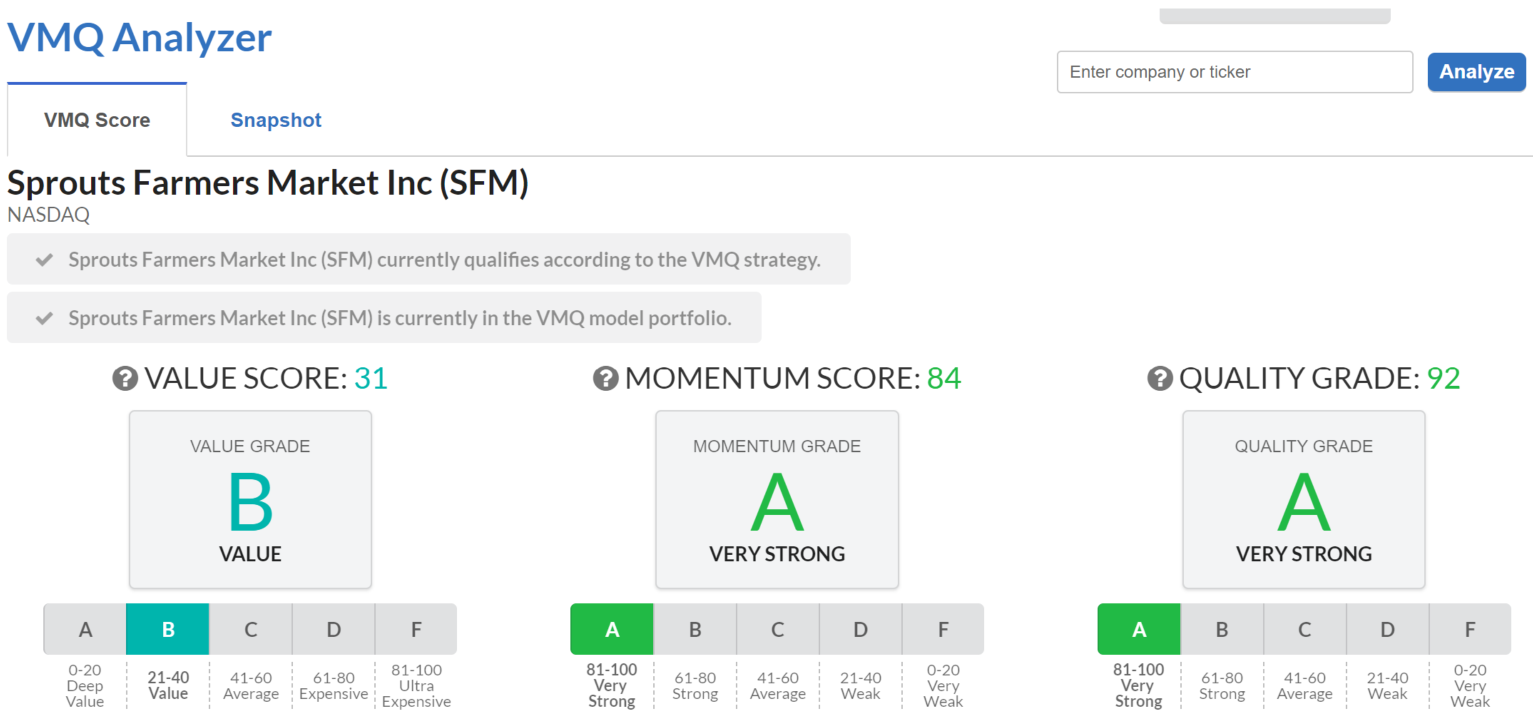
Sprouts Farmers Market, Inc. (SFM)

Addition alert issued on May 15, 2020.

Sprouts Farmers Characteristics

- Health-oriented chain of grocery stores
- Devotes higher-than-industry average 20% of store space to fresh produce
- Refining brand to focus on core target; CEO sees potential for strong sales growth
- Valuation was cheap: Value Score of 34
- Momentum Score of 91 suggested bargain hunters had taken notice of the stock
- Quality Grade was A

Current VMQ Grades and Scores



Source: VMQ Stocks, July 8, 2020.

Process for Selecting Candidates

- Go through list of VMQ Ideas to identify stocks with the best combination of a low Value Score and a high Momentum Score
- Conduct due diligence to identify any potential red flags (dual class ownership, forthcoming merger, a sizeable drop in future projected earnings, etc.)
- As much as possible, the model is trusted

A Few Final Thoughts

- To beat the market, you have to invest differently than the market; this is what VMQ is designed to
- Being truly active will lead to a portfolio that is different than the S&P 500; as such, returns will be different too
- Combining factors is a feature, but makes strategy less intuitive relative to a ”pure” strategy such as deep value

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https://tinyurl.com/VMQtrial

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Upcoming Webinars:

Register at
www.aaii.com/webinars

Wayne Thorp on Investing Like a Stock Superstar: Value Investing With a Twist
Wednesday, July 15, 2020, 7:30 p.m. CDT

John Bajkowski on AAII Shadow Stock Portfolio: From Theory to Practical Application
Wednesday, July 22, 2020, 7:30 p.m. CDT

Derek Hageman on Open House: Dividend Investing
Wednesday, July 29, 2020, 7:30 p.m. CDT

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