WHY WE PREFER QUALITY FOR THE LONG TERM

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Last week's Behind the Markets podcast featured a discussion with Paul Esposito, senior portfolio manager at Prestige Wealth Management Group and chair of their investment policy committee. Paul is responsible for global capital market research, formulating both strategic and tactical asset allocation recommendations as well as conducting fund manager due diligence. Prestige is a full-service registered investment advisor (RIA) that offers investment management, estate planning, tax planning, accounting services and financial planning. Their goal is to be a client's personal CFO to grow and preserve their wealth.

Prestige just conducted a strategic review of how they manage their investment portfolios.

Prestige's number one principle is to be a tax-conscious, long-term strategic investor. They infuse macroeconomic and tactical elements into portfolios, but they select factors optimized for long-term returns. Prestige has used factors like quality, value, momentum and size to some degree over time.

But the bigger shift Prestige recently made was to move away from traditional mutual fund portfolios.

More importantly, Esposito described Prestige as migratifng away from being a "Dimensional" shop, subscribing to the Fama-French three-factor model view of the world with factor over-weights to size and value. Dimensional Fund Advisors is predicated on the academic financial market research of Eugene Fama and Kenneth French; hence, the comparison.

Esposito sees the world as very debt-laden, with demographic declines favoring slower long-term economic growth rates around the world, particularly in Europe and Japan. The magnitude of that debt is deflationary, in his view, which pressures economic growth.

Given the long-term economic backdrop that Prestige is anticipating, the firm is embracing quality and momentum strategies as anchors to an all-weather portfolio.

The value factor has disappointed over the last 12 years. While Prestige sees some elements of value catching up to growth in the short run on the vaccine news and reopening of the economy, over the longer term, they see the pandemic accelerating strategic shifts that can lead to further growth in revenue and dividends in the quality factor space.

In particular, Prestige has favored the quality dividend growth strategies of companies that can deliver revenue and earnings growth rates above GDP growth, and they are instilling that strategically into portfolios. Esposito described new profitability tilts Dimensional Fund Advisors added to their fund portfolios as an attempt to correct for some of the value traps in small caps, but they did not go far enough, in his view, to access the quality factor exposure more directly.

Prestige has also much more aggressively moved away from traditional mutual funds, which can deliver large capital gains distributions and tax consequences for investors even in years when those funds experience negative performance or very modest gains. These capital gains were a real conundrum for Prestige, particularly in small caps, emerging markets and actively managed value funds. Esposito described these gains distributions as adding "insult to injury" in these cases and another reason his firm has shifted to quality dividend growth ETFs.

Portfolios Focused on U.S. Markets

Esposito described his firm focusing on the U.S. markets and ignoring international allocations as due to the U.S. being the best house on the block compared to other international economies like Europe or Japan, from debt levels to fiscal and monetary policies and better demographics. Prestige also thinks they get international exposure from S&P 500 companies that have almost half of their revenue coming from overseas. With retirees domiciled in the U.S. and liabilities being U.S. dollar-driven, they also do not want some of the currency risk or volatility cycles that come with foreign markets.

This was a great conversation on how one WisdomTree client has strategically changed their factor models. You can listen to the full conversation below.

Behind The Markets Podcast: Paul Esposito

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DEFINITIONS

Factor : Attributes that based on its fundamentals or share price behavior, are associated with higher return.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Momentum : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Size : Characterized by smaller companies rather than larger companies by market capitalization. This term is also related to the Size Factor, which associates smaller market-cap stocks with excess returns vs the market over time.

Mutual Funds : An investment vehicle made up of a pool of moneys collected from many investors for the purpose of investing in securities such as stocks, bonds, money market instruments and other assets.

Fama-French : Refers to a factor-based model to describe stock returns developed by Eugene Fama and Kenneth French. Their original three-factor model breaks down the components of stock returns to market risk, company size and book to market ratio, or value. .

Deflation : The opposite of inflation, characterized by falling price levels.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Value Trap : a security that appears to be inexpensive based on valuation metrics, which may accurately reflect grim business prospects and inherent risk rather than an attractive, underpriced opportunity to capture upside potential.

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.

Capital gains : Positive difference between the sale price of an asset and the original purchase price.

Active manager : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

Fiscal Policy : Government spending policies that influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending, in an effort to control the economy.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Currency risk : the risk that an investment will decline in value due to a change in foreign exchange rates.

Volatility : A measure of the dispersion of actual returns around a particular average level. .