Darwin, or Newton?

Third Quarter Review and Outlook

Morgan Housel of the Collaborative Fund wrote a perspective earlier this month associating market behavior with two categories of the laws of nature: those of Newton, and those of Darwin[1]. The paper goes on associate different areas of market behavior with these two sets of laws.

Value investing is one market phenomenon Housel did not touch on, but it fits into the structure just as well. The method essentially attempts to determine the economic rewards an investment can deliver, relate that worth to the current price, and invest where there is an imbalance. The work of Eugene Fama and Ken French many years ago showed how investing in these imbalances, traditionally measured by earnings or book value, generates a 'value premium'. These are the Newtonian laws of value investing.

Since 2016, or if you want to ignore the brief respite between 2014 and 2016, since 2006, the value premium has been absent. A narrow range of growth stocks have led the market, leaving everything behind. After a several years of these trends, we end up with a gap between expensive and cheap stocks, the likes of which we have seen only a few times in financial history.

There is a Darwinian aspect to this as well. The measures that best forecast the worth of a company have evolved over time. Book value, and even earnings are measures built around companies of the past, dare I even say of Benjamin Graham's time. Today, R&D, SG&A, and other intangibles typically expensed immediately provide better insight. Over the last several years, these measures have helped rediscover the value premium

Additionally, the work of Fama and French has not been lost on the investment industry. Some of the largest 'smart-beta' products in existence are value style products. Such products have found limited success in providing returns. They hoped to deliver Newton, they ran into Darwin.

The important question is how each of these sets of rules will be relevant going forward.

While Darwin's laws have permanently altered the nature of value investing, that evolution does not completely explain that massive disparity between expensive and cheap. Unless civilization is about to collapse, Newton's laws can only be ignored for so long. At some point the valuation gap will close and traditional Fama and French value measures will provide strong performance for investors.

The timing is uncertain. In a recent article, Yin Luo of Wolfe Research[2] listed the following reasons why there might be a rebound in value performance:

1. A vaccine
2. Another stimulus package
3. Further Fed support
4. Resolution of the election
5. Improved sell-side analyst sentiment
6. Economic recovery in China
7. Book-to-market gets too cheap
8. Capitulation in value investing
9. Long-term treasury yields rise

Take your pick, any one or a combination of these events could release the Newtonian forces and trigger a value rally. Once that happens though, Darwin will take over. Between the change in the measures of value, and the plethora of value strategies available to investors, the value premium finds itself obsolete and arbitraged away.

Why do we care?

Vitruvian Capital is not a value investor. Our investment processes are driven by the flow of information, not valuation.

Why do we care about value? Because all our signals are pointing in the direction of this value reversal.

[1] Housel, Morgan, "Accountable to Darwin vs. Accountable to Newton", https://www.collaborativefund.com/blog/darwin-newton/

[2] Luo, Zhong, Russa, et al "The Risk of a Drastic Value Rally", 11/4/2020

We have been open about our performance this year – the US small cap equity strategy has had the toughest year since 2009. COViD's effect on volatility levels affected some of our methods of analysis such that they changed from being driven by information, to being driven by liquidity. Investors de-levered, pulling money from many positions not because of merit because they were forced to.

The de-levering is finished, but volatility levels remain. It is our view that volatility and the value performance cycle are intrinsically linked. If you look at the list above, any of those events could reduce volatility as well. We will be well-positioned to benefit.

We have been through these cycles before, small and large, not only during the history of this strategy, which harkens back through the financial crisis of 2008, but also during our own careers, ranging back through the technology bust of 2000 and the emerging market crises of the late 90s. After such drawdowns, the signals from our investment strategy identify the resulting opportunity, and once the cycle rebounds, portfolio performance returns, recovering not only the losses from the downturn, but more.

For this cycle, value is that opportunity.

Performance Review

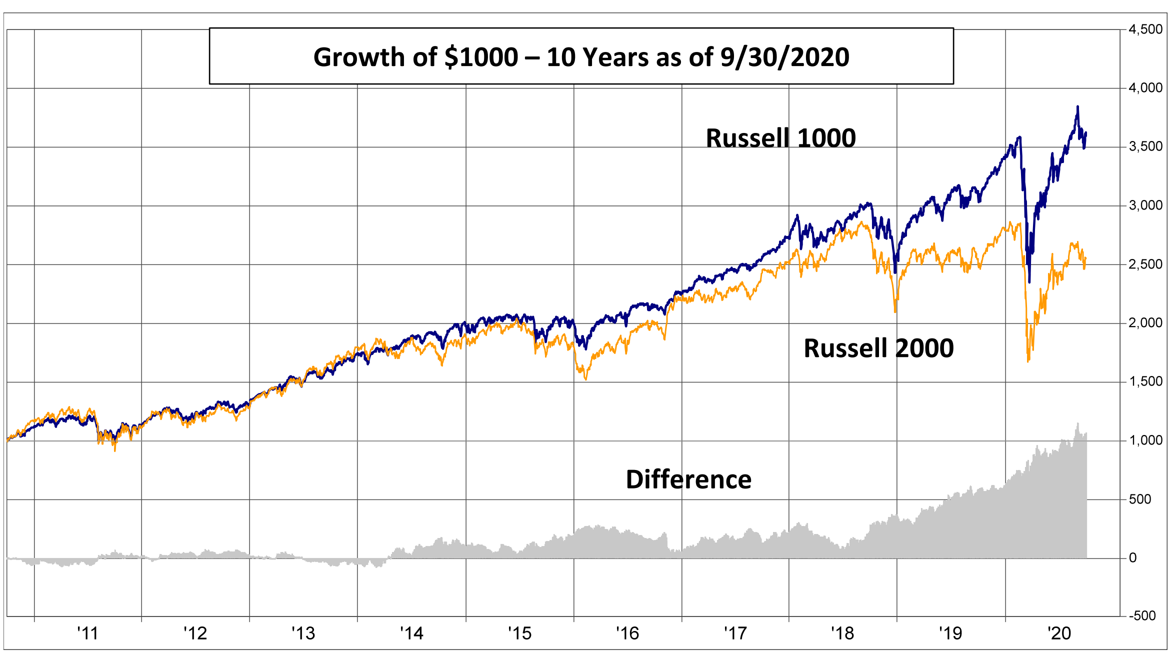
In the 2nd quarter of 2020, the Small Cap Equity Strategy returned 2.84%, underperforming the Russell 2000 return of 4.93% by 2.09%.

Not a quarter we are pleased with by any means. The volatility cycle continued to be strong, with concerns about the election and rising numbers of COViD cases in Europe and the US keeping levels of uncertainty high. 3 and 6-month VIX futures, have remained at high levels, propped up not only by changes in the outlook for the pandemic, but also by uncertainty surrounding the presidential election.

The recovery can take time – during the Global Financial Crisis, the volatility related performance cycle took more than a year to reverse. Once the reversal had completed, the portfolio went on to reverse the drawdown and outperform by nearly as much. We expect the same this cycle.

Small Cap Outlook

Related to value, small caps are positioned to outperform large caps going forward (All else being equal, cheap stocks tend to have smaller market capitalization). One simple chart should be enough to make this point.



Product Launch – International Small Cap

The pandemic provided us with the opportunity to launch a new product: the Vitruvian International Small Cap Equity Strategy. This strategy uses the same methods as our Small Cap Equity strategy, applied to non-US developed markets.

The strategy was born over 3 years ago when the team was at HighMark Capital. We launched a model portfolio in January of 2017 and ran it until the team departed the firm in 2018. In 2019, we resumed our research in the area, filled in our performance between HighMark and now, and seeded the strategy in July of this year.

We present a 3 ½ year and various portfolio data on the last page of this note. This is a theoretical record that consists of three parts: 1. Our model portfolio that we ran at HighMark, 2) A backtested portfolio, start at the end of that portfolio through July of this year, using the same investment process, and 3) Our live portfolio from July 17, 2020 onward

Top 10 Stock Positions	Weight	Country
Charter Hall Group	2.58%	Great Britain
Sankyo Corp.	2.32%	Japan
Benefit One Inc.	2.23%	Japan
Colowide Inc.	2.01%	Japan
Strike Company	1.73%	Japan
Ebara	1.56%	Japan
Nippon Gas	1.50%	Japan
Resorttrust	1.35%	Japan
Burford Capital	1.29%	Great Britain
Sanwa Holdings	1.27%	Japan

Market Cap Ranges	Intl Small Equity	MSCI EAFE Small Cap
Market Cap (Average $m)	1,858	2,093
Market Cap (Median $m)	1,315	632

Top 3 Countries	Intl Small Cap	MSCI EAFE Small
Japan	35.25%	30.93%
United Kingdom	12.45%	16.14%
Australia	7.62%	8.47%

* This theoretical track record is the aggregation of actual, model and backtested performance. Please see the bar chart in the lower right, and the performance notes in the appendix