The Case for Core Portfolios

Four Reasons to Consider "Core" Portfolios rather than "Growth" and/or "Value"

Growth and value investing are two sides of the same coin as, over time, when one style is in favor, it is generally to the detriment of the other. Therefore, getting the most return out of either style is dependent on the impossible task of timing the market. Leaving "the party" too early or staying too late both have material consequences to overall performance. Market uncertainty and risks are constantly changing in ways that are difficult to forecast. Beyond the challenge of market timing, we believe, over the long-term, there are four key reasons to invest in a core portfolio rather than growth and/or value, regardless of which side of the coin is currently in favor.

We believe Core Portfolios:

1. Minimize Style Risk
2. Minimize Behavioral Risk
3. Minimize Factor Risk
4. Maximize Company-Specific Value Creation

1) Core Portfolios Minimize Style Risk

Self-described growth investors argue that in order to outperform the market, one must invest in companies that grow faster than the market. Value investors argue that in order to outperform the market, one must invest in companies that are cheaper than the market. Who is right? Both claim to offer evidence that their version of investing is the better choice, and indeed, both can prove their argument by usually referencing a "long-term" study that shows their "style" is most effective, given a favorable time-frame.

However, the data supports that they are both correct. Over certain longer-term periods, growth outperforms value. It is also true that, over certain longer-term periods, value outperforms growth.

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Relative Performance of Large-Cap U.S. Growth vs. Value Stocks
Against U.S. 10-Year Yields

Source: Longview Economics, Macrobond, Ibbotson & Associates.

If you have been a growth investor since 2009, you think you are pretty smart. If you have been a value investor since 2009, you think the opposite. In fact, the relevance of value investing is being questioned today even by its most loyal proponents, as evidenced by the recent Wall Street Journal headline below.

> **'Our Recent Performance Sucks.'**
> **Here's Your $10 Billion Back.**
>
> A value investor who used to have a great record just called it quits. Maybe that means bargain hunting for stocks is about to make a comeback—but don't hold your breath.

Source: Zweig, Jason. "'Our Recent Performance Sucks.' Here's You $10 Billion Back." *The Wall Street Journal*, 23 Oct. 2020.

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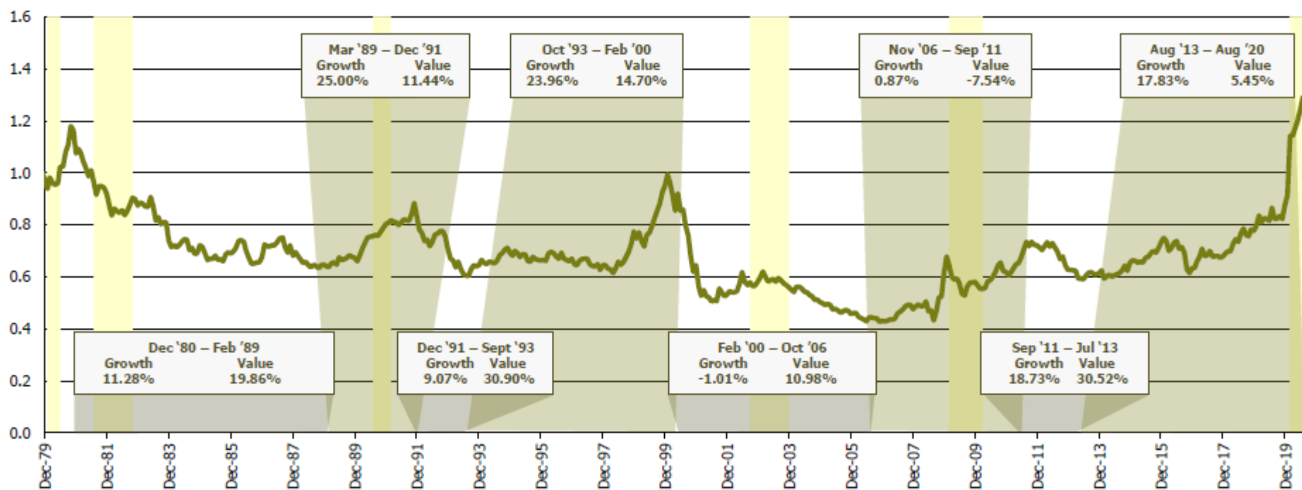
However, if you have been around a little longer than 2009 you would observe that since 1980, growth stocks delivered 11.70% while value delivered an only slightly "better" 12.14%.

U.S. Large Cap Growth vs Value (Cumulative)

Annualized Return from Peak to Trough



Annualized Return 12/31/1989 – 9/30/2020
U.S. Large Cap Growth 11.70%
U.S. Large Cap Value 12.41%

Source: RMB Research Core, Data as of 9/30/20

Mathematically, it makes sense that, over longer time periods, both growth and value portfolio styles should perform about the same, since growth portfolios are "priced for high growth" and value portfolios are "priced for low growth."

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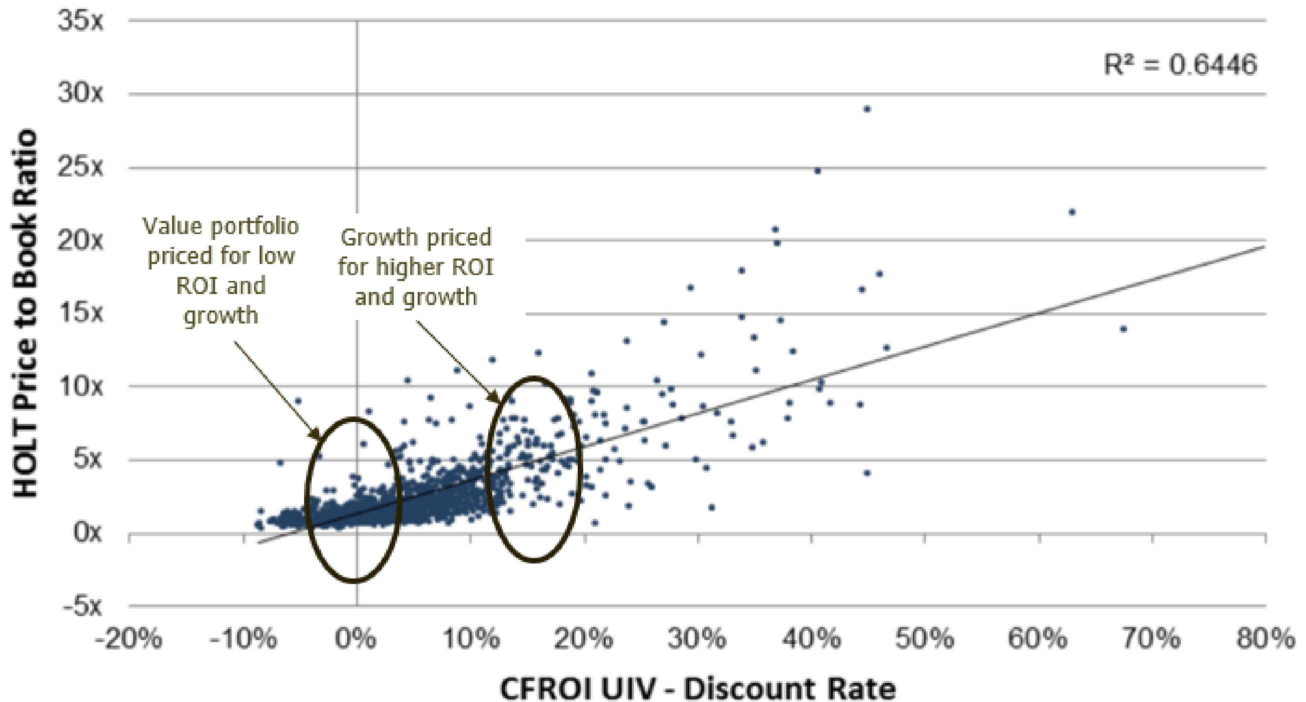
Both Ideas Can Be True



Source: Credit Suisse HOLT.

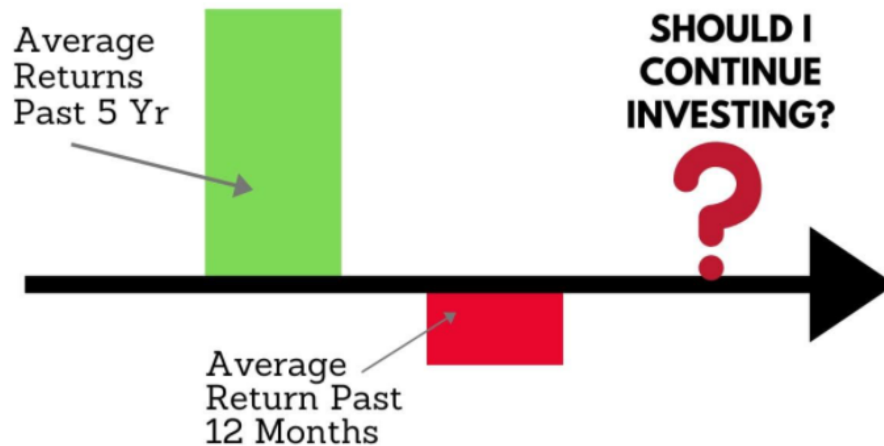
But it is impossible to predict when one outperforms the other, and there is significant risk to unfortunate market timing—as value investors are painfully aware of today.

A benefit of minimizing style risk for investors is that core portfolios deliver investors a smoother ride over time, without the "style risk" that can be extreme and very relevant to investors, based on recent performance tables.

2) Core Portfolios Minimize Behavioral Risk

As the previous charts demonstrate, performance between growth and value can be volatile, which increases behavioral risk. Many asset allocators use one-, three-, and five-year historical returns to evaluate strategy returns. The behavioral trap of a "recency bias" occurs when investors overweight newer information relative to older information.

Recency Bias



Source: tradebrains.in/recency-bias

This can result in "performance chasing" and poor timing decisions as it relates to the allocation of growth vs. value. In 1979, after a vicious bear market, Business Week fell into this trap, when it published "The Death of Equities" on the front cover, only months before a raging bull market. In 1999, Business Week did it again when it published "The Death of Small Cap Value" after small-cap value significantly underperformed large-cap growth for several years, as the NASDAQ bubble inflated. When it burst, small-cap value went on to significantly outperform large-cap growth for a long period.

Because core portfolios own both growth and value stocks, they reduce behavioral risk associated with recency bias and/or overconfidence. This minimizes investor cognitive dissonance, which reduces the likelihood of allocating into or out of a growth or value strategy at exactly the wrong time. Core portfolios address the difficult task of timing when to re-allocate as they remove the requirement to defend at least one poor performing manager every quarter.

3) Core Portfolios Minimize Factor Risk

Growth portfolios are essentially factor bets that overweight technology and healthcare and underweight financials, energy, and materials. Value portfolios tend to be factor bets that overweight financials, credit risk, energy, and materials and underweight technology and healthcare.

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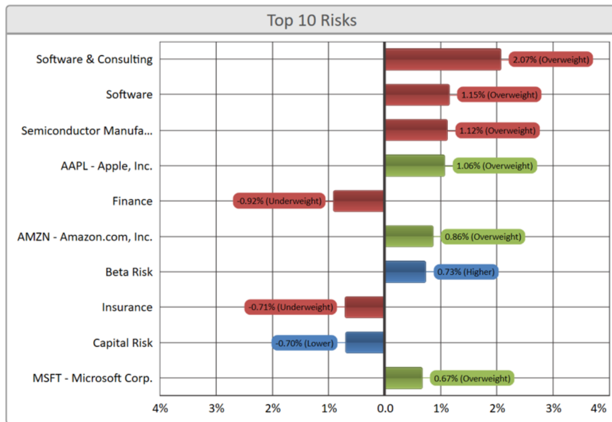
Russell 3000 Growth vs. Value – Factor Bets

Russell 3000 Growth Index vs. Russell 3000 Index



Russell 3000 Value Index vs. Russell 3000 Index

Source: RMB Research Core/Alphacuity Data date: 11/16/2020

Arguably, core portfolios provide more efficient diversification and can opportunistically rebalance, rather than waiting for asset allocation committee approvals. Timing factor performance is very difficult. Studies conducted by finance professors Antti Petajisto and K.J. Martijn Cremers[1] show that factor bettors underperform over the long term because getting the timing right is so hard. Diversified active stock pickers, which, by definition, are "core portfolios," have the best chance to consistently outperform, according to this study.

U.S. Equity Mutual Fund Performance and Characteristics, 1990-2009

Petajisto's Active/Passive Management Categories	Gross Excess Return (%)	Net Excess Return (%)	Average Active Share (%)	Average Tracking Error (%)	Average # of Stocks
Stock Pickers	2.61	1.26	97	8.5	66
Concentrated	1.64	-0.25	98	15.8	59
Factor Bets	0.06	-1.28	79	10.4	107
Moderately Active	0.82	-0.52	83	5.9	100
Closet Indexers	0.44	-0.91	59	3.5	161

Source: Antti Petajisto

The RMB Small Cap Core portfolio would fall into the Petajisto diversified active "Stock Picker" bucket above and has a twenty-year track record of performing in-line with the professors' observations.

[1] "How Active Is Your Fund Manager? A New Measure That Predicts Performance," K.J. Martijn Cremers and Antti Petajisto, The Review of Financial Studies/v22n9 2009

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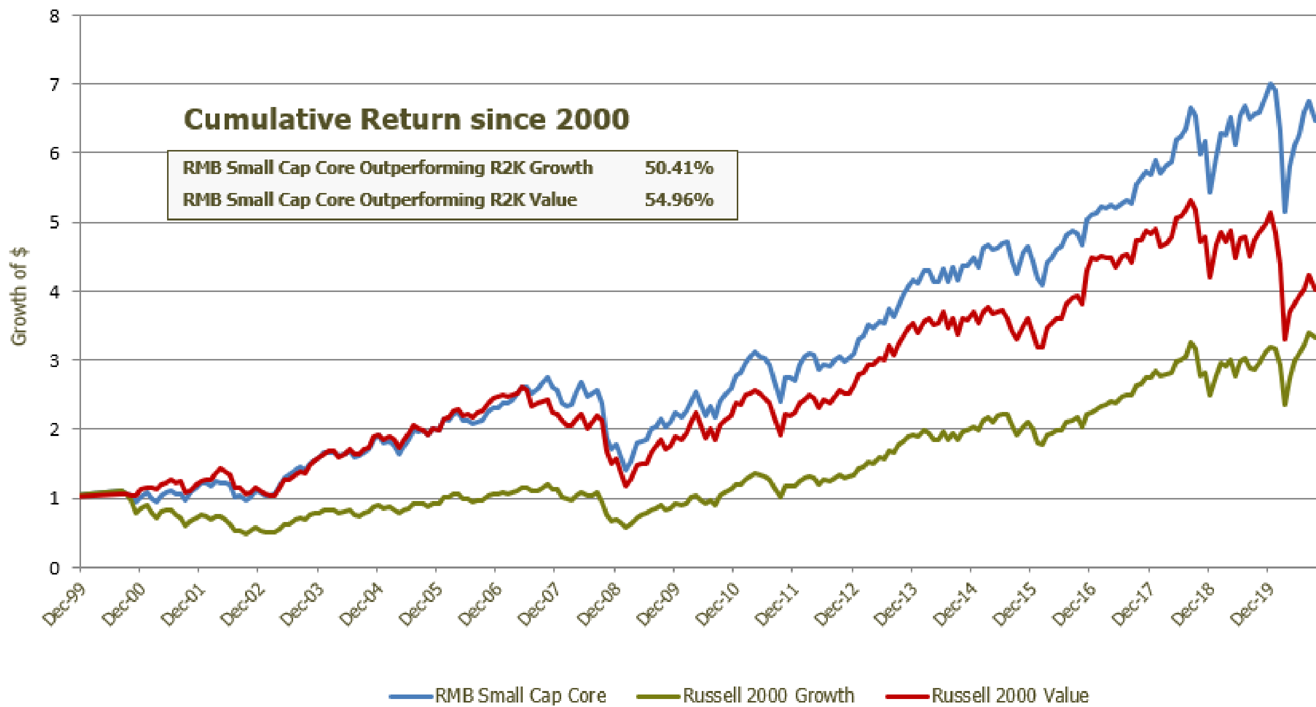

Source: RMB Research Core, Data as of 9/30/20

4) Core Portfolios Offer a Wider Opportunity Set to Maximize Company-Specific Value Creation

Growth and value companies are the opposite sides of the same coin and are connected by the corporate lifecycle, as shown below.

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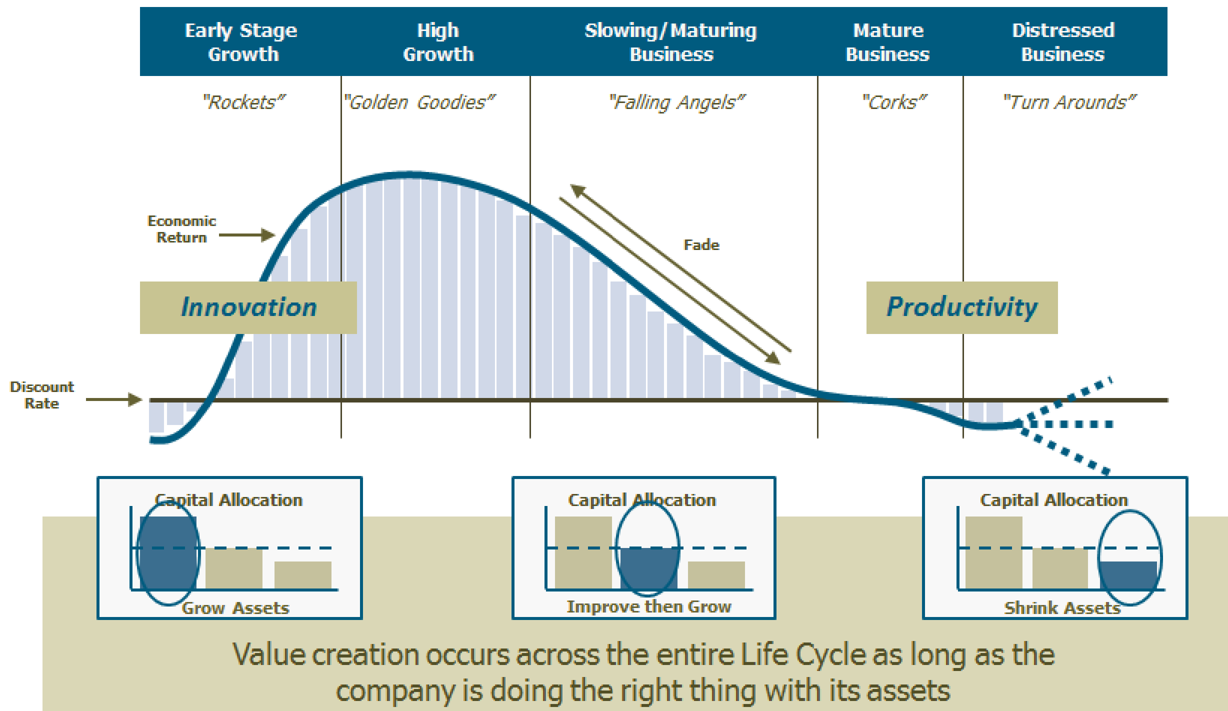
The Corporate Life Cycle



All companies go through development, growth, maturity, and decline (and sometimes, rebirth as detailed below). Growth companies are on the left side in the above illustration, and value companies are on the right. In terms of capital allocation and value creation, growth companies allocate capital to high-return projects that create value through innovation. Value companies allocate capital in a way that typically drives productivity to push economic returns higher and reduce debt. Therefore, both growth and value companies can produce great returns for investors, if they are allocating capital in a way consistent with long-term value creation. Why limit company-specific opportunities to a smaller portion of the market?

Consider that, in 1999, Apple was less than $1 billion in market cap. Today, it is about $2 trillion, as it reallocated capital away from its product lineup in PCs toward innovative new products, like the iMac, iPod, iPhone, iTunes, Apple TV, and now, streaming services. Apple was a value stock for many years until it became a growth stock in the mid-2000s. And now, some argue it is a value stock again, as many of its products are maturing. The point is that whether a stock is classified as value or growth should be irrelevant. What matters is where management allocates capital. By limiting one's universe to either growth or value, one limits their opportunity set.

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Summary

In our view, core portfolios are preferable to growth or value because they offer a smoother ride for investors, a wider opportunity set and better risk-adjusted returns. We believe the most important risk to maximize is company-specific risk, as it relates to investing in highly skilled businesses that create value for customers, partners, employees, and shareholders. By looking across a broad investment universe, one gets a more complete picture and understanding of which companies are winning or losing the competition for capital.

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