

The MarketGrader 100 Index 2017 Performance Review

January 2018

A bull market combined with rules-based selection focused on GARP yielded stellar performance

2017 was a good year for US equity markets. But MGONE hit a home run. Figures 1 & 2 below compare the performance of MGONE to the Russell Broad (Russell 3K), Large Cap (Russell 1K) and Small Cap (Russell 2K) indexes, and to the widely followed S&P 500 Index.

Figure 1. MGONE Performance – Historical Comparison to Size Benchmarks



Note: All returns are price-only and exclude dividends. Sources: Bloomberg and MarketGrader Research.

Figure 2. MGONE Performance – 2017 Comparison to Size Benchmarks

Index	Returns	Excess Return of MGONE
MGONE	26.59%	-
Russell 3K (Broad)	18.85%	7.74%
Russell 1K (Large)	19.24%	7.35%
Russell 2K (Small)	13.14%	13.45%
S&P 500	19.42%	7.17%

Note: All returns are price-only and exclude dividends. See Figure 1A in the Appendix for comparisons of the MGONE with the total returns for these indexes. Sources: Bloomberg and MarketGrader Research.

Performance of the size benchmarks reveals that in 2017 large cap stocks significantly outperformed small cap stocks. Indeed, on a price-basis the large cap Russell 1K index returned a total of 19.24% while the small cap Russell 2K index returned a total of only 13.14% (a small-large spread of -6.10% which in the long-run should be positive based on the historical premium earned by small cap companies over large caps). The S&P 500, another large cap benchmark, earned a return of

19.42%, which was almost identical to the Russell 1K. However, MGONE gained a whopping 26.59%, beating the Russell 1K by 7.35%, the Russell 2K by 13.45%, and the S&P 500 by 7.17%, respectively.

Therefore, purely from a capital appreciation perspective, MGONE outperformed the S&P 500 by more than 700 basis points in 2017. Readers familiar with MGONE's methodology know that the index follows a rigorous process of selecting GARP stocks based on MarketGrader's proprietary stock rankings built using company fundamentals. More on MGONE's methodology can be found [here](#). But even so, outperformance of this magnitude is not only significant, but very hard to achieve – especially in a bull market. This is something most active managers can attest to as they have an especially difficult time outperforming the market during a run-up such as the one that took place in 2017. To top it all, MGONE is an index – a smart-beta index, no doubt – following a transparent rules-based approach to stock selection and not an actively-managed portfolio based on subjective stock selection. Furthermore, since MGONE is not a large cap index as it picks stocks from all size segments of the US market, its outperformance was not a result of being over-weighted in the mega-cap FAANG stocks (FAANG being an acronym for Facebook, Amazon, Apple, Netflix and Google). If anything, allocations to mid-cap and small-cap stocks would have hurt performance for any portfolio in 2017. So, in terms of understanding MGONE's outperformance, it appears something else was going on in 2017. What was it?

Our astute readers who followed the stock market in 2017 would probably guess that if the excess returns of the MGONE did not come from size exposure in the portfolio index, then they probably came from the style exposure, which was also our reasoning at MarketGrader. To verify such a hypothesis, Figure 3 compares the performance of MGONE to both the size and style equity benchmarks.

Figure 3. MGONE 2017 Performance – Comparisons to Size & Style Benchmarks

Index	Returns	MGONE Excess Returns
MGONE	26.59%	-
Russell 3K (Broad)	18.85%	7.74%
R3K Value	10.49%	16.10%
R3K Growth	27.81%	-1.22%
Russell 1K (Large)	19.24%	7.35%
R1K Value	10.90%	15.69%
R1K Growth	28.36%	-1.77%
Russell 2K (Small)	13.14%	13.45%
R2K Value	5.81%	20.78%
R2K Growth	21.26%	5.33%
S&P 500	19.42%	7.17%

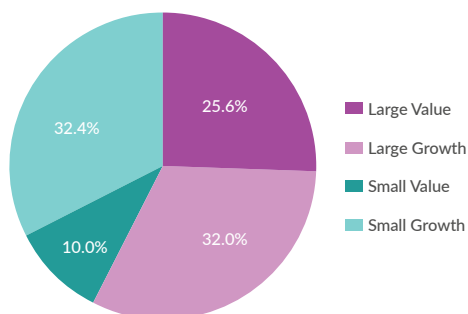
Note: All returns are price-only and exclude dividends. See Figure 1A in the Appendix for comparisons of the MGONE with the total returns for these indexes. Sources: Bloomberg and MarketGrader Research.

It goes without saying: Growth stocks hammered value stocks in 2017 as investors placed a huge premium on growth stocks, which in our view has been facilitated in recent years by the accessibility and prevalence of passive index funds. For instance, for the broad market, growth stocks outperformed value stocks by 17.32% (27.81 less 10.49). Similarly, within large cap stocks the growth premium was 17.46% (28.36 less 10.90). Within small cap stocks the growth premium was 15.45% (21.26 less 5.81). These market returns by size and style category suggest that any portfolio that was to outperform the broad market, or the core large cap benchmarks in 2017, would have to have a growth tilt since that was the segment of the market that paid a premium in the past year.

Now given the stock selection methodology of MGONE that is implemented twice a year when the index is reconstituted and rebalanced, it is clear that the index is agnostic to the style of individual stocks. In other words, it treats both the universe of value and growth stocks identically during the time the stock selection is performed for its reconstitution. Therefore, it is not a growth index per se. However, as a consequence of its rules-based selection geared towards GARP stocks, it is possible that it may have a growth tilt (or a value tilt). In essence, this depends on the earnings growth of value stocks versus growth stocks and their likelihood of being selected into the index. Readers who might want to delve into this further can click [here](#) for a copy of our research on US company earnings as a reliable source of long-term returns in US equities. It so happens that in 2017, the stock selection based on the best GARP stocks did result in MGONE having a small tilt towards growth stocks. So, the readers that had guessed that MGONE's excess returns were coming from a style tilt, in this case an overweight in growth stocks, were correct, though only partially. The reason they would have been only partially correct is because not all of the excess return can be explained by the style weights. The index actually has an excess return after controlling for size and style. This means that true to its name the smart-beta MGONE generated an excess return over and above that can be explained by its size and style exposures. Or put differently, the MGONE generated pure alpha.

The simplest way to understand and calculate alpha is to run the portfolio through a style analyzer. That is exactly what we did for MGONE's returns from 2017. Figure 4 presents MGONE's factor loadings for the size and style factors using the Russell benchmarks to represent the performance of the size and style factors.

Figure 4. MGONE: Size & Style Factor Loadings for 2017



Sources: FactSet and MarketGrader Research

The results from the style analysis reveal that for 2017 the returns of the MGONE portfolio index could be best explained by a “passive” portfolio that had an asset allocation of 25.6% in the R1K Value index, 32.0% in the R1K Growth index, 10.0% in the R2K Value index and 32.4% in the R2K Growth index, for a total allocation of 100% of the portfolio. Note that the total loading for the growth factor is 64.4% (32 + 32.4) which is only a 14.4% tilt from a style-neutral portfolio that is weighted equally across the growth and value factors.

Figure 5 presents the return attribution of MGONE using the factor loadings presented in Figure 4 and the performance of the size and style benchmarks.

Figure 5. MGONE: Size & Style Factor Attribution for 2017

Size & Style Factors	Benchmark	Benchmark Returns	MGONE	
			Factor Loadings	Implied Return Attribution to Factor
Large Value	R1K Value	10.90%	25.6%	2.79%
Large Growth	R1K Growth	28.36%	32.0%	9.08%
Small Value	R2K Value	5.81%	10.0%	0.58%
Small Growth	R2K Growth	21.26%	32.4%	6.89%
Total Attribution			100.0%	19.33%
MGONE 2017 Return				26.59%
MGONE Stock Selection Alpha				7.26%

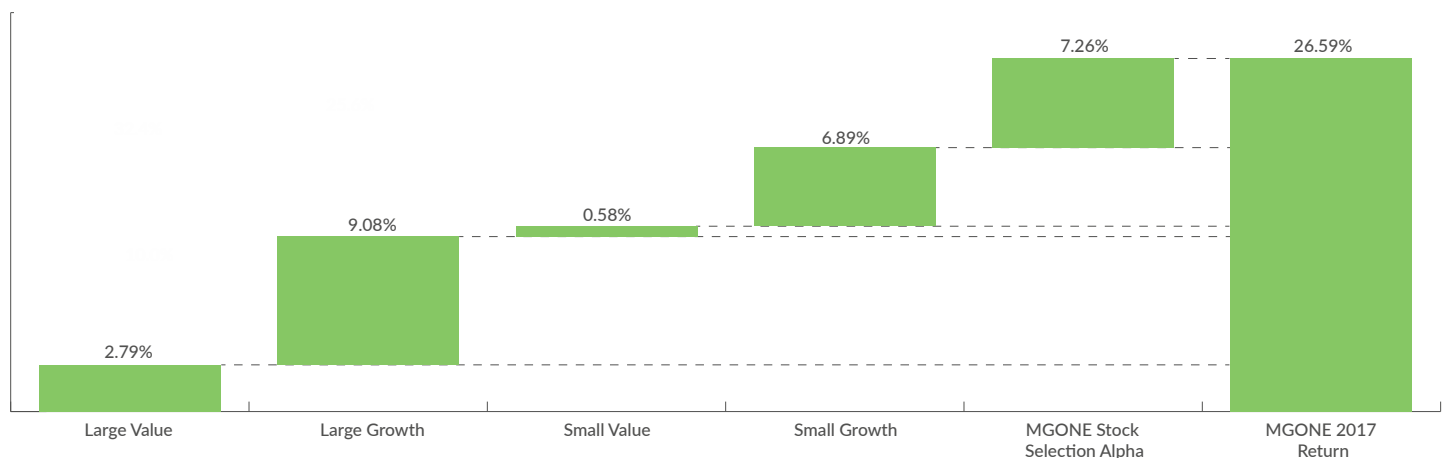
Note: All returns are price-only and exclude dividends. Sources: Bloomberg, FactSet and MarketGrader Research.

The “passive” portfolio that best mimics MGONE as represented by the factor loadings would have had a return of:

1. 2.79% from the large value allocation which is calculated as the return of the R1K Value index times the portfolio allocation to the R1K Value index (or 10.90 times 0.256);
2. 9.08% from the large growth allocation (28.36% times 0.320);
3. 0.58% from the small value allocation (5.81% times 0.100); and finally,
4. 6.89% from the small growth holding (21.26% times 0.324), for a return of 19.33%.

But the 2017 return for the MGONE was 26.59%. This means that the difference between 26.59% (the true return of MGONE) and 19.33% (the return that can be attributed to the size and style factors) is a result of stock selection and is referred to as the alpha of the portfolio. This amounts to a stellar 726 basis points of alpha due to stock selection, as can be seen in Figure 7. However, recall that MGONE is an index and does not perform active stock selection. Nonetheless, the stock selection in this case is incidental, that is, it is an outcome of implementing the rules-based methodology twice a year when the index is reconstituted and rebalanced. Clearly, MGONE’s rules-based methodology led to the creation of a portfolio index that was not only able to ride the rising market tide of 2017, but – to the envy of many passive and active portfolio managers – was also able to deliver significant alpha.

Figure 7. MGONE: 2017 Performance Attribution



Note: All returns are price-only and exclude dividends. Sources: Bloomberg, FactSet and MarketGrader Research.

Appendix

Figure 1A. MGONE Performance – 2017 Comparisons to Size & Style Benchmarks

Index	Returns	MGONE Excess Returns
MGONE	26.59%	-
Russell 3K (Broad)	21.13%	5.46%
R3K Value	13.18%	13.41%
R3K Growth	29.59%	-3.00%
Russell 1K (Large)	21.69%	4.90%
R1K Value	13.66%	12.93%
R1K Growth	30.21%	-3.62%
Russell 2K (Small)	14.65%	11.94%
R2K Value	7.84%	18.75%
R2K Growth	22.17%	4.42%
S&P 500	21.83%	4.76%

Note: "Returns" are on a price-basis for the MGONE and total-basis for the other benchmarks. Source: Bloomberg and MarketGrader Research.

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