

Epoch Systematic Strategies: Our Statement of Beliefs



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Our Objective

We aim to deliver strong risk-adjusted outcomes for our clients through our ability to generate and implement differentiated investment insights. We believe that our investment philosophy, which emphasizes free cash flow and careful analysis of a firm's historical and future capital allocation decisions, gives us our differentiated view. Our investment process applies our investment insights in a systematic and data-driven manner.

Sources of Mispricing

Our investment approach delivers alpha by exploiting three sources of market inefficiency: biases which affect investor behavior, structural limits to arbitrage, and information asymmetries.

Behavioral Biases

Behavioral biases can cause investors to over- or under-react to information in predictable and exploitable ways. We believe that market inefficiencies that arise from behavioral biases are the most likely to be sustainable over time since human behavior is difficult to change.

For example, we believe investors over-emphasize reported earnings, especially near-term earnings, at the expense of free cash flows. As a result, they may underestimate a firm's ability to consistently and sustainably generate free cash flow, causing the company's stock to trade at attractive free cash flow yields. While more investors today subscribe to our belief in the primacy of free cash flows, we believe many still do not. Moreover, accurately measuring and forecasting free cash flow requires care and expertise. E.g., we use industry-specific definitions of free cash flow for banks, insurance companies and REITs in order to more accurately reflect nuances in their financial reporting conventions and business models. We also implement accounting adjustments such as the amortization of R&D expense to address distortions introduced by GAAP and IFRS accounting. More importantly, the focus of our research is understanding the sources of competitive advantage which allow a firm to generate durable and growing free cash flow, and what may be underestimated or misunderstood in consensus estimates of free cash flow.

Similarly, investors tend to be skeptical about the ability of profitable firms to maintain and even improve their operating performance in the future. While it may be reasonable to expect high margins for a firm to revert to the industry mean, this reasoning does not apply to firms with sustainable competitive advantages, particularly those with advantages which are less tangible and difficult to measure. We seek to understand these nuances. We look for firms with high and sustainable profitability levels, strong balance sheets to provide financial flexibility, and thoughtful capital allocation policies which allow the firms to generate shareholder value in the future.

Structural Limits to Arbitrage

A stock can also be mis-priced because it is costly or difficult for informed market participants to implement their views of the stock. E.g., the cost of gathering the data necessary to arrive at an informed view of a company may exceed the potential profits from implementing the view. Even if this were not the case, informed investors can be prevented from shorting an over-priced security if it costs too much to short and/or they cannot find enough shares of the security to borrow. In some cases, the degree of mispricing could be so large and last for so long that an informed investor runs out of capital before he or she can eliminate the mispricing. These barriers are referred to as structural limits to arbitrage.

As active investors, we can add value by avoiding stocks which are over-valued relative to their fundamental characteristics. Since limits to arbitrage can artificially prop up these over-valued stocks for months or even years, we believe it is important to maintain a long investment horizon. We can go one step further by carefully examining the actions of investors in the markets for listed stocks, stock lending, options, and ETFs or funds. We believe we can derive profitable and persistent alpha signals by parsing the intentions of investors in these markets—whether they are informed or otherwise.

Information Asymmetry

A third source of mispricing stems from differences between insider vs. outsider knowledge of a company. Company insiders such as C-suite executives always know more about a company's true operating and financial condition than outsiders such as minority shareholders. The **information asymmetry** caused by this gap in knowledge can be an exploitable source of inefficiency.

For example, we prefer companies which fund their investments out of retained earnings, rather than equity issuance, not only because it demonstrates the ability of the business to sustain its growth through cash flows, but also because it reveals management's view of the value of the firm's stock. Stock issuance is costly and more likely to be chosen as a source of funding when company insiders believe that the stock price of the firm is high relative to their internal estimate of the value of the firm.

In the presence of information asymmetry, poor incentives can exacerbate the perennial principal-agent issues between company managers ("agents") and minority shareholders ("principals"). We emphasize earnings quality in our research and stock selection model because it allows us to avoid firms with managers who are driven to manipulate earnings in order to meet short-term earnings targets. These managers may also be incentivized to make decisions which are potentially harmful to a firm in the long-term such as delaying necessary investments.

To summarize, we believe our investment philosophy is theoretically sound and exploits multiple sources of inefficiency. This does not necessarily mean that it is used widely and applied consistently by other market participants. In fact, investors appear to be shortening their investment horizons and continue to be excessively focused on short-term financial results.

Our Alpha Opportunity Depends on Market Efficiency

Our research tells us that our investment approach delivers alpha over time. However, the size of our alpha opportunity depends on the relative efficiency of the markets in which we operate. We believe that financial markets—and equity markets, in particular—are efficient but not perfectly so.

At any point in time, the relative efficiency of a given market depends on its information environment as well as its breath, depth, and structure. The following conditions increase the efficiency of a market:

Information Environment	<ul style="list-style-type: none"> • More extensive reporting standards increase the amount of investment-relevant information available to investors and increases market efficiency. • Higher reporting frequency increases the quantity and flow of investment-relevant information and increases market efficiency. • Smaller discrepancies between the actual operating and financial condition of a firm and the information it is required to report under prevailing accounting standards increases the quality of information provided to investors and thus market efficiency.
Market Breadth and Depth	<ul style="list-style-type: none"> • Broad markets with hundreds or thousands of securities are typically much more efficient than narrow markets with few investable securities. The latter group are more likely to experience persistent distortions and mispricing due to a lack of investable options for local investors. • Deep financials markets provide ample liquidity and enable informed investors to quickly eliminate or reduce dislocations in security prices.
Market Structure	<ul style="list-style-type: none"> • Markets dominated by informed investors such as professional active managers are more likely to be efficient. • Similarly, markets with broad and deep sell-side broker coverage are more likely to be efficient. • Smaller lot sizes allow arbitrageurs to reduce or eliminate small price distortions. • Lower transaction costs allow more frequent and active trading, which can encourage speculation but also informed trading to reduce mispricing and increase market efficiency. • Lower short sale constraints and borrow costs allow arbitrageurs to drive over-priced securities back to fair value and increase market efficiency.

The absence of these conditions in turn reduces the efficiency of a market. By these measures, we consider U.S. large cap equities a more efficient asset class, and Emerging Markets equities and small cap stocks less efficient asset classes. While our conclusions are unsurprising, our framework allows us to objectively assess the efficiency of asset classes over time. E.g., as financial markets in Emerging Markets countries evolve, we should expect them to become more efficient.

However, even the most efficient markets occasionally exhibit unusual market behavior, most famously during the technology bubble of the late 1990s. It appears that investors are not rational at times. As active managers, we aim to benefit from these temporary market dislocations. E.g., a wave of indiscriminate selling by market participants may produce a temporary opportunity for us to increase our position in a portfolio stock which has been unfairly penalized.

Overall, we have a balanced view about market efficiency. We do not believe markets are easy to beat nor do we believe they are completely inefficient. They are competitive and dynamic. As Professor Andrew Lo describes in his Adaptive Markets Hypothesis (AMH): “Financial market dynamics are driven by

our interactions as we behave, learn, and adapt to each other, and to the social, cultural, political, economic, and natural environments in which we live.”¹ Similar to other competitive fields such as professional sports, investment success depends on advantages which can erode over time as participants quickly adopt superior methods and adapt to the actions of others.

Active Managers Must Constantly Innovate and Adapt

A key development in equity markets in the past three decades is the popularization of factor investing. Factor investing can be considered a way to systematically capture one or more of the sources of mispricing described above.²

Our stock selection model, the Epoch Core Model, is a factor model, but it differs from traditional quantitative models, such as the Fama-French-Carhart model in important ways. When we constructed our Model, we went to great lengths to ensure that it represents our investment philosophy as well as reality. We started by clearly stating our core beliefs and ways to capture our beliefs, validated our assumptions with data, and made extensive adjustments to our Model inputs to reduce accounting distortions. We also made sure that the model is balanced and reflects key concepts that we care about philosophically.

Successful investing is a craft requiring judgement and experience, but also constant innovation and adaptability. As such, our research efforts are aimed at:

- Uncovering new alpha signals;
- Creating better versions of current signals;
- Curating and incorporating a more accurate set of investment-relevant information;
- Combining information in more sophisticated ways;
- Speeding up information gathering and processing; and
- Delivering insights faster and in more impactful ways.

1. Lo, Andrew W., *Adaptive Markets: Financial Evolution at the Speed of Thought*, Princeton University Press, 2017, p. 188.

2. *There has been much debate amongst academic researchers about whether the excess returns historically associated with these factors are the result of persistent mispricing or simply compensation for bearing risk. We find these debates to be incomplete. Some factors commonly used in quantitative alpha models may indeed be associated with higher risk, but not all of them are. The behavior of market participants, e.g., crowding into a popular factor or using the same risk model, can itself change the risk profile of a factor or set of factors. The profitability of a strategy may also vary over time as it is exploited more intensively or less.*

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