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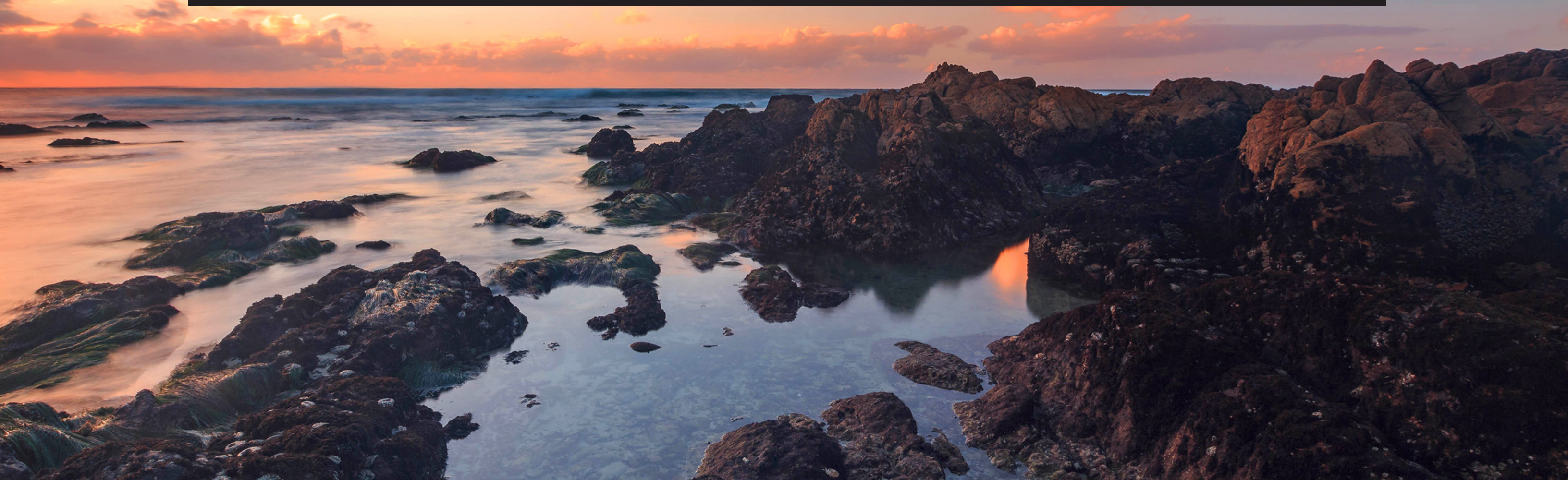


SOMETHING OLD, SOMETHING NEW…

In the 1980s, as a young venture investment banker, I flew around the country in search of the next breakthrough innovation. Driving the freeways of Los Angeles to visit a company creating a unique kind of supercomputer, I noticed something new – a few cars had a brake light in the center of the rear window. An after-market manufacturer sold them, based on research that suggested it improved safety. That research must have been convincing, because the center brake light became mandatory within a couple of years.

Driving my rental car to a firm attempting to use monoclonal antibodies to cure cancer, I perceived something new – a cup holder. I had been spilling coffee while driving for years, and here was a solution. Later, on my way to visit a company with an advanced software application, schlepping my suit bag on my shoulder in the airport, I observed another novelty – a flight attendant wheeling her suitcase with a handle. Now everyone has roller bags and no sore shoulders.

In other words, while I traveled hither and yon searching for advanced semiconductors, gene-splicing and faster, more powerful algorithms, I was discounting, barely noticing, real innovation. While I struggled to understand business plans through a haze of half-remembered physics and biology classes, the simplest things were improving my everyday life.

SOMETHING NEW

In finance, it similarly is easy to assume improvements must be complex and sophisticated, beyond the ken of ordinary investors. If it really is good, it should be complicated, hard to understand and expensive, right? At least, that is what hedge fund managers, charging two percent of assets and 20 percent of profits, would like you to believe.

When Vanguard introduced the first retail index fund in the mid-1970s, many scoffed, and few realized the import of the concept. How could something so simple and basic as buying the whole market, at a very low cost, beat market wizards?

It took decades, but indexing is now a dominant force in the investing world. Jack Bogle's recent death generated many tributes to his popularization of the concept, a fitting coda to this hugely beneficial innovation.

Index investing, though, is not the end of financial history, any more than the cup holder was the end of innovation in beverage consumption.

One of many recurring flaws of human nature is the assumption that history does not continue to march forward, that *now* we know everything worth knowing.

Index investing has been hugely constructive, bringing cheap, transparent, diversified, liquid investing to millions, but those principles do not explain the coinciding increased popularity of expensive, opaque, concentrated, illiquid hedge fund investing.

History never ends, just the most recent chapter in the ongoing story.

The past decade has seen the introduction of new investment vehicles variously referred to as factor investments, smart beta or strategic beta.

> "What starts out here as a mass movement ends up as a racket, a cult, or a corporation."
> - Eric Hoffer, *The Temper of Our Time*

Like indexing, factor investing relies upon a very simple concept: buy diversified portfolios that emphasize an attribute, such as value or price momentum that, academic research suggests have been associated with higher returns than the relevant index. Quantitative rules select securities rather than active discretion by a manager. Accordingly, factor investments tend to have much lower costs than actively managed investments.

Simple factor investments were, but immediately accepted they were not.

Indexing acolytes attacked proponents of factor investing as varying from what they viewed as the only correct investment approach, the final step of investment innovation. Active investment managers, seeing customers melt away into index funds, have reason to fear that factor-based investments represent yet another existential threat. Their line of defense against the indexers was that they skillfully depart from the index to invest in value, blue chip or growth investments.

Replicating value, quality or momentum investing at a fraction of the price, factor investing makes active managers look like mere closet indexers at a much higher price.

The very real benefits of broad diversification and low costs wrought by the rise of indexing should not blind us to any alternatives to capitalization-weighted index investing. Substantial research across many market cycles and across many assets verify the benefits of tilting investments towards the factors of value, quality and price momentum. Like indexing, factor portfolios can be diversified and very low cost. The research has been convincing enough that factor investments make up the heart of the equity portfolios for most of our clients. We believe this is one innovation worth pursuing.

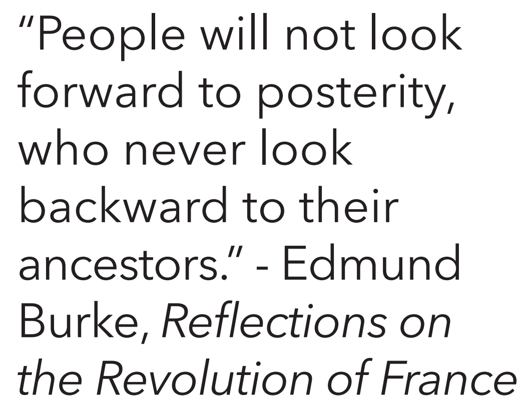
SOMETHING OLD

When we refer to factor investing as new or innovative, we are talking about the burgeoning number of efficient ways to invest in the factors, not necessarily the underlying concepts. In 1968, George Goodman, under the pseudonym Adam Smith, wrote *The Money Game*, which I believe is one of the best investment books ever. Goodman indicates that a test of good stock investment ideas is that they are always greeted with one of two words of skepticism: “Here?” or “That?” “Here” meant that the skeptic believed it was a good company, but the stock had already run up. “That?” meant it was an undesirable company whose day had passed.

Goodman perceptively points out that for any good investment idea, such skepticism is necessary, because the absence of skepticism means the stock price already fully discounts the validity of the idea.

Using Goodman’s words, “That?” is just value investing, while “Here?” is just momentum investing. Ideally, an investment approach will have both an economic and behavioral rationale. For example, in addition to Goodman’s “That?”, value also can be a euphemism for “never heard of it” or “yuck,” Value companies are riskier than average due, for example, to being in a troubled industry or having an over-leveraged balance sheet – say, a heavily indebted copper plating manufacturer in Indiana. Therefore, they have a higher cost of capital. As investors, we are providers of capital and therefore receive that higher benefit as an economic reward for bearing the risk. This is the economic rationale for value investing.

The behavioral rationale for value investing also is simple. If you are at a cocktail party and talk in whispered tones about a small biotech firm about to get unanticipated FDA approval for a cancer treatment, you will be very popular.



Accordingly, there are non-economic reasons to invest in that biotech company. If you speak in hushed tones about the Indiana copper plating company, the next words you likely will hear will be “excuse me, I need to freshen my drink.” On an emotional level, people do not tend to care about mundane companies, no matter how low their stock price.

With any investment approach, one major question is whether there is a reason the strategy should continue working in the future if people know about it now. We believe this is a huge advantage of factor investing. As *The Money Game* points out, factor concepts have been known at least for the half-century since its publication.

Why should factor investing work when everyone knows about it, and has known about it for many decades?

The answer is that investors are human. Factor investing might be simple, but it is hard. Nobody will *ever* care about that copper plating company. Value, momentum, or any other factor will underperform periodically, sometimes for many years, certainly for longer than the attention span or pain threshold of most investors. As one of the programmers at those software companies I used to visit might say, this sounds like a bug, but it is a feature.

Human nature does not change much over time. Since valid investment factors have a behavioral rationale, there is a reason to believe they can last. We were given the Ten Commandments millennia ago, and most of us still struggle to comply.

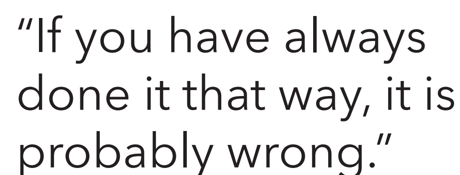
The difficulty of enduring through periods of factor underperformance may increase their validity and longevity.

While the plethora of new factor investing instruments is new, the idea was longstanding even when Goodman described it a half century ago in *The Money Game*. So, the something new is also something old. The center brake light was not the invention of the incandescent bulb, just the superior placement of one. The avant-garde technology behind the cup holder was … the hole. The groundbreaking miracle of the roller bag was … the wheel. "Modern" factor investing is the efficient repackaging (and rebranding) of concepts that have been present in investing for a very long time. That history allows us to evaluate and measure the factor effects over long periods and many market cycles, helping us to prepare mentally for underperformance and giving us confidence that unlike, say, an active manager's hot hand, the underlying dynamics are likely to continue in the future.

SOMETHING BORROWED, SOMETHING BLUE

Investors and market commentators sometimes fear innovation, and not without reason. Widespread adoption of "portfolio insurance" (use of futures and options to hedge market declines) contributed to the market crash in 1987. New forms of mortgage loans sliced, diced and combined into new kinds of securities were a catalyst for the global financial crisis a decade ago. Financial market innovations often are just by products created to increase fees or commissions. Repelled by the previous debacles and expensive product creation by Wall Street, a growing contingent of the investment community has adopted capitalization-weighted index funds as the only way to invest.

Accordingly, many have been understandably skeptical of the recent prolific creation of investment vehicles emphasizing factor investing. If something works in the financial market (and success likely will be measured by generating fees rather investor success), others will "borrow" the concept and create new products that can be marketed under the same conceptual banner.



Many good ideas have been commoditized and overdone by Wall Street. The factor concept, by its very success, likely will be no exception. Some products sold as factor investments even now lack economic and/or behavioral rationale. Supposed factors discovered only by data mining are less likely to generate superior returns in the future. For example, "thoracic surgery instrument manufacturers with an 'R' in the name" may have had stupendous returns in the past, but a portfolio made up of such stocks lacks any theoretical foundation that would lead us to expect continued success. Chasing after spurious investment correlations found in back-tested data likely will give investors something to be blue about.

CONCLUSION

It is an unfortunate fact that much of the difficulty in successful investing is a matter of investor behavior. As in dieting, it is not a knowledge problem, but a discipline issue. Many things that come easy to all of us are the result of flawed psychology and cognitive biases.

Because investment success is hard, we like to believe that it is necessarily complex, that some secret formula or an elusive genius picking stocks is the path to triumph.

In reaction, others may conclude that capitalization-weighted indexing is the exclusive route to achieving financial goals. This is especially easy to believe now, after a decade in which the U.S. stock market has quadrupled, since many investors think of indexing as exclusively involving the S&P 500.

We believe that factor investing offers a middle path between opaque, expensive and needlessly expensive actively managed investments and relying solely on cap-weighted index investing.

Good factor-based investing is diversified and inexpensive.

It is based upon venerable concepts that have stood the test of time. The ability to observe that history can give investors, and their advisors, the intestinal fortitude to stick with this rational approach over the long term, despite the inevitable periods of under-performance. Like the center brake light, the cupholder and rolling luggage, it is simply the application of long-existing concepts into something new and valuable.

Bill Berg, CFA, CFP®
Senior Vice President,
Senior Portfolio Manager

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