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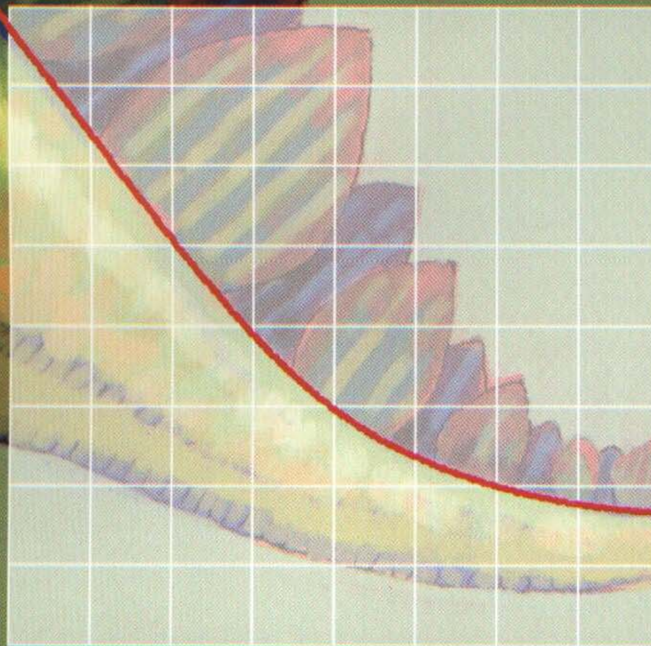

Analyst AGENDA

PROFESSIONAL PRACTICE

Fed Up

Can following the Fed help pick winners?

BY NANCY OPIELA

KEY POINTS

- The correlation between U.S. monetary policy and stock market returns is well established.
- One analyst believes a model linking large-cap and small-cap performance to availability of credit can help investors pick winners.
- Some observers fear that current interest rate levels could affect small-cap stocks negatively.

"Omit needless words." That was the advice William Strunk handed down in a Cornell University English class to his student E.B. White. Sometimes, Strunk would grab a student by the collar and repeat the phrase multiple times. That made an impression on White, who passed the advice to future generations of writers in the introduction to *The Elements of Style*, the classic composition handbook he authored with Strunk.

If Douglas Roberts were to teach a course in money management for the average investor, his mantra would be "Omit market noise." Roberts, a former Wall Street analyst and small-capitalization value manager, who is now managing principal of Channel Capital Research in Shrewsbury, New Jersey, has pared all the equity research and market predictions down to three simple words: Follow the Fed.

That's a twist, of course, on Martin Zweig's decades-old adage "Don't fight the Fed," which advises investors to prepare to sell stocks and equity mutual funds when the U.S. Federal Reserve Board raises interest rates and, conversely, to get ready to scoop up equity bargains when the Fed lowers rates. Roberts' adjusted adage, however, anchors an investment model that links the performance of large-cap and small-cap stocks to the availability of credit.

Ibbotson Associates, data clearly show that small-cap stocks beat large-caps in the long run; from 1928 to 2005, small-caps returned 12.70 percent a year compared with the 10.03 percent return of large-caps. But what struck Roberts is that the outperformance occurred in small clusters, thus making proper timing critical to receiving the enhanced returns. For example, Jeremy Siegel's research shows that small-caps averaged a 35.3 percent compounded return in the 1975–83 period, which was more than double the 15.7 percent return posted by large-caps. Without that small-cap boom, large-caps just edged small-caps—9.84 percent versus 9.49 percent.

Analyzing the balance and timing of these trends relative to interest rate moves by the Fed, Roberts found a link between the performance of small-cap and large cap stocks and the ease of obtaining credit. Accordingly, he developed his "Follow the Fed Standard Strategy," which directs investors into small-cap or large-cap stocks based on real (inflation-adjusted) short-term interest rates.

"If the Fed's short-term rates fall below the rate of inflation, small-caps prosper from the easy credit. When the Fed's short-term rates are above inflation, the playing field advantage goes to large-caps, which have access to the capital market and can raise billions regardless of credit conditions," explains Roberts.

> "For years, I figured the model was too simple and tried to poke holes in the theory."
>
> **DOUGLAS ROBERTS**
> Channel Capital Research

He says his research was corroborated by his own experience as a small-business owner. From 1985 to 1992, Roberts was the chief operating officer of the Flori Roberts/Dermablend Group, a family-owned pharmaceutical/cosmetic group of companies that was acquired in 1992 for US$22 million in cash and stock by IVAX Corporation (IVAX was later bought out by Teva Pharmaceutical in January 2006). About this experience, he observes, "Not just for our company, but for a lot of our customers, if money wasn't readily available, it was difficult to grow and prosper. Throughout history, the major banks have set the tone."

Testing data going back to 1928, Roberts found that his system would have resulted in US$10,000 growing to US$128.1 million by 2005, more than the US$111.9 million it would have reached if it had been invested only in small-cap stocks throughout the period and US$17.3 million more than large-cap stocks would have produced. Moreover, in addition to handily outperforming the S&P 500 Index, Roberts' strategy would have resulted in fewer than one or two trades every few years. The real bonus to such low turnover, he says, is that investors don't have to spend their free time managing their money.

Insisting individual investors should think like institutional investors —that is, in decade-long timeframes— Roberts notes that during the 1990s, when large-caps returned 18.20 percent a year, his strategy returned 18.41 percent (it also bested the 15.09 percent return for small-caps). In the 1970s, his strategy would have returned almost 6 percentage points more than small-caps returned and 11 percentage points more than large-caps returned. Roberts is quick to point out, however, that his strategy hasn't outperformed over shorter periods. From 1 January 2000 to 31 December 2005, for example,

his strategy would have returned 3.85 percent a year, decidedly short of the 12.84 percent turned in by small-caps but better than the –1.13 percent posted by large-caps.

"For years, I figured the model was too simple and tried to poke holes in the theory," he admits. "However, over the long term, by investing in the type of company that Fed policy is making credit and financing easiest to obtain, you can be in the hottest stocks in terms of total returns."

Of course, the connection between U.S. monetary policy and stock market returns is not news. In fact, "Is Fed Policy Still Relevant for Investors," a study conducted in June 2004 by researchers from CFA Institute, Northern Illinois University, the University of Richmond, and Texas Tech University, showed that during times of restrictive monetary policy, or rising interest rates, the equity markets perform poorly, resulting in lower-than-average returns and higher-than-average risk. Conversely, periods of expansive monetary policy, with falling interest rates, generally coincided with higher-than-average returns and less risk.

Specifically, analyzing 38 years of data, the researchers found that stocks averaged returns of 21.86 percent during periods of expansive monetary policy versus just 2.84 percent when Fed policy on interest rates was restrictive. And although the analysis shows that the relationship between monetary policy and returns has lessened throughout the years, the results are consistent across policy periods, with the exception of a single monetary period in the mid-1990s that coincided with the technology boom.

Interestingly, the study's authors also found that small-cap companies, as well as companies in cyclical markets, are particularly sensitive to changes in monetary policy.

Ram Kolluri, president and chief investment officer of Global Investment Management in Princeton, NJ, also invests for his clients according to how Fed policy affects stocks. "Liberal monetary policy from the Fed clearly favors small-caps," he says. "Because they are more dependent on banks for credit, small-cap companies are the first to feel the impact of a recession or a recovery."

Kolluri says that with the Fed now desperately fighting to keep its credibility as an inflation fighter, all bets are off on future rate cuts. "The interest rate holding pattern could result in a global slowdown that will have a negative impact on small-caps going forward," he adds.

Kolluri puts Roberts' model in the same family as Ed Yardeni's Fed model, a valuation metric used to determine stocks' relative attractiveness to U.S. Treasury securities. The difference, of course, is that Roberts focuses exclusively on the divide between U.S. large-cap and small-cap stocks—and his model is available to the average investor. With the current overnight federal funds rate at 5.25 percent, well above the rate of inflation, Roberts' system says the average investor should be invested in large-caps.

Roberts views his model as part of a trend in finance to simplify strategy to the point where individual investors can take control of their own finances. "The move to simplify started with Jack Bogel and index funds, and as it continues, it will change the nature of Wall Street investment finance—whether Wall Street wants to change or not," says Roberts. "It's a wave that can't be stopped."

Roberts argues that only simple investment models easily understood by all investors can combat the short-term mentality encouraged by personal finance magazines and convey the wisdom of investing for the long term. "Inevitably, any strategy is going to have a problem market, a period when it underperforms," he explains. "If investors don't understand the strategy, they panic when the performance isn't there and bail out at the wrong time. However, if they have a clear understanding of how the strategy works, then they feel comfortable staying the course."

To educate his investors, Roberts gives away his standard Follow the Fed model for free to investors who register at his web site, www.channelcapitalresearch.com. "I want potential clients to teach themselves," he says. "I want them to see firsthand that our strategy works."

Although the strategy can work with any portfolio of mutual funds the individual already owns, Roberts favors index funds or exchange-traded funds, such as the S&P 500 Spyders or the Diamonds Trust, which tracks the Dow Jones 30 Industrials.

For a fee, Roberts' firm also offers the more sophisticated Follow the Fed Proprietary Strategy, which incorporates such additional factors as spreads between high-quality and low-quality paper, money supply figures, valuation matrices, and the shape of the yield curve. The goal is to generate more than a 3 percent higher return over the free model. He says US$10,000 invested in 1928 in the firm's Follow the Fed Proprietary Strategy would have grown to more than US$780 million by the end of 2005.

Roberts reports that his systems are catching the attention of financial advisers as well as individual investors. "In addition to the performance results, our strategies' simplicity, mechanical nature, and low number of trades are easy sells to advisers' clients," he says.

Encouraged by this positive response, Roberts is currently at work developing additional investment models—for fixed-income securities, gold, and international equities.

Nancy Opiela also writes for the Journal of Financial Planning *and* Focus, *fidelity's magazine.*

RECOMMENDED RESOURCES

"Gridlock's Gone, Now What?"
Financial Analysts Journal (Sept./Oct. 2006)
(cfapubs.org)

"Is Fed Policy Still Relevant for Investors?"
Financial Analysts Journal (Jan./Feb. 2005)
(cfapubs.org)

"What Explains the Stock Market's Reaction to Federal Reserve Policy?"
CFA Digest (November 2005)
(cfapubs.org)

"More on Monetary Policy and Stock Price Returns"
Financial Analysts Journal (July/August 2005)
(cfapubs.org)

"Stock Prices, Firm Size, and Changes in the Federal Funds Rate Target"
CFA Digest (May 2005)
(cfapubs.org)