

The short term is not the enemy of the long term

Federated Hermes MDT Advisers

Key takeaways

- While long-term fundamentals are crucial, information may potentially be gleaned from short-term market trends to address near-term performance.
- The emergence of certain fast-growing but expensive tech stocks with strong performance last decade brought about a review of our stock selection factors.
- We have found that incorporating factors such as price trends and market sentiment alongside fundamentals-based metrics may improve investment performance over time.

“In the short run, the market is a voting machine, but in the long run it is a weighing machine.”

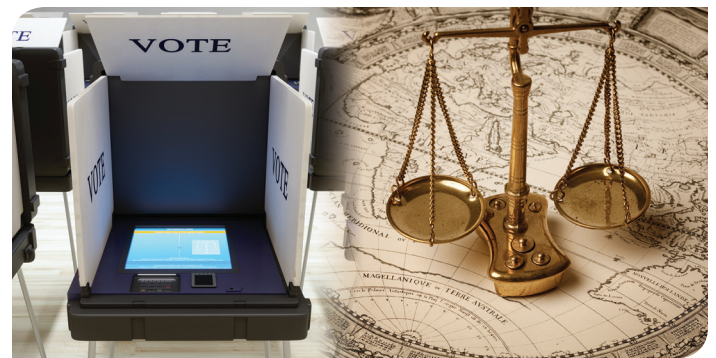
– Benjamin Graham

Investors seeking to determine a security's “true” long-term value and invest in those priced below that value can employ various methods. Some may build dividend discounting models or apply multiples to earnings forecasts. Others may rely on top-down analysis, estimating total addressable markets, market shares and profit margins. One commonality these investors share is the inevitability of periods when those methods appear to malfunction.

As a result, one classical way to interpret Graham's words above (and presumably the one intended by Graham, widely considered the father of value investing) is essentially: *Have confidence, ye value investors! The short-term beauty contest that is the stock market will often overlook those rugged, less universally loved stocks in your portfolio. Still, over the long run, the market's weighing machine can come around to recognize the value in those stocks' fundamentals.* And there is a reason this advice has stood the test of time. Generally, the worst time to abandon a well-reasoned investment process is when the voting machine is voting for all the “wrong” kinds of stocks, in disregard of commonly accepted investment principles.

What if we read Graham's words as a reminder not to ignore the short run while waiting for the long run to arrive. Perhaps a portfolio could have better outcomes if the voting machine favored some of the stocks while the weighing machine favored others.

What if, rather than looking at the voting machine as just a source of noise in the markets — in effect, as the enemy of the weighing machine — we read Graham's words as prescriptive, as a reminder not to ignore the short run while waiting for the long run to arrive? Perhaps a portfolio could achieve better outcomes by harnessing the voting machine when it favored some of the stocks and the weighing machine when it favored others.



In 2015, several strategies at Federated Hermes MDT (MDT) underperformed their benchmarks. A key factor in the outcome was our decision to underweight certain fast-growing but expensive tech stocks while overweighting companies whose businesses, in retrospect, were on a collision course with those same stocks. The companies being disrupted appeared to offer strong value across a range of metrics. As they underperformed during the year, many seemed to represent even better value as their stock prices retreated. The dominance of a few tech companies was such a prominent feature of the stock market in 2015 that the media coined a nickname for those exciting growth stocks — FANG (Facebook, Amazon, Netflix, Google).

It seems clear in hindsight that had we locked into the modeling that drove that negative outcome in 2015, our investors would have been in for a much bumpier ride over the ensuing years, as the FANG companies and others like them continued to outperform. Fortunately, our ongoing research efforts, driven by the desire to determine whether investing in companies with qualities like the FANGs could improve portfolio results over the long run, helped yield a better outcome.

Since 2015, MDT has added a variety of purely price-based, or technical, factors to our stock selection models. The added factors consider price trends over a wide range of intervals, from as short as a few months to as long as half a decade. Some detect momentum-type effects, in which companies that have performed well over a particular horizon have continued to perform well (and vice versa). Others detect reversal effects, in which the largest losers may become the biggest winners (and vice versa). What they all have in common, of course, is that they are pure expressions of market sentiment — results tabulated by the voting machine.

Adding price-based factors to our existing lineup of fundamentals-oriented factors in MDT's decision-tree-based stock forecasting model has uncovered interesting relationships. We expected that certain companies with substantial value and/or quality characteristics, combined with good technicals, would, on average, produce appealing outcomes, which turned out to be true. However, we also encountered favorable outcomes from companies with strong fundamental characteristics and extremely weak recent

performance. In the same vein, we found that outcomes can be favorable in the short- to medium-term for certain companies with very strong technical characteristics, even without validation across most of our value and quality characteristics.

A benefit of managing a portfolio of investments is that diversification may help to improve risk-adjusted outcomes. Adding price-based factors to our investment process has not only helped us find new and interesting types of stocks to invest in but, perhaps even more importantly, from a portfolio construction point of view, some of those new opportunities are significantly differentiated from what we were previously able to find. Over the years since 2015, our portfolios have benefited in two ways from price-based (momentum) factors: either because the voting machine loved certain stocks and drove their prices higher, or because they were extremely out of favor when we purchased them.

We still find strong informational content within our value and quality characteristics — an investment strategy with only voting machine factors can likewise be enhanced by adding the weighing machine.

As with active and passive investment strategies, there is no reason that short-term technical and long-term fundamental factors cannot coexist. There can be complementary benefits. We see no contradiction and no reason to choose exclusively between the short and long run. In our opinion, the best response to Ben Graham's observation on the behavior of markets is this: "Why not both?"

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The specific company references provided are for illustrative purposes only and are not necessarily representative of past or future investments in any specific MDT portfolio. Due to their relatively high valuations, growth stocks are typically more volatile than value stocks.

Value stocks tend to have higher dividends and thus have a higher income-related component in their total return than growth stocks. Value stocks also may lag growth stocks in performance, particularly in late stages of a market advance.

The quantitative models and analysis used by Federated Hermes MDT may perform differently than expected and negatively affect performance.

Investing in equities is speculative and involves substantial risks. The value of equity securities will rise and fall. These fluctuations could be a sustained trend or a drastic movement.

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Past performance is no guarantee of future results.