ROTHKO

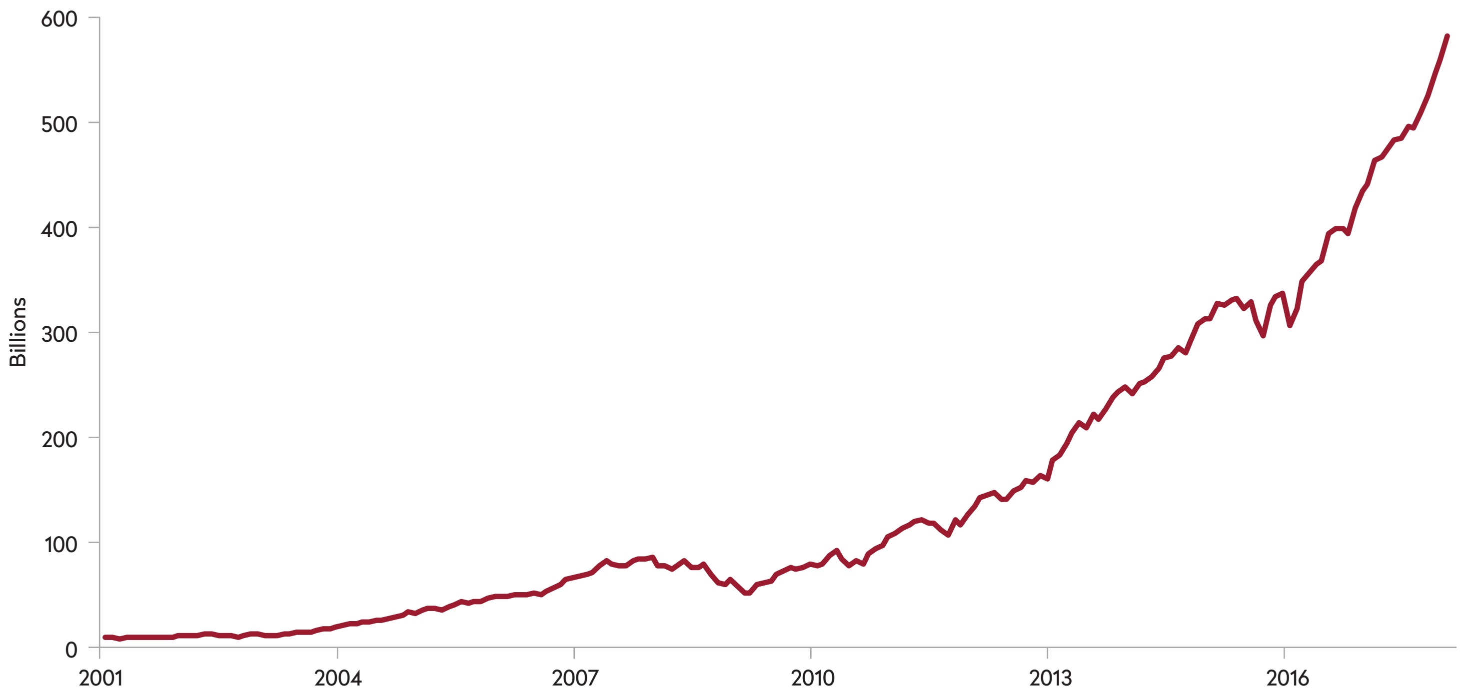
MONDRIAN INVESTMENT PARTNERS LIMITED

Rising Vol and Hidden Liquidity Traps

Quarter 1, 2018

- **Cheap dollars have inflated "factor quant" strategy returns with $1.5[1] trillion of inflows**
- **Volatility has started to tick up as monetary normalisation starts**
- **Avoiding liquidity bottlenecks will be key as pressure is released from the system**
- **We believe crowded trades in factor strategies risk another "quant quake"**

Exhibit 1: Factor Crowding in Global Equities (AUM of Factor ETFs)



Note: In this chart we show only the assets under management (AUM) of the largest ETFs in "factor" strategies. ETFs are used to allow flow data to be easily calculated on a higher frequency basis. The total shift into factor strategies is much higher than represented in this chart, which shows the rapid growth of factor ETFs over this period. In additiona to this growth there would also be mutual funds, other comingled structures, derivatives and segregated accounts run by a multitude of semi-passive and quantitative strategy providers.

"Factor Quant" Strategies – Living Beyond Their Means

Factor quant strategies have seen huge inflows (see Exhibit 1) as memories of the "quant quake" have faded and as the tide of "cheap dollars" has hidden potential liquidity traps. Many investors have been happily surprised at the higher returns provided by "factors" over this period. Min Vol, Momentum, High Dividend and Quality have all outperformed in the US and other global equity markets since the 2008 financial crisis and the Fed's QE. The problem is that the period of outperformance in these strategies tends to be led by large in-flows, while the periods of the worst performance tend to be led by the worst out-flows.

We do not think this is a coincidence. For example, overall, US and EAFE Low Vol equity ETFs experienced large inflows coupled with outperformance in the first nine months of 2016, followed swiftly by large outflows and significant underperformance.

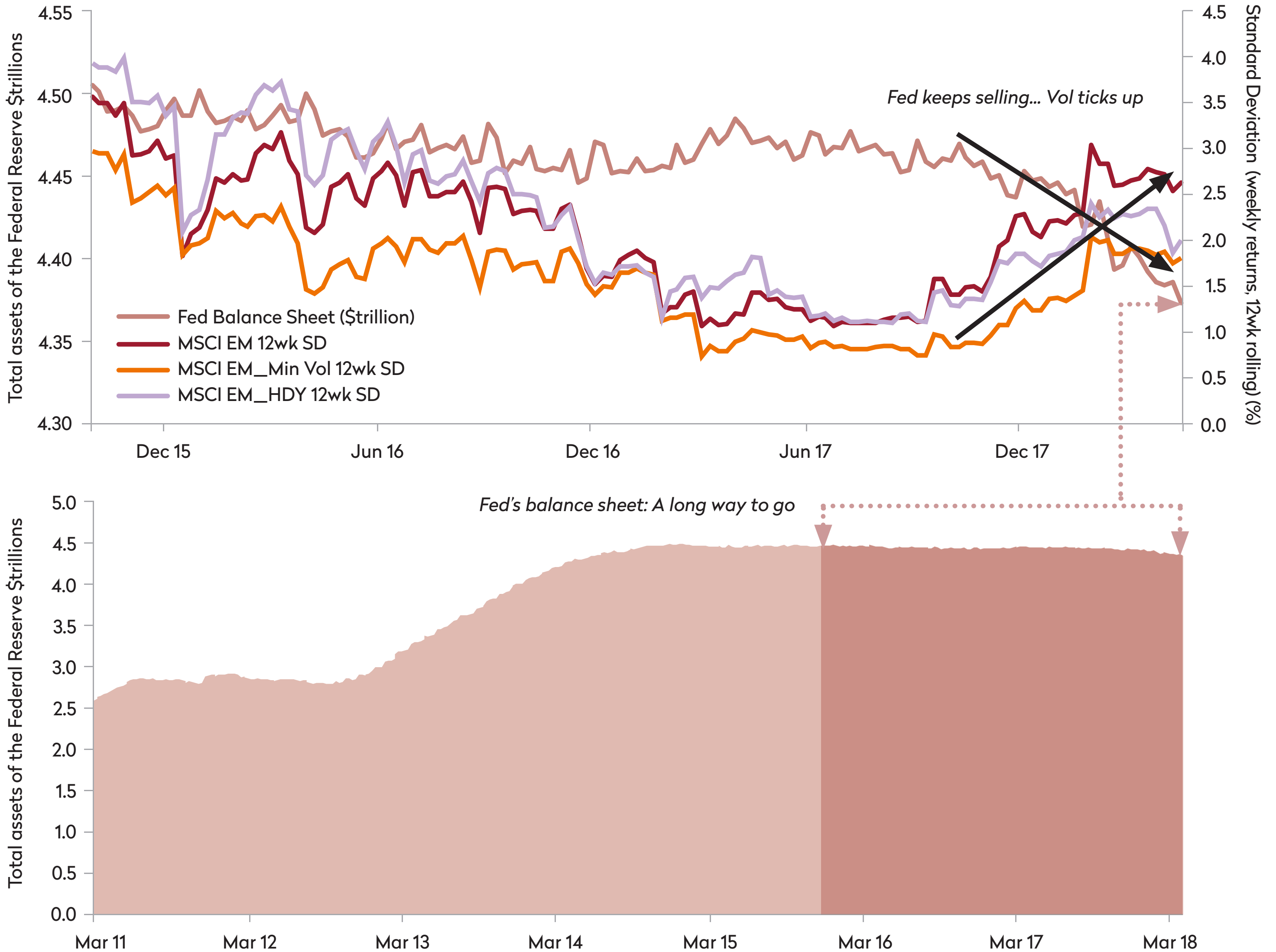
Factor strategies are liquidity constrained with "market impact" far higher than similar trade sizes in the underlying assets classes. As monetary conditions reverse, it is probable than the beneficial inflows will temper or reverse. At best we expect factor returns to fall to much lower levels in future and at worst, result in sharp capital losses if externalities shock these crowded, dangerous trades.

[1]Rothko Investment Strategies, Factset, etf.com. We estimate that from ETF data alone.

The Long Road to Normalisation

It would be complacent to believe benign conditions will remain. For one, long rates in the US continue to tick up as does volatility in global equity markets (see Exhibit 2). The Fed's balance sheet has started the long journey to normalisation and with inflationary pressures building in the US and other markets, a 1994 scenario is a possible outcome. This could quite easily be the external shock that factor investors should fear.

Exhibit 2: US$ Monetary Conditions and Vol Starts the Long Journey to Normalisation



Source: Rothko Investment Strategies.

Income Orientation and Intrinsic Value

We believe a low correlation with traditional factors is currently the best insulation from crowded factor trades. A high alpha and a high active share are important. Also, we believe income orientation will continue to be a key driver of defensiveness and that intrinsic value matters far more when there are fewer dollars in the world. Rothko matches all of these descriptions and we believe we are well positioned to continue to participate in up markets while defending capital in market declines.

[1]FT: "The Ghosts of 1994" - www.ft.com/content/32cca748-8fe8-11e2-9239-00144feabdc0.

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