# Investment perspectives

## The one-armed economist

### First Investors Hedged U.S. Equity Opportunities Fund

Investment Management Team
Wellington Management Company LLP

The **First Investors Hedged U.S. Equity Opportunities Fund** has continued to perform as it's designed to do, with a year-to-date return of 12.08% for its Advisors' share class (as of 6/5/19) compared to 9.50% for its blended benchmark (70% Russell 3000/ 30% BofA U.S. 3-Month Treasury Bill). We recently sat down with the investment team from the Fund's subadvisor, Wellington Management Company LLP, for an update on the Fund and their market outlook.

### What has happened in the equity market recently?

The market has rebounded substantially after the drawdown seen at the end of 2018, and is now up more than 15% year-to-date.[1] We've seen growth strategies outperform, while quality, which had faced some headwinds in the first quarter, has rebounded a bit. Value strategies have continued to lag, although there was an uptick in performance in the beginning of the year.

### What about the big picture?

On a high-level macro overview, there have been a lot of headlines around trade, which seem to be driving a large portion of market volatility. What this means for equities is that trade tensions could impact businesses. This dynamic is likely to have meaningful reverberations across equity markets as investors seek to understand what the real impact of trade tensions with China are. These can also impact consumers, with prices on certain goods potentially rising in response to higher input costs. That, in turn, may lead to higher inflation, but there are still a large number of unknowns in this equation. Part of what makes the situation with China a bit challenging is that the rhetoric employed by both counties revolves around national security. This dimension increases the stakes for both parties.

### Any insight into a possible resolution on the trade issue with China?

Predicting the outcome seems like a fool's errand. It reminds us of a quote from Harry Truman, who in frustration said, "I would like a one-handed economist", because he was tired of the way economists say on the one hand this could go up and on the other hand, it could go down. There is also broader economic data, like the PMI indices, GDP, and unemployment, that suggests there are some signs of recovery. This could, of course, reverse course again, given the geopolitical uncertainties specifically around trade, but inflection points are difficult to predict and we want to position the portfolio to do well regardless of how or if this issue is resolved.

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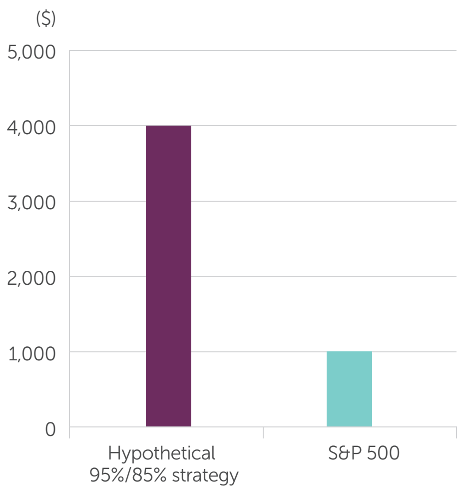
[1] Russell 3000 Index, 5/21/19.

## Why do you think it matters to have an all-weather portfolio and why is it important to offer more protection during down markets?

In *Exhibit 1,* we show a hypothetical strategy that captures 95% of the S&P 500 Index's up market, but only 85% of its down market. This strategy handily outperformed the S&P 500 over the long term and it is fairly intuitive that it's largely due to the mathematics of compounding. What may be less intuitive, and potentially more interesting, is the chart on the right which shows the relative outperformance, on a cumulative basis, of the hypothetical strategy compared to the S&P 500. There are some sharp episodes of outperformance when the market pulls back, but by targeting this asymmetric upside/downside capture ratio, an investor is still able to preserve their capital or excess return in up markets. Essentially, the strategy keeps pace with market rallies and then really shines during pullbacks.

### Exhibit 1: Value of outperformance during down markets

Hypothetical 95% upside/85% downside vs. the S&P 500 since 1930 - Growth of $1



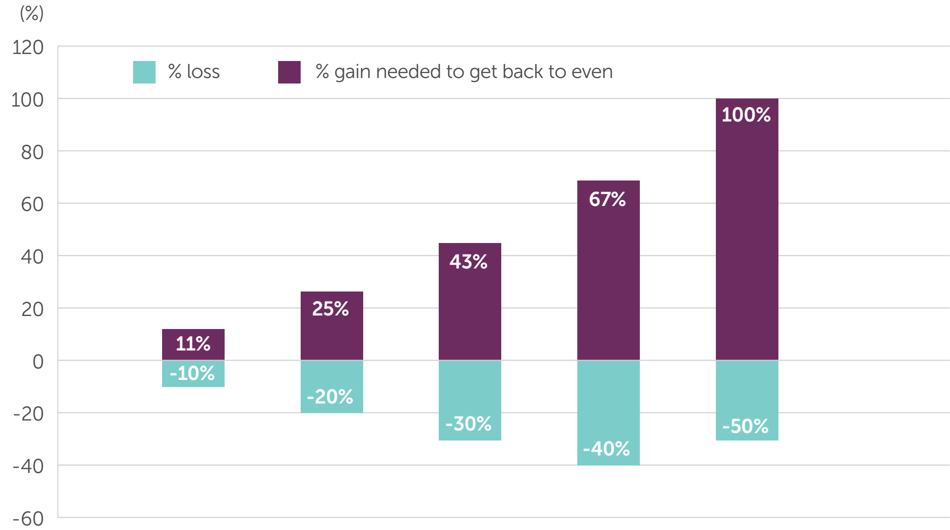

Relative performance of a hypothetical 95% upside participation/85% downside participation strategy in bull and bear markets vs. the S&P 500[2]


*Source: Wellington Management Company LLP. Past results are not necessarily indicative of future results. This strategy is hypothetical and is not offered by Wellington Management Company LLP. Actual performance may differ substantially from the hypothetical performance presented.*

An investor may ask: *Why is this happening?* The answer is that when markets move up, they rarely move in a straight line. Typically, there is still a level of volatility, even in a rising market, although it may be less than in a declining market. And let's not forget that volatility can be positive or negative. By mitigating those down months, the portfolio is able to compound its returns based on a higher base. *Exhibit 2* illustrates why compounding based a higher level is important. For instance, if a portfolio were to lose 50%, an investor would need to make back 100% to just get even.

[2] Period analyzed from January 1995 through March 31, 2019 based on monthly returns. The 95%/85% strategy is for illustrative purposes only, and is not representative of an actual account managed by Wellington Management Company LLP. Hypothetical returns were calculated with monthly S&P 500 Index returns. Each positive monthly return was multiplied by 0.95 and each negative monthly return by 0.85. The resulting monthly return stream was then used to calculate hypothetical performance and characteristics for the 95%/85% strategy. Simulated performance is developed with the benefit of hindsight (i.e., actual knowledge of market condition, result of similar strategies) and thus has many inherent limitations.

Exhibit 2: Mathematics of recouping losses



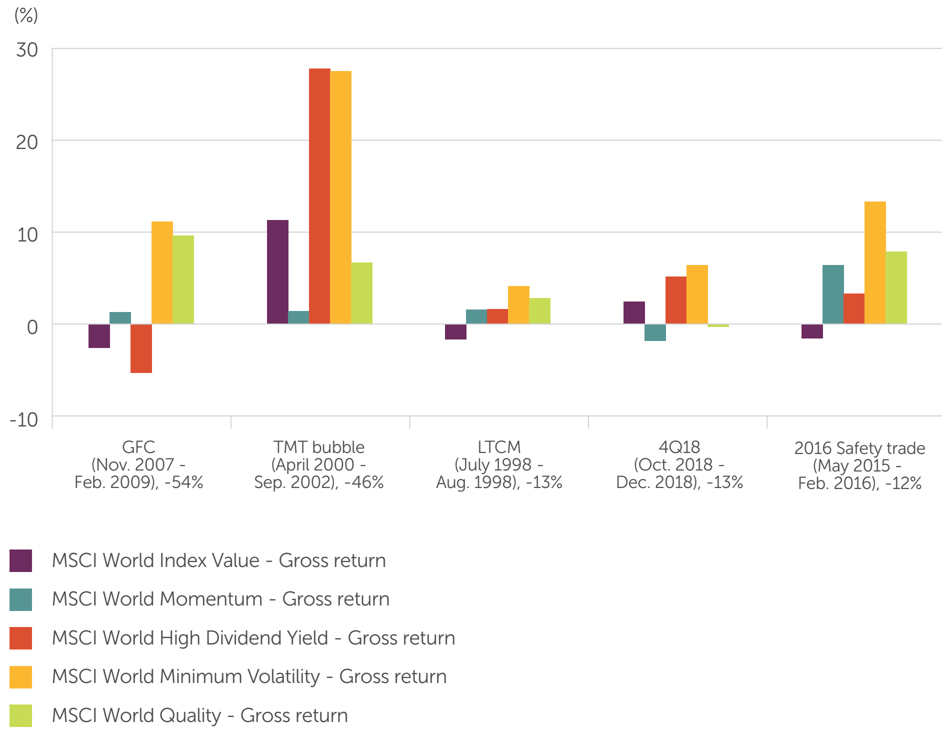

*Source: Wellington Management Company LLP. For illustration purposes only.*

## Can you describe your strategic approach to investing?

When we talk about strategy, we often focus on maintaining a balanced risk profile in order to mitigate drawdowns. We have a slightly more defensive tilt, which means that we have exposure to a number of factors. Furthermore, our research indicates that factors perform differently throughout an economic cycle, with the added caveat that the current cycle is imperfectly linked to equity markets. Our analysis regarding factor performance under various scenarios suggests that having a diversified profile is beneficial, especially if an investor doesn't think that they have a "one-armed economist" who can successfully time the market or economic cycle.

Additionally, we would point out the importance of equity fundamentals. Looking more closely at *Exhibit 3*, no two market pullbacks appear identical. There are a few items to highlight. First, minimum volatility and quality typically outperform so we consider them to be risk-averse factors. In the **First Investors Hedged U.S. Equity Opportunities Fund,** we have a bias towards those factors, because we're aiming to achieve a better downside capture ratio. Interestingly, if you look at the TMT bubble period, one factor that wouldn't typically be expected to outperform is value, which did, because what drove the excess preceding the bursting of the bubble was that, in our opinion, the market lost its focus on fundamentals. In the aftermath, value performed quite well. This in an interesting side point as, often when reviewing portfolios that aim to protect their shareholders during down markets, it can seem surprising that there is a value exposure. In the US Hedged Equity Fund, there are both value and growth stocks so that the Fund can maintain performance across disparate market environments.

**Exhibit 3: Every down market is different**
**MSCI World Factor excess returns during worst five drawdowns of MSCI World Index**




*Source: FactSet, 2/28/19. The returns of the represented factors are calculated with the following indices. Index; Momentum: MSCI World Momentum Index; Minimum Volatility: MSCI World Minimum Vol Index; Dividend Yield: MSCI High Dividend Yield Index; Quality: MSCI World Quality Index; Value: MSCI World Value Index. All return and drawdown data is cumulative. The five MSCI World drawdowns were chosen because they are the five steepest drawdowns for the index during the period. The five worst MSCI World drawdown time periods are as follows. GFC: November 1, 2007 – February 28, 2009; TMT Bubble: April 1, 2000 – September 30, 2002; LTCM July 1, 1998 – August 31, 1998; 4Q18 October 1, 2018 – December 31, 2018; 2016 Safety Trade: May 1, 2015 – February 29, 2016. The five worst MSCI World drawdowns were calculated since the inception of the MSCI World Dividend Yield Index on July 1, 1995.*

*Exhibit 3* shows that increased levels of volatility and drawdowns doesn't necessarily mean that a portfolio is going to perform the same way, even with a hedge being employed. An investor can have a strategy that's very diversified across market cap, sector and industry, but implementing diversification across multiple values has also been beneficial to this strategy.

## As we are late in the economic cycle, can you provide any thoughts about the challenges facing investors trying to evaluate how certain factors, like growth, value or quality, will perform?

Technically speaking, what works best at the end of a cycle are higher quality expressions of any factor. For instance, within value, low price-to-earnings (P/E) tends to underperform towards the end of the cycle, but low enterprise value to free cash flow outperforms. That is a fairly technical concept so some explanation may be helpful. There are a number of methodologies to value a company. If it's based on a low P/E ratio, companies with high leverage might be captured within that screen. Alternatively, if a valuation metric is used that considers a company's debt, as well as their equity yield or their market cap, leverage can be accounted for in the methodology. This matters since, typically in an economic slowdown, levered companies have worse balance sheet positions and tend to perform more poorly compared to firms that borrow less. From a fundamental perspective, it is important to understand the factors driving these dynamics. However, different market environments impact which factor is going to behave better or worse.

## Can you give us an example?

For the Hedged U.S. Equity Opportunities Fund, last year, traditional quality factors like cash flow and return on investment tended to do very well earlier in the year. Embedded in our thinking at the time was whether or not the U.S. was moving into the latter stages of the cycle and, if so, how would that impact more leveraged companies as, in our opinion, the equity market was favoring companies that didn't have significant levels of debt.

In the fourth quarter, the dynamics changed completely. First, there was a fear-driven selloff, meaning that the market wasn't distinguishing between high-quality and low-quality companies. Instead, it was separating high-priced volatility and low-priced volatility stocks, which is a classic flight-to-safety dynamic. There was also less concern about the specifics of leverage, in part, because there was less concern about interest rate risk. These concepts came together to make the fourth quarter selloff more technical in nature. We also noticed that observation we made was there was a lot of selling of the top hedge fund names, partly due to tax loss harvesting. A few of those same names rebounded in the first quarter of 2019 as the same investors bought them back.

## How has the Fund performed this year?

Security selection has been a big driver of returns on a year-to-date basis, with the equity managers themselves outperforming the Russell 3000 by about 2.5%.[3] All of the underlying managers have outperformed their respective style benchmarks, indicating strong security selection. While some managers may have underperformed the Russell 3000 because, perhaps, value faced headwinds but the growth-in-quality managers benefited from their style as well as from their security selection.

The risk sleeve, which is where we look for the exposure that the Fund is not getting naturally from the underlying asset managers and provides exposure to risk-aversion factors, which is currently dividend growth and excludes any names owned by the active managers, detracted a bit from the Fund's performance. This is due to the market favoring other risk-aversion factors that we're obtaining through our quality managers, so we expect it not to perform in lockstep with the rest of the portfolio, even though it underperformed the broader market, which was in line with our expectations.

As far as performance contributors, there are a couple of names in healthcare and IT that did well. For some time, we have been maintaining an underweight to FAANGs by not owning Facebook and Apple. Microsoft is more of a quality name, occasionally appearing in that bucket, but in general, the managers in these strategies find it challenging to own mega-cap tech names. They see better opportunities elsewhere. This includes Shopify, which was owned by the all-cap growth manager. It is a cloud-based e-commerce company, which saw its stock grow nicely on an earnings basis. After it hit our internal price target, we sold the position after locking in the returns from the stock's rally.

ServiceNow, which is owned by both growth managers, is a mid-cap tech stock. The company is cloud-based but they provide infrastructure solutions to healthcare, education, government and financial services companies. The stock also rose based on earnings, but unlike Shopify, we continue to see upside in the company and have maintained a position in the stock.

In contrast, also in healthcare, we own Align Technology, which may be familiar to some for its Invisalign product. They own 90% of the market share for transparent tooth alignment. The healthcare team believes that, despite possibly losing some market share to competitors, the growth in their market is going to expand and we expect the upside to continue.

Broadly speaking, though, we're really happy with the positioning for the portfolio both in terms of the hedges and the underlying managers and think that we're positioned to try to preserve capital in the event that we see a further correction.

[3] Source: Morningstar, 5/30/19.

## Any parting thoughts?

It is important that our managers stay in their designated "lanes", meaning large-cap growth managers ought to buy large-cap growth stocks. Although the hedges that we have employed have detracted somewhat from performance, we would expect that to happen, given that we are in a rising market. Additionally, since it is far too expensive to add a hedge when the market realizes that things are going to be volatile, the hedge is always employed.

One of the major competitors to this Fund is the JPMorgan Hedged Equity Fund. Just to provide a short recap, in the fourth quarter of 2018, the S&P fell about -13.5%, the Hedged U.S. Equity Opportunities Fund was down approximately -9.1% and the JPMorgan Hedged Equity Fund was down about 5.4%. Based on the beta targets the two funds seek, in our opinion, those returns are in line with expectations. Even more impressive, when looking at the rolling one-year performance as of 5/30/19, the S&P was up 7.8%, the Hedged U.S. Equity Opportunities Fund 8.1% and the J.P. Morgan strategy 4.1%. If an investor would have adopted a lower beta strategy over the last year, they would have missed out on roughly half the return captured using the Hedged U.S. Equity Opportunities Fund.

The **MSCI World Index** is a broad global equity index that represents large and mid-cap equity performance across 23 developed markets countries. It covers approximately 85% of the free float-adjusted market capitalization in each country and MSCI world index does not offer exposure to emerging markets.

The **MSCI World High Dividend Yield Index** is based on the MSCI World Index and includes large and mid cap stocks across 23 Developed Markets (DM) countries. The index is designed to reflect the performance of equities in the parent index (excluding REITs) with higher dividend income and quality characteristics than average dividend yields that are both sustainable and persistent.

The **MSCI World Minimum Volatility (USD) Index** aims to reflect the performance characteristics of a minimum variance strategy applied to the MSCI large and mid cap equity universe across 23 Developed Markets countries. The index is calculated by optimizing the MSCI World Index for the lowest absolute risk (within a given set of constraints).

The **MSCI World Momentum Index** is based on the MSCI World Index which includes large and mid cap stocks across 23 Developed Markets countries. It is designed to reflect the performance of an equity momentum strategy by emphasizing stocks with high price momentum, while maintaining reasonably high trading liquidity, investment capacity and moderate index turnover.

The **MSCI World Quality Index** is based on MSCI World, which includes large and mid cap stocks across 23 Developed Market (DM) countries*. The index aims to capture the performance of quality growth stocks by identifying stocks with high quality scores based on three main fundamental variables: high return on equity (ROE), stable year-over-year earnings growth and low financial leverage.

The **Standard & Poor's 500 Index** (S&P 500) is a capitalization-weighted index of 500 stocks. The Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

**Price/earnings (P/E)** is the price of a stock divided by its earnings per share. Sometimes called the multiple, P/E gives investors an idea of how much they are paying for a company's earning power. The higher the P/E, the more investors are paying, and therefore the more earnings growth they are expecting.

It is not possible to invest directly in an index.



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