

## Quant Coalescence

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Collaborative insight provided by CIO Michael Chapman.

### **May, 2016: “Some cattle, pork bellies and corn for thought?”**

According to statistics and research credited to Factset’s John Butters, “as of May 6<sup>th</sup>, 2016, 1<sup>st</sup> quarter earnings are coming in at -7.1% year over year with 87% of companies in the S&P 500 having reported. This marks the first time the index has seen four consecutive quarters of year-over-year declines in earnings since Q4 2008 through Q3 2009. For Q2 2016, 55 companies have issued negative EPS guidance and 24 companies have issued positive EPS guidance. The forward 12-month P/E ratio is 16.5. This P/E ratio is based on Thursday’s closing price (2050.63) and forward 12-month EPS estimate (\$124.64).”

As our commentary mentioned in March, if you extrapolate the downwardly (now realized) 1<sup>st</sup> quarter 2016 S&P 500 earnings estimate over the entire year of 2016; you get P/E ratios that are extremely elevated to the historical norm.

Even at the current 16.5 forward 12 month P/E mentioned by Factset calculations above, the forward P/E of the S&P 500 is above the 5, 10 and 15 year averages: 13.6, 14.1 and 16 respectively. All things being equal, the market has to either go down, earnings have to improve dramatically for the remainder of the year or the market has to be comfortable trading at very high forward multiples.

\*\*\*Side note, the earnings on the S&P 500 quoted above are based on the sum of the earnings of all 500 companies in the S&P 500, both negative and positive. This is a method of valuing the overall equity market by looking at all 500 companies in the S&P 500 as ONE company. In other words, how much is an investor paying for the estimated (forward) or trailing (actual) earnings of “the market”.

This all leads us to the possible “why” of the current allocations for PCM’s quant strategies for May, 2016. As is always the case, we look for *fundamental* reasons as to why our *quantitative analysis* results in certain themes rising to the top. For the May 1<sup>st</sup>, 2016 reallocation; commodities, materials, metals and commodity exporting countries/currencies are all strong themes. Could it be that with asset bubbles everywhere...created by central bank intervention... coupled with the selloff in commodities and metals over the last several quarters....that this asset class is one of the few attractive and fairly valued? Just some cattle, pork bellies and corn for thought!

Before we break down the weightings of the individual strategies, below is a table of our gross composite performance for our models for 1<sup>st</sup> quarter 2016. We look forward to winning several performance awards and were very pleased with the quarterly outcome, especially in light of the historical *selloff* combined with a historical *comeback*; all in one quarter. An excerpt from our 1<sup>st</sup> of 2016 quarterly client letter sums it up:

“So there it was; **a record for the worst open to the equity markets in history for January**. Six weeks into 2016 on

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Feb. 11, all of the major U.S. stock indexes were down more than 10% for the year. A bear market looked all but certain. That day the Dow Jones Industrial Average closed nearly 15% off its May 2015 record high. The benchmark Standard & Poor's 500 was down 14.2% and the NASDAQ composite was down 18.2%.

Then we had the record "comeback" rally. According to CNBC, the **Dow Jones Industrial Average saw its biggest quarterly comeback since 1933**. Most of the U.S. indexes finished the quarter unchanged or slightly up. Let's digest that. **For the U.S. equity markets to finish the quarter basically flat, the markets set a record on the downside and on the upside in just one quarter!** Now THAT is volatility....and we LIKE it!

What does this all mean to you and your investments? Let's start with a barometer of what the average investor experienced during the 1<sup>st</sup> Qtr. 2016. The NASDAQ composite was down 2.8% and the IBD mutual fund index, which is an index of 19 very large growth mutual funds, closed down 3.14%. "

And the PCM results? See below:



### Provident Capital Management, Inc.

#### First Quarter 2016 Gross Composite Performance

STRATEGY	ASSET CLASS	Jan 2016	Feb 2016	Mar 2016	1st Qtr 2016
PCM Absolute Equity Income Composite	Multi Directional Equities	-0.09	-0.46	4.91	4.33
PCM Absolute U.S. Sectors Composite	Multi Directional Equities	0.21	0.28	3.88	4.39
PCM Absolute International Composite	Multi Directional Equities	-2.28	1.49	2.89	2.04
PCM Emerging Market Equity Composite	Multi Directional Equities	-1.14	-0.53	-1.46	-3.10
PCM Absolute Metals Composite	Multi Directional Metals	-1.07	3.92	1.99	4.85
PCM Absolute Commodities Composite	Absolute Commodity	-0.06	3.53	-1.56	1.85
PCM Emerging Market Bond Composite	Multi Directional Bonds (Global)	-0.17	0.04	1.97	1.84
PCM Managed TIPS	Inflation Protected Bonds (Global)	0.59	1.28	1.82	3.73
PCM Global Bond HF Portfolio	Multi Directional Bonds (Global)	0.26	1.24	2.11	3.65
PCM Emerald Long-Short Debt HF Com	Multi Directional Bonds (Global)	0.1	0.71	1.63	2.45
PCM Absolute Bonds Composite	Multi Directional Bonds (Global)	0.66	1.46	2.51	4.69
PCM Absolute U.S. Bond Composite	Multi Directional Bonds (US)	1.02	0.36	0.45	1.84
PCM Emerging Market Blend Composite	Multi Directional Blend	-0.08	0.62	2.14	2.69
PCM Alpha 1 Composite	Multi Directional Multi Asset Class	0.91	2.03	-0.25	2.70
PCM Global Macro 3M Composite	Multi Directional Multi Asset Class	-0.95	1.35	1.15	1.54
PCM Sapphire Global Macro HF Compos	Multi Directional Multi Asset Class	-1.21	1.76	0.20	0.73
PCM Global Tactical Composite	Multi Directional Multi Asset Class	-3.27	1.51	0.65	-1.17
PCM SuperGlobal Macro Composite	Multi Directional Multi Asset Class	-0.06	1.57	0.07	1.58
PCM Global Macro Index Composite	Multi Directional Multi Asset Class	-0.21	0.77	-0.78	-0.23
PCM Conservative Portfolio Composite	Multi Directional Portfolio	-0.02	1.13	1.15	2.27
PCM Total Return Portfolio Composite	Multi Directional Portfolio	-1.46	0.97	0.91	0.40
PCM Diamond_RubyMulti-Strategy HF Composite	Multi Directional Portfolio	-0.58	1.21	1.12	1.75
PCM Stable Growth Plus Portfolio Composite	Multi Directional Portfolio	-1.19	1.04	0.69	0.53

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And now...back to our regularly scheduled newsletter and our May, 2016 allocations theme. Gold, materials, energy, commodities, commodity exporting countries and commodity exporting currencies all rose to the top of the quant rankings. As mentioned to start the May newsletter, this could be a product of these asset classes being one of the few areas that have sold off in the last year and hence a value play. This may also be explained by the new Central Bank and worldwide phenomenon known as “NIRP” that we explained in March, which could make all hard assets more attractive. As a reminder, NIRP is an acronym for the uncharted waters of Negative Interest Rate Policy. This uncertainty of what all of this could mean with no precedent makes gold and other hard assets potentially more attractive. We also see continued allocations to dividend paying equities and global bonds. Global bonds have continued to be attractive, as they have gone up in price as negative interest rates have been announced.

### **PCM Strategies: 05.2016 Allocations\***

\*(Please note that performance numbers on the website for indexes do not include dividends and are appropriately calculated sequentially.)

1. [PCM US Bond Total Return Index<sup>SM</sup>](#): High yield and investment grade corporates and inflation protected U. S. Treasuries (TIPS)
2. [PCM Absolute Bond Index<sup>SM</sup>](#): High yield U.S. and international corporate bonds
3. [PCM Absolute U.S. Sector Index<sup>SM</sup>](#): Materials, industrials and energy
4. [PCM U.S. Industries Total Return Index<sup>SM</sup>](#): Materials, industrials, aerospace and telecom
5. [PCM Absolute Equity Income Index<sup>SM</sup>](#): Preferred equities, international real estate and cash equivalent
6. [PCM Emerging Market Total Return Equity Index<sup>SM</sup>](#): Emerging Europe, Latin America and the Middle East
7. [PCM Total Return Portfolio Index<sup>SM</sup>](#) and [PCM Stable Growth Plus+ Portfolio Index<sup>SM</sup>](#): International bonds, gold, materials, energy, and preferred equities are all themes in these portfolios.
8. [PCM Global Tactical Index<sup>SM</sup>](#): Canadian equities and Canadian dollar, gold, materials and high yield corporate bonds
9. [Global Macro Index<sup>SM</sup>](#): Gold, broad based commodities, International inflation protected Treasuries, emerging market bonds and high yield U.S. corporate bonds
10. [PCM Alpha 1 Index<sup>SM</sup>](#): Broad Based commodities
11. [PCM Absolute Commodities Index<sup>SM</sup>](#): Silver and cocoa

PCM was recognized as a “Top Gun” for our performance during the volatile 3<sup>rd</sup> quarter of 2015 by Informa Investment Solutions. Four of our models were in the top 10 performers out of hundreds of products and money managers.

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### PERFORMANCE RECOGNITION: 3<sup>rd</sup> Quarter, 2015

#### Informa Investment Solutions' (PSN) Ranks PCM "Top Gun" Products

- **PCM Protective Equity** - (Top 10/#5) All Cap Universe (*543 products in the All Cap universe*)
- **PCM Diamond** - (Top 10) US Balanced Universe (*314 products in the US Balanced universe*)
- **PCM Global Macro** - (Top 10/#2) Global/Intl Balanced Universe
- **PCM Global Tactical** - (Top 10/#8) Global/Intl Balanced Universe (*297 products in the Global/Intl balanced universe*)

\*\*\*We have enhanced our website AGAIN at <http://www.pcminvestment.com>. You can now see performance of our indexes (previous day and month to date) on our streaming ticker. We include performance for both our indexes and our composites, as applicable. You will be asked to enter your email address to get into the website. There will be no password required, so you won't have to worry about forgetting it. This is partly due to helping us stay in compliance with requirements in our industry that we know who has reviewed our website content. Please use the website link above to see all of our indexes and composites.

In addition to the above mentioned "Top Gun" performance awards from Informa Investment Solutions, PCM composites have been previously recognized for performance by Informa Investment Solutions; the [PCM Absolute Bond Composite<sup>SM</sup>](#) for the three year performance ending the 4th quarter of 2014, as well as previous awards for 1-year trailing performance and 3-year trailing performance. As of 2<sup>nd</sup> quarter 2014, the [PCM Absolute Bond Composite<sup>SM</sup>](#) and the [PCM Absolute Commodities Composite<sup>SM</sup>](#) both won a "Top Gun" award for performance in their respective category for the 1-year trailing performance period, with the [PCM Absolute Bond Composite<sup>SM</sup>](#) also winning the "Top Gun" award for 3-year trailing performance. The [PCM Alpha 1 Composite<sup>SM</sup>](#) was awarded the "Top Gun" performance award for the 1st quarter of 2014. We are very pleased to see these particular multi directional strategies being recognized, as the [PCM Absolute Bond Strategy<sup>SM</sup>](#) and [PCM Alpha 1 Strategy<sup>SM</sup>](#) are particularly timely for where we are in the current market cycle.

To view Morningstar Fact sheets of all of our index models, please visit our website at [www.pcminvestment.com](http://www.pcminvestment.com) under the "[PCM multi-directional Strategies](#)" tab.



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### About "PCM Quant Coalescence"

Welcome to Provident's "Quant Coalescence" communication. We suspect that many of you are no different than us. That is to say that when our quantitative models rebalance every 2 weeks for some indexes or once a month for other indexes, you sometimes find yourselves asking "What is behind a rotation into that ETF?" This communication is our opportunity to "unite for a common end" with our clients and partners; keeping you updated on our thoughts and perspectives. As you know, our indexes are based on an absolute approach: we strive to make money in up markets or down markets, while trying to greatly minimize loss in any market environment.

Our indexes are also quantitative, reflective of our systematic, unbiased and technical approach. Since our indexes are unbiased, the quantitative models would obviously at times rotate into positions that cause us to scratch our heads. Nevertheless, being so close to the analysis as it unfolds, allows us to quickly begin to validate the fundamental reasons behind the quantitative "following of the money." At other times, the trades are not validated right away; the story unfolds as the days pass. We have been very excited about many of these "validations" and "ah ha" moments. We had another "ah ha" moment when we decided that these insights would also be interesting to those who have entrusted us with their financial peace of mind. Our goal is to be short and to the point, specific to what is happening in our indexes rather than a lengthy macroeconomic perspective.

For further disclaimers and disclosures, see our website for [index disclosures](#) and [composite disclosures](#).