3FOURTEEN RESEARCH
MANAGE RISK. EXPLOIT OPPORTUNITY.

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Historic Turbulence Ahead

"A ***momentum investing*** *strategy is the rather insane proposition that you can* ***buy a portfolio of what's been going up*** *for the last 6 to 12 months,* ***sell a portfolio of what's been going down*** *for the last 6 to 12 months, and you beat the market. Unfortunately for the case of sanity, that seems to be true."* – **Cliff Asness**

*"****Yesterday's weirdness*** *is* ***tomorrow's reason*** *why."* – **Hunter S. Thompson**

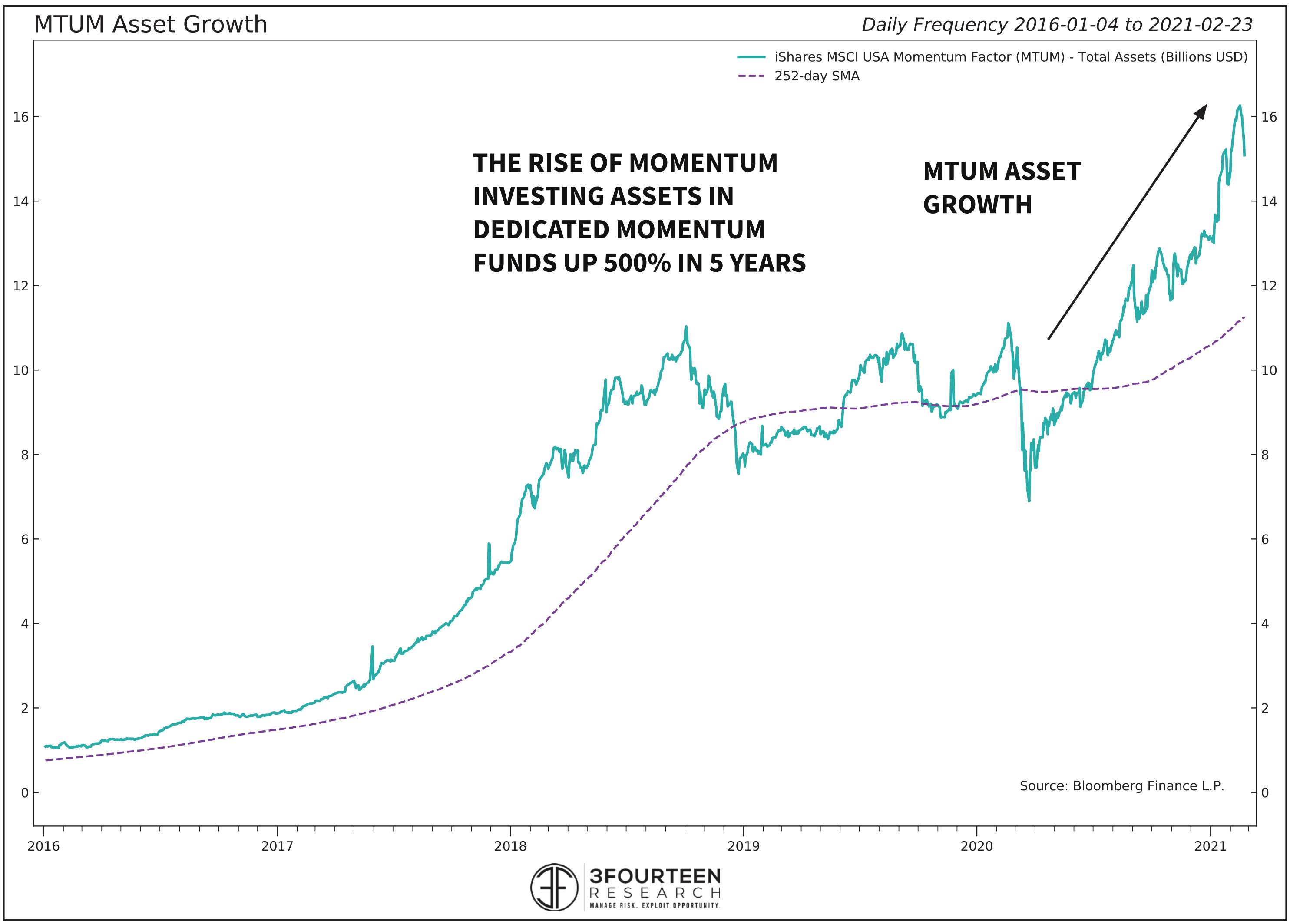
"He looked across the sea and knew how alone he was now. But, he could see the prisms in the deep dark water and the line stretching ahead and the strange undulation of the calm. ***The clouds were building up now...****"* – **Earnest Hemingway,** The Old Man and the Sea

"And how will this come to pass? He paused and lowered his voice. In the same way all change comes to pass, I fear, And I am sorry it is so. It will come to pass by violence and upheaval, by flame and by fury, for ***no change comes calmly over the world.****"* – **Walter M. Miller Jr.**

"The shortest route to courage is absolute ignorance." – **Dan Simmons,** Endymion

EXECUTIVE SUMMARY

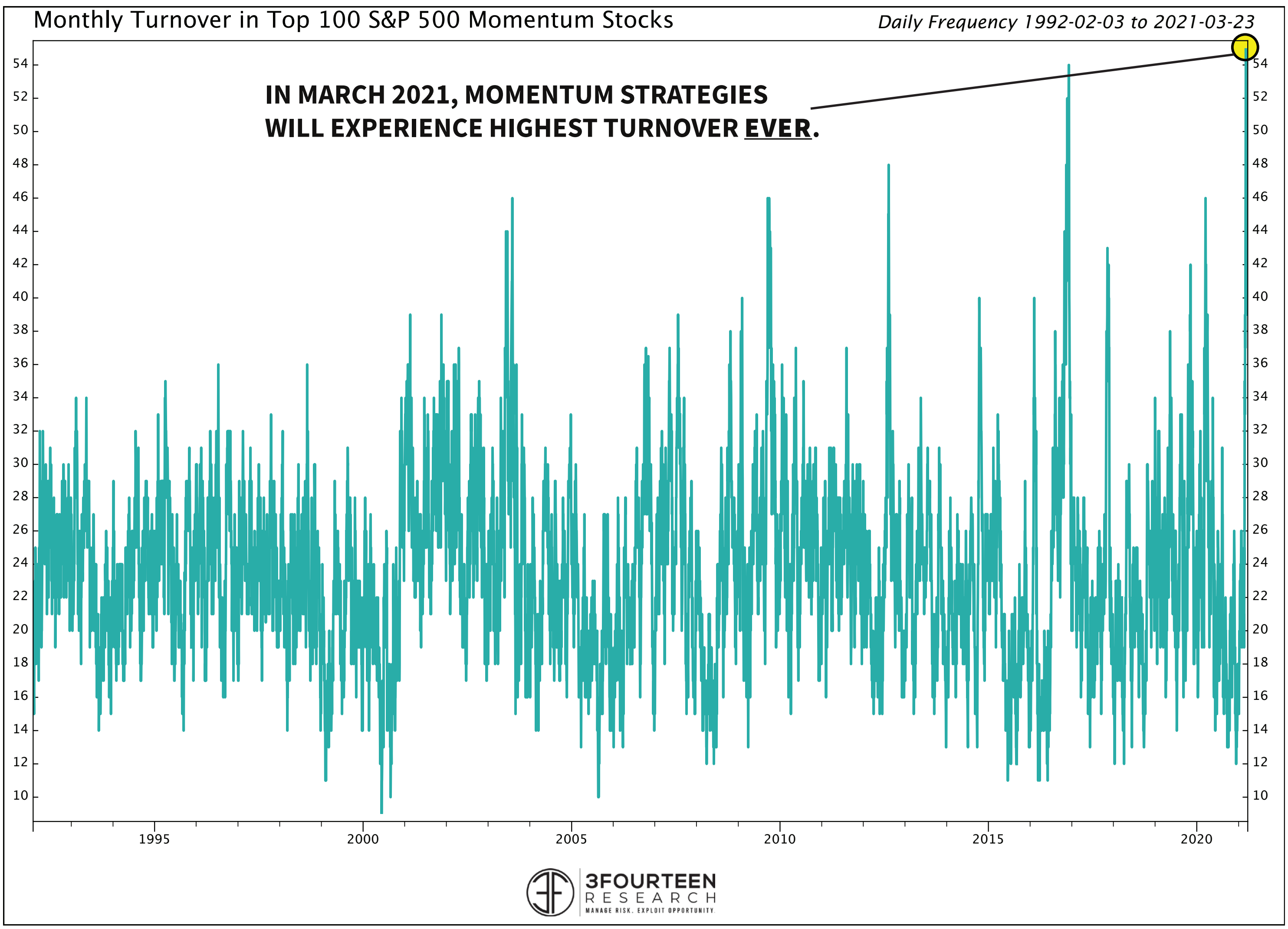
- Next month, momentum funds will enter a period of historic portfolio turnover.
- During this period, momentum managers will be buying Cyclical stocks at a record pace.
- Energy and Financials sectors will benefit. Tech and Healthcare will experience structural outflows.
- In 2016, we witnessed a similar shift in momentum portfolios.
- Since then, however, momentum funds have grown by 500%. We expect the coming turnover to surpass anything we have previously experienced in the space.



In ten days, history will be made. As the anniversary of last March's volatility draws near, this appears to be a mathematical certainty with practical implications. Let us explain. The scars of 2020 are multi-dimensional. Of course, society bears the mark of a generational pandemic. Last year, everyone experienced some degree of loss—life, freedom, wealth, and connection have all suffered.

Investors also have scars. Crises reverberate for cycles into the future. Most of us know friends or family members who pulled their money out of markets following the 2008 crash and have yet to gather the courage to reenter. Even the Tech Bubble of 1999/2000 still occupies a large swath of investor headspace. This is evident in the constant comparisons of today's market to the '99 bubble. **Crises loom large in the collective psyche. 2020 will be no different. Investors will be fighting the ghosts of last year far into the future.**

While we wait to see what long-term psychological trauma 2020 inflicted on investors, one aftereffect is a statistical guarantee. **The violent downdraft (and subsequent rally) of last March is poised to create the most turbulent rebalance ever for momentum-based strategies.** In the chart below, we calculate a rolling turnover for a hypothetical momentum strategy that buys the top 100 stocks in the S&P 500 as determined by 12-month price change. Further, to get a peek into future turnover and constituents, we hold current stock prices constant through 3/23 (last date in the chart). According to our study, on March 5th upcoming, 55 of the 100 stocks in this hypothetical portfolio will be new additions compared to the previous month. On the other side of the coin, there will be structural selling of another 55 stocks to make room for these new additions. **Based on our study, this is the highest momentum-strategy turnover ever observed. What's more, the sector/industry/style rotation implied by this turnover is stunning.** This is all occurring at a time when momentum investing—and closely related strategies—is on the rise. Today, we examine this looming factor rebalance, the equities that will be bought, the equities that will be sold and potential implications for investors.

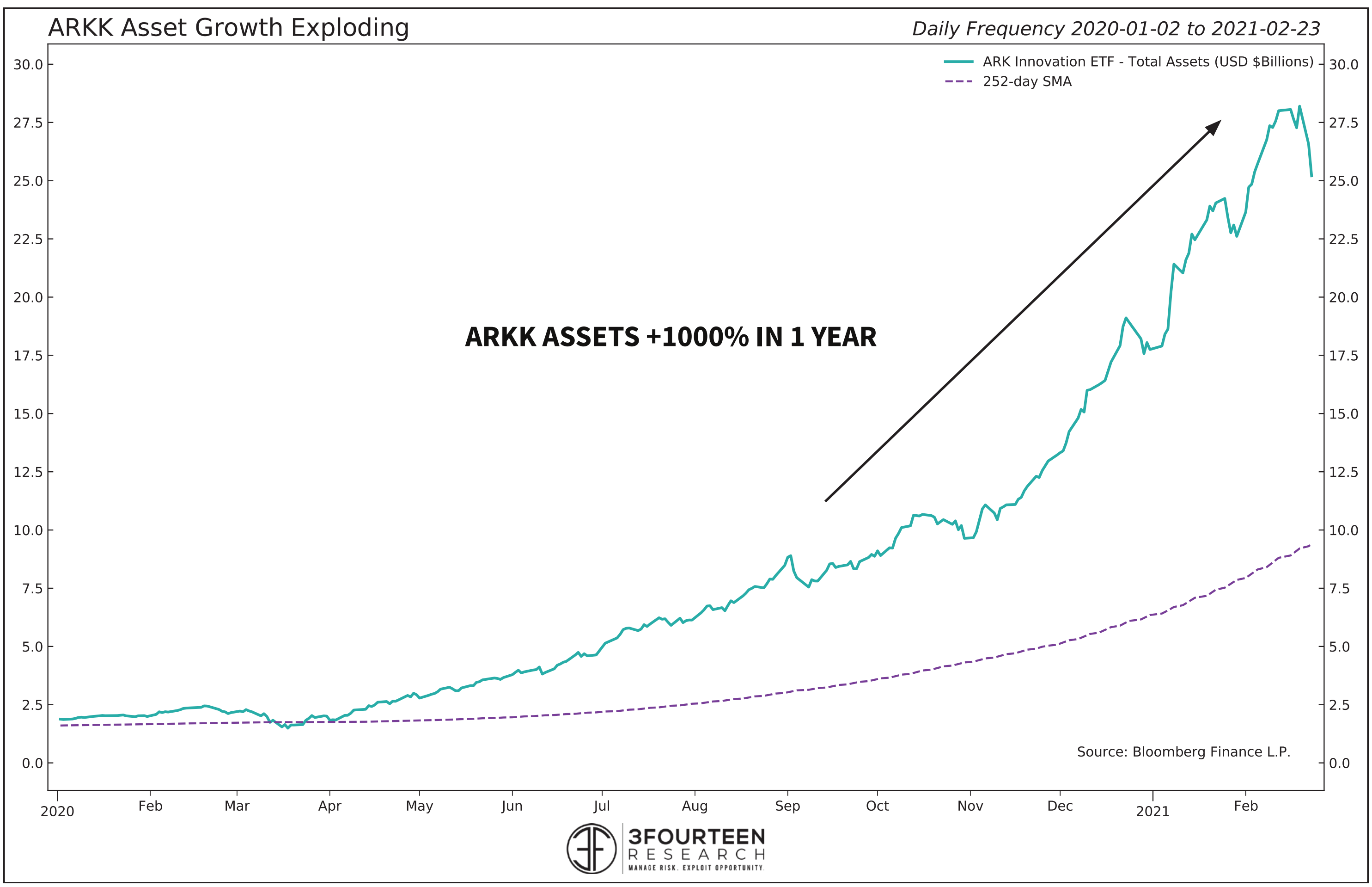


At this point, we can almost hear the hand-waving response from dedicated momentum-based portfolio managers. Anticipated counterpoints include the following:

- "Our strategy is more complex than a simple 12-month rate of change (e.g. a blend of the six-month and the 12-month minus one-month)."
- "There are infinite ways to define momentum. You are cherry-picking one calculation."
- "We rebalance continuously, quarterly or semi-annually, which means that front-running any shift is premature."

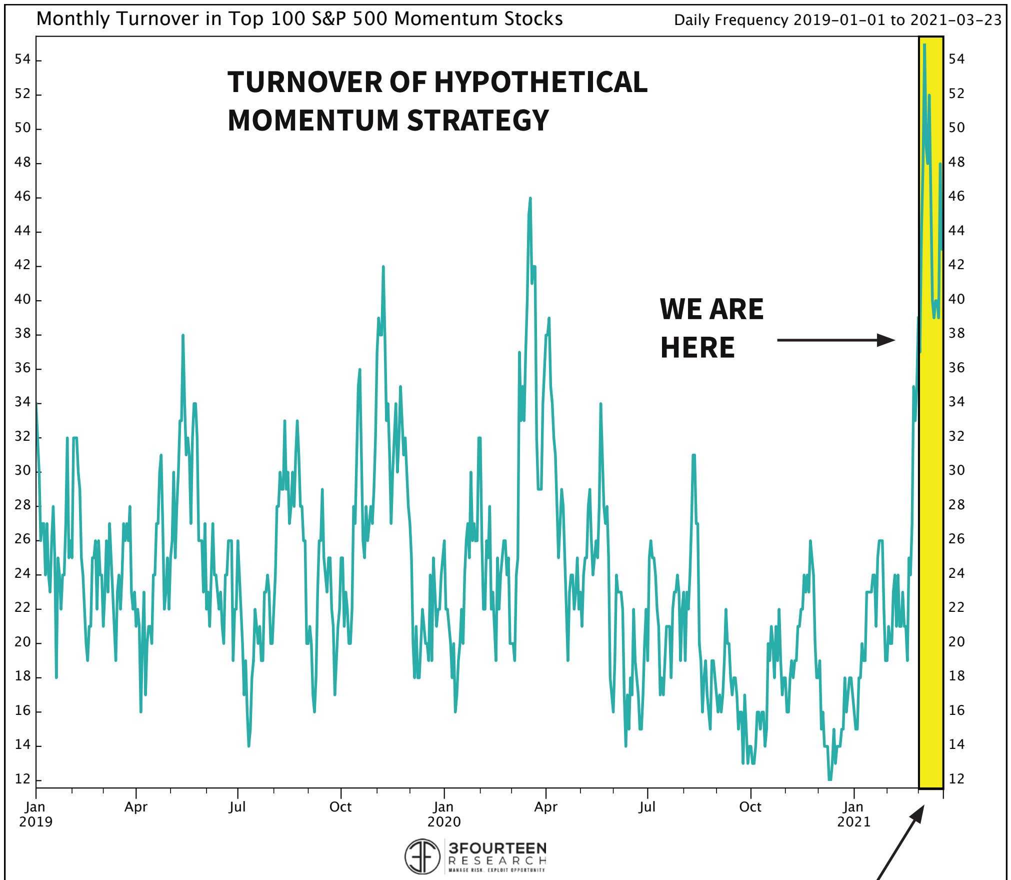
In truth, all of these imagined objections to the above study have some validity. There are myriad ways to calculate momentum and rebalance a portfolio. It is also correct that we are not aware of a major fund that does EXACTLY what we lay out on page two—i.e buy the top 100 stocks based on 12-month ROC and rebalance monthly. **However, we are also unaware of any major momentum strategy where the price of securities in question 12 months ago is not a MAJOR factor in determining portfolio positioning. This "base effect" is the key. And, given the historical anomaly that March 2020 represents, the upcoming 12-month base effect will become the primary consideration for most momentum managers.** Academic modifications to the definition of momentum will not impact the base effect coming in March. Remember, 12 minus one (or two) month momentum only serves to tamp down near-term spikes in the data by ignoring recent price swings.

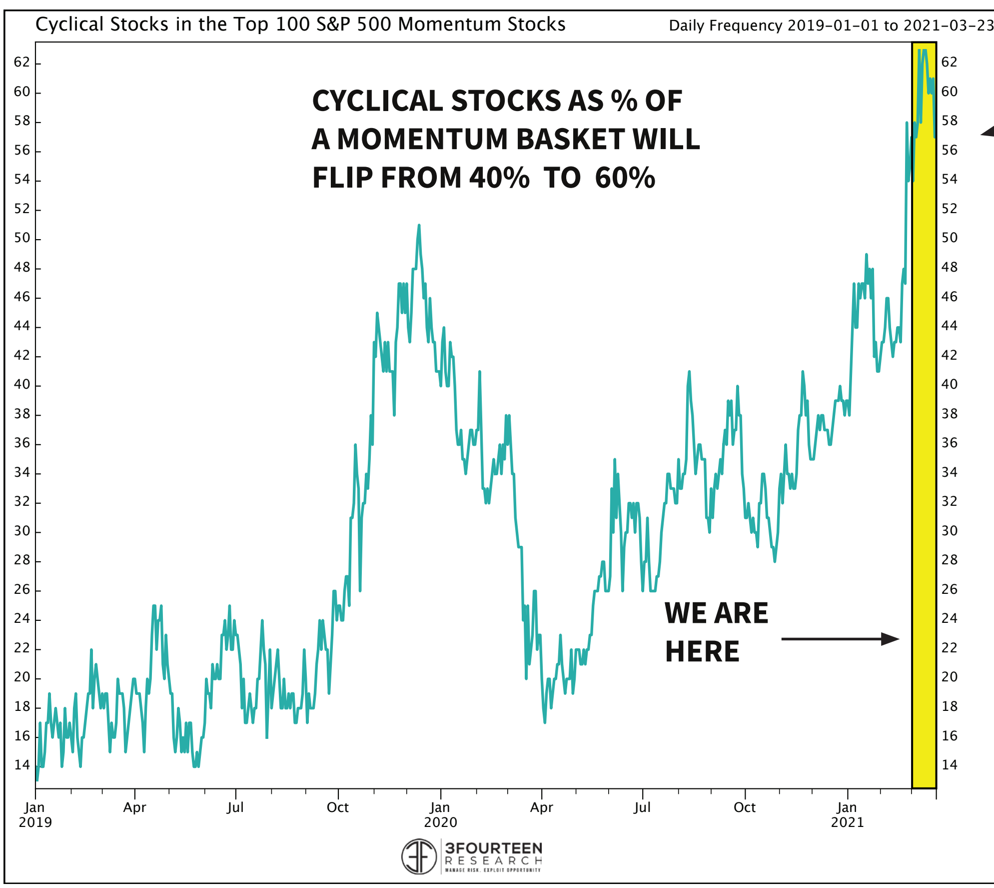
In today's market, momentum is everywhere and nowhere at the same time. Each momentum fund has its own unique definition and implementation strategy. There is no singular "momentum factor." We calculate ~$60 billion of ETF + Mutual Fund assets that trade in dedicated momentum strategies (the largest of which is the MTUM ETF – pg 1). Yet, this number undershoots the true scope of momentum-based strategies. There are untold billions of additional "momentum" dollars trading in non-ETF/Mutual Fund structures. Also, more generic "Factor" funds are on the rise. These funds trade off of multiple factors. Invariably, momentum will be one such embedded factor. Finally, **momentum may be hiding in strategies that have nothing to do with the factor explicitly.** For example, Cathie Wood's uber-successful discretionary ETF—ARKK —has grown by more than 1000% in the past year (up to $25 billion in assets, below). Throughout 2020, ARKK's correlation to our hypothetical momentum strategy hovered around 90%.



Suffice to say, the limits of momentum investing are difficult to quantify these days. And, determining exactly where the ripple effects of the looming rebalance end is impossible. **At the very least, we can say two things with certainty: First, dedicated momentum funds will be turning their portfolios over at a record pace this Spring. And, second, momentum's popularity is currently at its historical zenith.**

With those two principles in mind, we turn back to the hypothetical momentum strategy laid out on page two. In the chart to the right, we once again plot the portfolio's turnover pushed into the future (same as the chart on page two), but in this case we zoom in to recent history to bring the March turnover into focus.

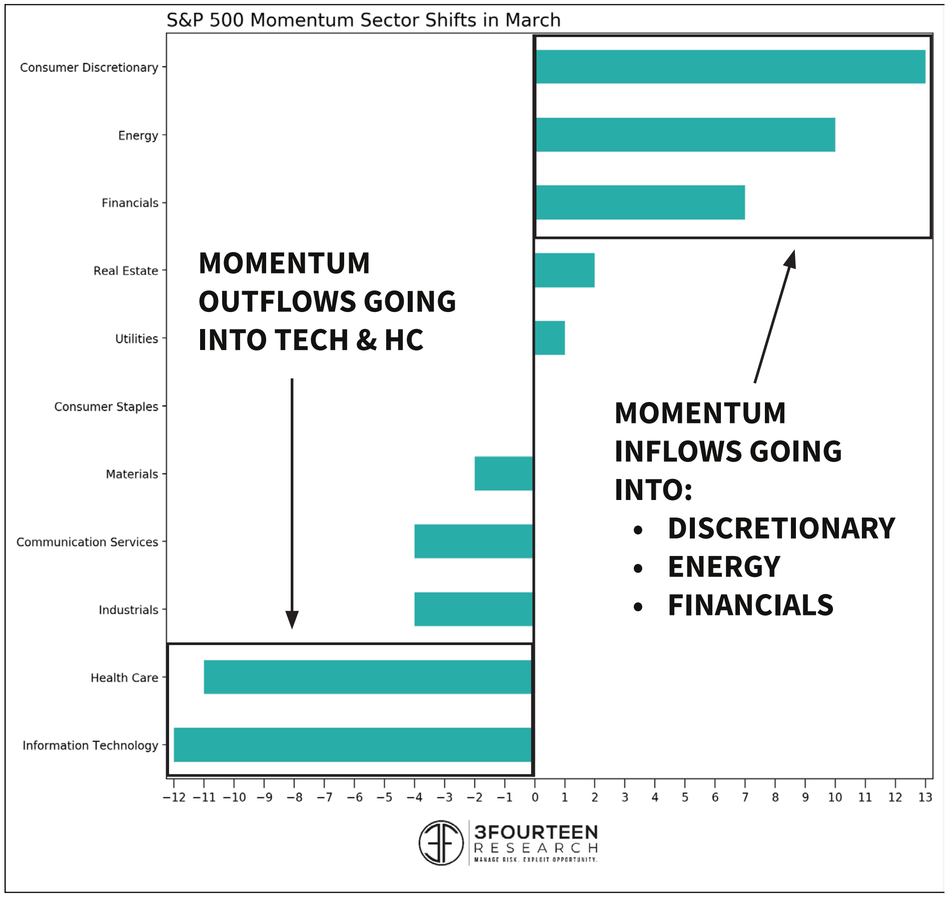


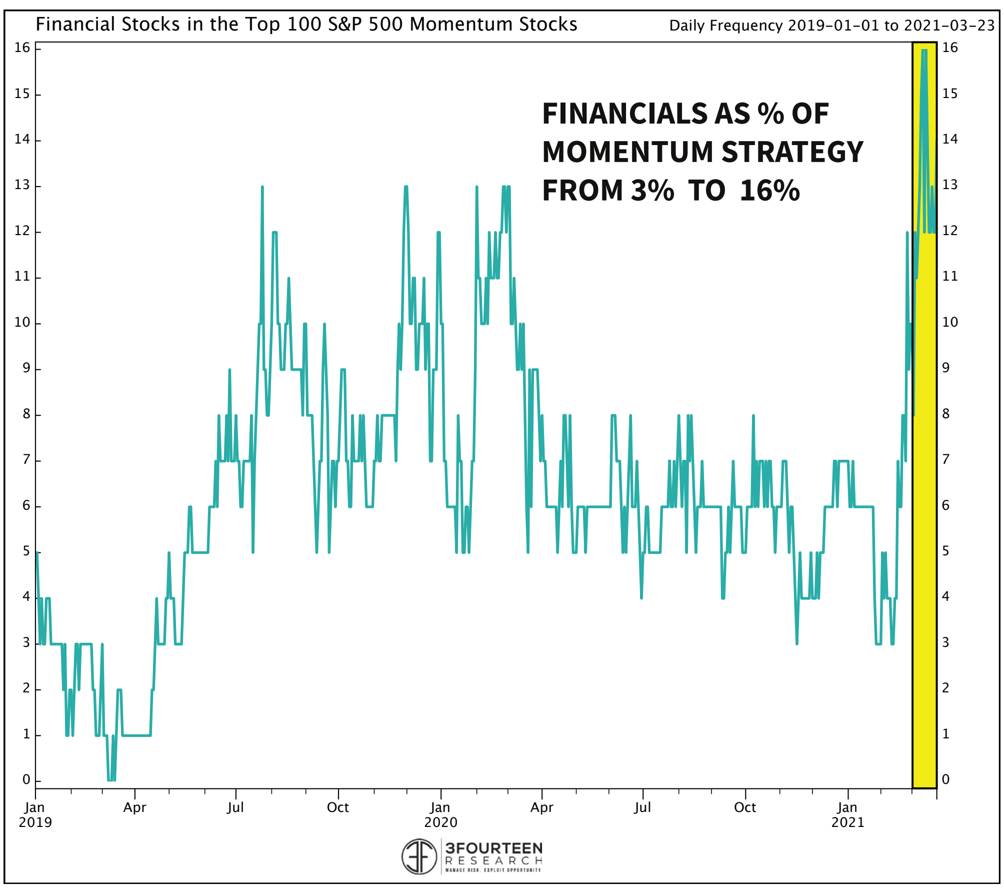


HIGHLIGHTED AREA = FUTURE DATA

The upshot of this massive rebalance: Momentum managers will be buying Cyclical stocks and selling Defensive stocks at a record pace. The underlying portfolio shift will be dramatic and has the potential to power certain sectors over the coming months. In the chart to the left, we calculate the percentage of our hypothetical momentum portfolio invested in Cyclical stocks. **Throughout 2020, Cyclicals made up ~30-40% of the portfolio. By late March, this number will jump above 60%.**

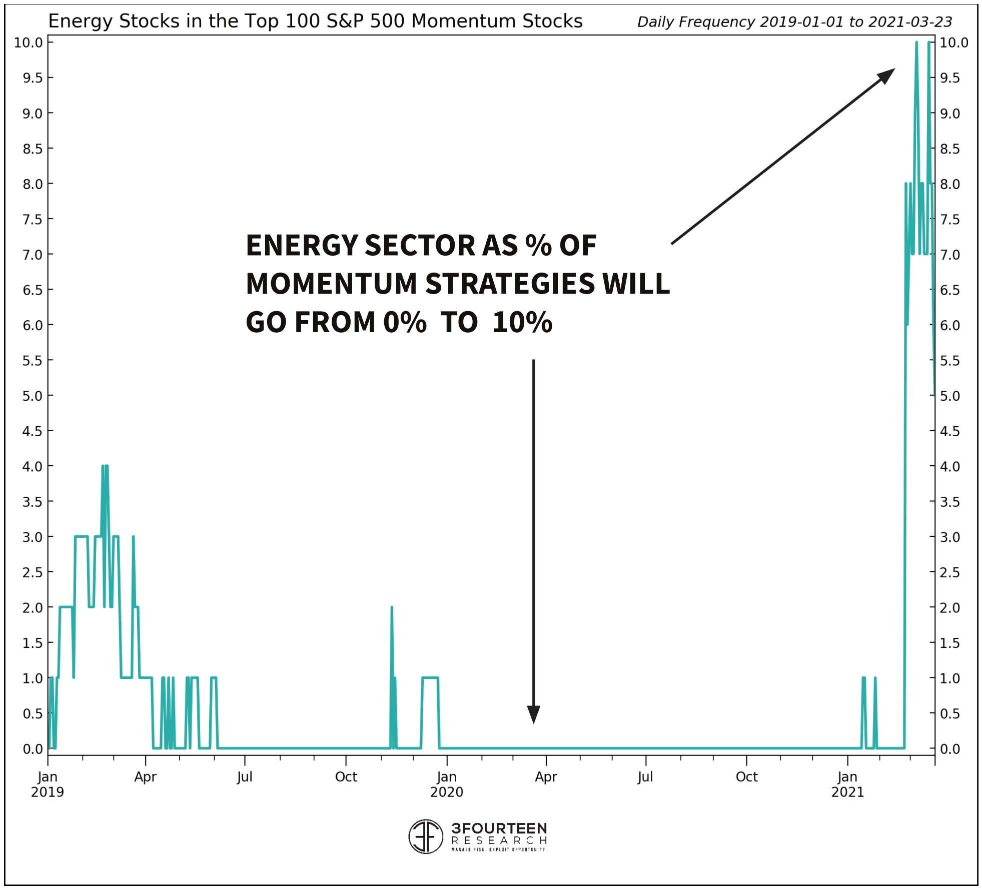
At the sector-level, momentum funds will be buying Consumer Discretionary, Energy, and Financials. To make room for these new additions, PMs will be selling Tech and Healthcare. In the chart to the right, we plot the percentage change that each sector will experience in our momentum portfolio as we move from February to March. Positive bars indicate sector additions. Negative bars indicate sector deletions.



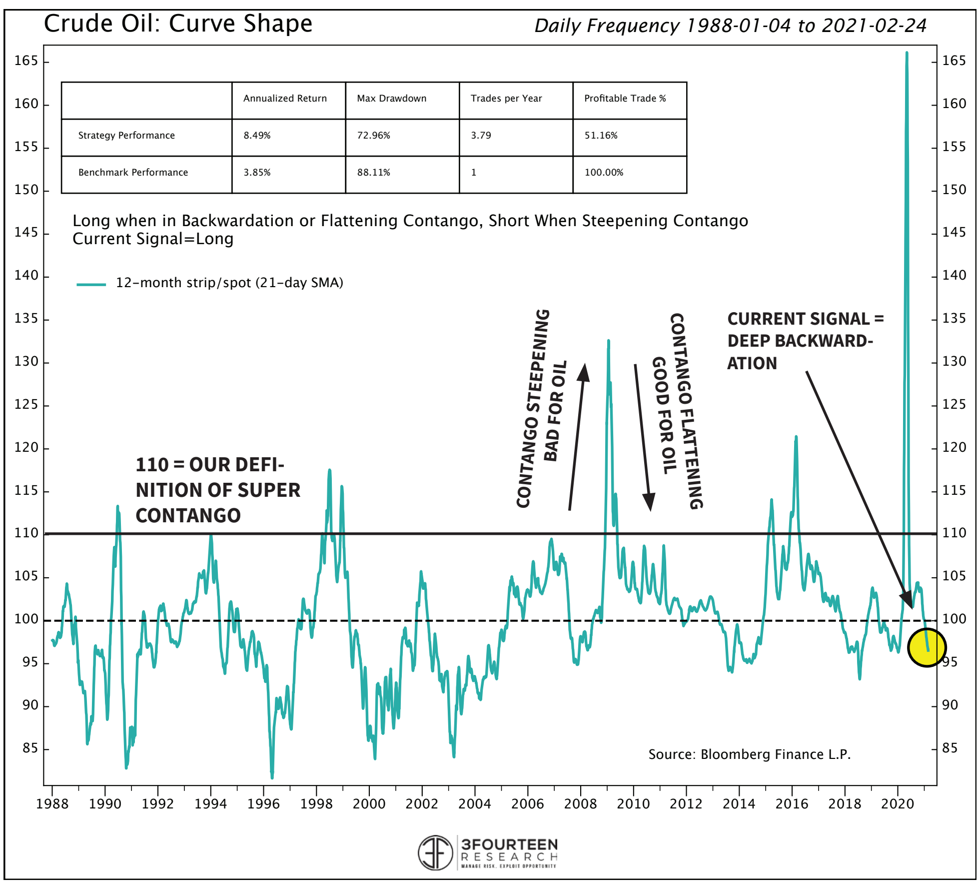


The stars are aligned for the Financial Sector to continue its outperformance. From early February to early March, we calculate that the Sector's share of our hypothetical momentum strategy will increase from 3% of the portfolio to 16% (chart left). The Sector is set up to receive these flows at a time when the macro backdrop looks particularly positive. The rise in bond yields boosts net interest margins for banks and reinvestment rates for insurers. Simultaneously, buyback restrictions are loosening. Of course, all of this is occurring while the reopening boom draws closer. **We reiterate our XLF recommendation with additional picks at the end of this report.**

By next month, momentum investors will return to the Energy Sector for the first time in years. Throughout 2020, Energy stocks had no place in momentum strategies. Now, however, the Sector is poised to grab a meaningful share of these funds. Energy's share of our hypothetical momentum strategy will go from 0% to 10% over the next month (chart right). Given Energy's tiny market cap (less than 3% of S&P 500), these flows could have an outsized impact on the group.



Just like the Financial Sector, this dynamic is occurring during a time when the fundamental backdrop has improved. Oil prices have rallied into the mid-$60s. Backwardation on the curve is steepening (implying a tight market – chart below).



As we said a couple of weeks ago: "At current oil prices, many energy equities do not need substantially higher prices to offer attractive returns. At $40 per barrel, a bet on energy is an implied bet on higher oil as well. At $60, these stocks work so long as oil simply holds steady."

On the next page, we display all 55 stocks that will be entering and exiting the momentum strategy described on page two. **Sorting through this list reinforces the ultimate point of this report: The coming turnover will be a boon for cyclical stocks—specifically the Financial and Energy Sectors.** One additional point is worth noting. The combined market cap of the stocks exiting these portfolios is ~$5 trillion. The combined market cap of the group entering the portfolio is only ~$1 trillion. The inflows will likely have a bigger impact than the outflows.

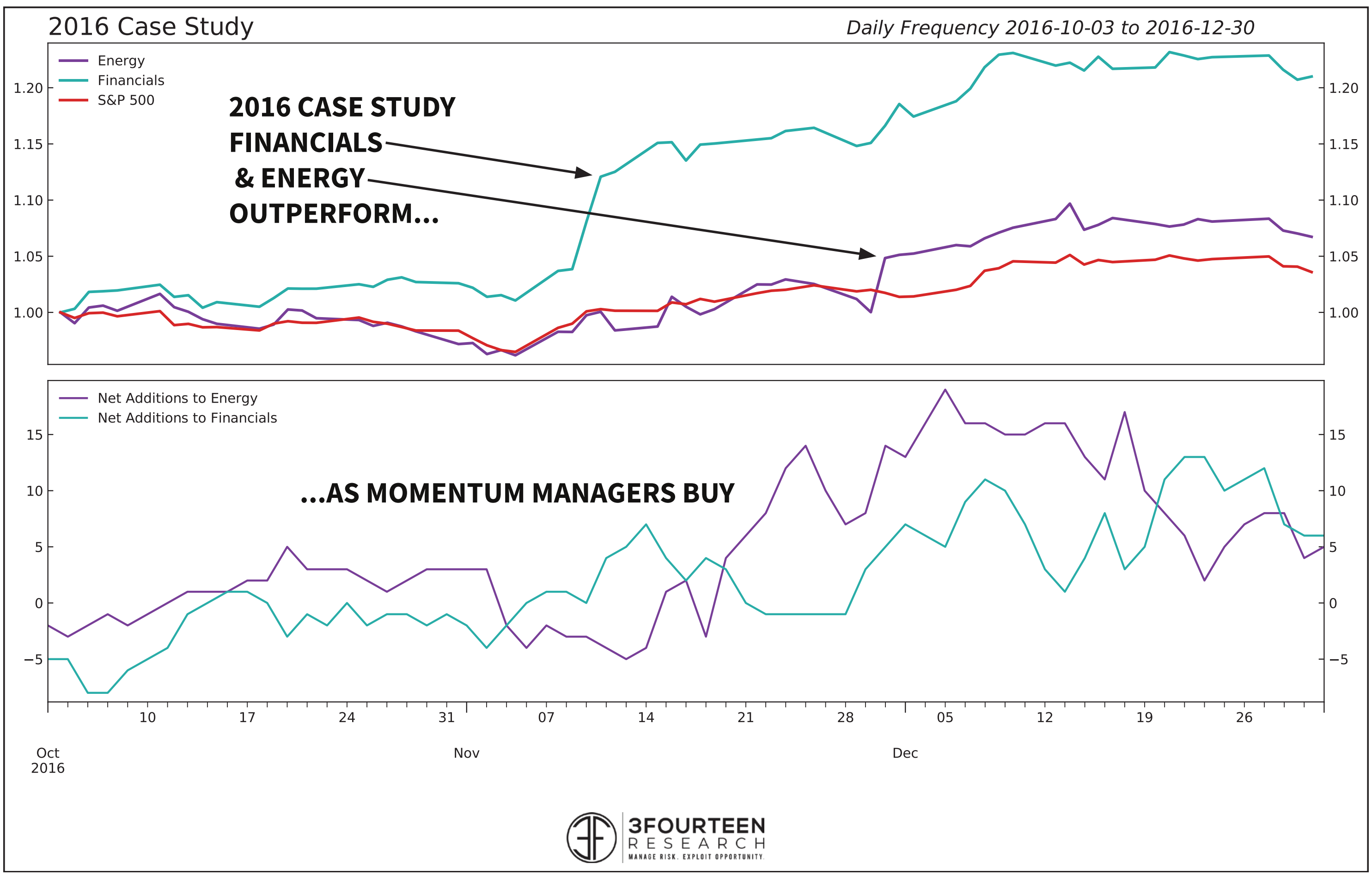
FEBRUARY: WILL BE SOLD				MARCH: WILL BE BOUGHT			
Ticker	**Sector**	**12-mo Today**	**12-mo March**	**Ticker**	**Sector**	**12-mo Today**	**12-mo March**
TT	Industrials	32%	84%	LYB	Basic Materials	12%	144%
CTVA	Basic Materials	36%	109%	LEN	Consumer Discretionary	24%	184%
ALB	Basic Materials	75%	120%	LKQ	Consumer Discretionary	13%	135%
DD	Basic Materials	44%	117%	LYV	Consumer Discretionary	1%	194%
TMUS	Communication Services	31%	64%	MGM	Consumer Discretionary	1%	405%
EBAY	Consumer Discretionary	61%	100%	MHK	Consumer Discretionary	13%	159%
NKE	Consumer Discretionary	38%	111%	NCLH	Consumer Discretionary	-53%	242%
NFLX	Consumer Discretionary	42%	71%	PHM	Consumer Discretionary	1%	138%
PKG	Consumer Discretionary	33%	48%	PVH	Consumer Discretionary	7%	178%
AMZN	Consumer Discretionary	55%	81%	RCL	Consumer Discretionary	-36%	256%
POOL	Consumer Discretionary	52%	75%	SEE	Consumer Discretionary	27%	148%
NWL	Consumer Staples	31%	97%	TPR	Consumer Discretionary	29%	191%
TGT	Consumer Staples	60%	85%	UA	Consumer Discretionary	16%	159%
MNST	Consumer Staples	31%	64%	UAA	Consumer Discretionary	21%	169%
FRC	Financial Services	34%	93%	ULTA	Consumer Discretionary	-1%	151%
MKTX	Financial Services	63%	81%	KMX	Consumer Discretionary	28%	152%
MSCI	Financial Services	32%	95%	GPS	Consumer Discretionary	27%	203%
WST	Healthcare	68%	99%	WYNN	Consumer Discretionary	-19%	188%
TMO	Healthcare	45%	59%	DISCK	Consumer Discretionary	21%	142%
MTD	Healthcare	62%	68%	FBHS	Consumer Discretionary	22%	139%
PKI	Healthcare	51%	107%	DHI	Consumer Discretionary	25%	176%
LLY	Healthcare	43%	41%	EXPE	Consumer Discretionary	17%	252%
A	Healthcare	46%	86%	CCL	Consumer Discretionary	-51%	163%
DHR	Healthcare	44%	83%	DRI	Consumer Discretionary	7%	287%
BIO	Healthcare	48%	78%	SYY	Consumer Staples	-0%	143%
ALXN	Healthcare	52%	89%	PXD	Energy	-7%	135%
ABT	Healthcare	35%	57%	BKR	Energy	7%	143%
ABMD	Healthcare	92%	122%	OXY	Energy	-46%	143%
WAT	Healthcare	32%	59%	OKE	Energy	-45%	197%
DXCM	Healthcare	36%	116%	MRO	Energy	-24%	169%
ROL	Industrials	42%	47%	MPC	Energy	-16%	216%
CMI	Industrials	40%	100%	HAL	Energy	-13%	338%
CAT	Industrials	40%	108%	WMB	Energy	2%	144%
AOS	Industrials	33%	56%	FANG	Energy	-12%	324%
UPS	Industrials	52%	62%	DVN	Energy	-18%	283%
PCAR	Industrials	31%	71%	LNC	Financial Services	-17%	178%
ODFL	Industrials	38%	92%	FITB	Financial Services	10%	192%
TTWO	Technology	78%	83%	DFS	Financial Services	21%	242%
TXN	Technology	31%	79%	KEY	Financial Services	-4%	144%
KEYS	Technology	44%	68%	COF	Financial Services	9%	169%
NOW	Technology	65%	108%	RF	Financial Services	16%	173%
MXIM	Technology	43%	120%	CMA	Financial Services	2%	140%
IPGP	Technology	73%	100%	AMP	Financial Services	18%	133%
GOOGL	Technology	35%	93%	SYF	Financial Services	12%	172%
GOOG	Technology	36%	94%	CFG	Financial Services	5%	174%
GLW	Technology	33%	77%	LH	Healthcare	17%	128%
FTNT	Technology	31%	122%	HCA	Healthcare	21%	159%
FFIV	Technology	56%	120%	ALK	Industrials	-17%	148%
ATVI	Technology	45%	83%	PH	Industrials	28%	167%
ANSS	Technology	30%	78%	TDG	Industrials	-5%	141%
ANET	Technology	42%	74%	SPG	Real Estate	-32%	143%
ADSK	Technology	45%	117%	VTR	Real Estate	-19%	203%
AAPL	Technology	72%	111%	DXC	Technology	-11%	180%
PAYC	Technology	35%	113%	WDC	Technology	-13%	135%
XLNX	Technology	53%	87%	AES	Utilities	24%	197%

Has momentum ever experienced a rebalancing like the one upcoming this Spring? In short, we don't believe there is a true parallel. However, late-2016 provides the closest possible analog. Back then, our hypothetical momentum strategy experienced its second largest turnover ever. Also, like now, the Financial and Energy Sectors were primary beneficiaries of the portfolio undercurrents. In the chart below, we plot those sectors versus the S&P 500 during the fourth quarter of 2016 on the top clip and each sector's gaining share of our momentum portfolio in the bottom clip. As momentum strategies tilted into Financials and Energy, both sectors outperformed the broad market.

Still, we are hesitant to draw exact parallels to any point in the past. Since 2016, dedicated momentum ETFs and Mutual Fund assets have grown by ~500%. And, as we stated earlier, momentum's reach extends beyond this discrete group of investment vehicles. All else equal, we believe that the upcoming momentum turnover will have an unprecedented impact on these cyclical sectors, which should feed the ongoing equity rotation.

CONCLUSIONS

- **Next month will usher in the most dramatic rebalance of momentum-based strategies ever.**
- **Dedicated momentum strategies have grown by 500% in the last five years, and momentum's reach as a selection criterion likely extends far beyond these dedicated funds.**
- **Momentum funds will be buying large amounts of Financials + Consumer Discretionary + Energy stocks, and selling Tech + Healthcare.**
- **We reiterate our existing list of picks within these sectors (MPC, VLO, SU, CNQ, ENB, & XLF). See – Deus Ex Machina, Warm Embrace of Consensus, and The Great Yield Famine for our previous commentary.**
- **To this list, we add the following Financial stocks poised to benefit from the economic backdrop/stimulus bill and momentum flows: LNC, COF, & DFS.**
- **We list all stocks in our theoretical momentum portfolio on pages 9-10 of the Appendix. In the left-hand table, we list the constituents as of today. In the right-hand table, we list the constituents in early March.**



APPENDIX

🔴 PORTFOLIO DELETION 🟢 PORTFOLIO ADDITION

FEBRUARY				MARCH			
Ticker	Sector	12-mo Today	12-mo March	Ticker	Sector	12-mo Today	12-mo March
🔴 CTVA		36%	109%	VIAC		48%	414%
VIAC		48%	414%	🟢 BKR		7%	143%
🔴 TT		32%	84%	MOS	Basic Materials	50%	303%
MOS	Basic Materials	50%	303%	FCX	Basic Materials	148%	591%
FCX	Basic Materials	148%	591%	🟢 LYB	Basic Materials	12%	144%
🔴 ALB	Basic Materials	75%	120%	EMN	Basic Materials	41%	188%
🔴 DD	Basic Materials	44%	117%	🟢 LYV	Consumer Discretionary	1%	194%
EMN	Basic Materials	41%	188%	🟢 UAA	Consumer Discretionary	21%	169%
🔴 TMUS	Communication Services	31%	64%	LOW	Consumer Discretionary	40%	174%
🔴 EBAY	Consumer Discretionary	61%	100%	🟢 MGM	Consumer Discretionary	1%	405%
DISCA	Consumer Discretionary	36%	155%	ETSY	Consumer Discretionary	314%	483%
🔴 NFLX	Consumer Discretionary	42%	71%	🟢 GPS	Consumer Discretionary	27%	203%
ETSY	Consumer Discretionary	314%	483%	GM	Consumer Discretionary	57%	215%
F	Consumer Discretionary	41%	156%	🟢 MHK	Consumer Discretionary	13%	159%
🔴 NKE	Consumer Discretionary	38%	111%	🟢 RCL	Consumer Discretionary	-36%	256%
LB	Consumer Discretionary	100%	414%	🟢 KMX	Consumer Discretionary	28%	152%
CMG	Consumer Discretionary	60%	217%	🟢 FBHS	Consumer Discretionary	22%	139%
NWS	Consumer Discretionary	32%	147%	LB	Consumer Discretionary	100%	414%
🔴 PKG	Consumer Discretionary	33%	48%	F	Consumer Discretionary	41%	156%
🔴 AMZN	Consumer Discretionary	55%	81%	🟢 EXPE	Consumer Discretionary	17%	252%
LOW	Consumer Discretionary	40%	174%	🟢 WYNN	Consumer Discretionary	-19%	188%
🔴 POOL	Consumer Discretionary	52%	75%	🟢 ULTA	Consumer Discretionary	-1%	151%
APTV	Consumer Discretionary	61%	356%	🟢 LKQ	Consumer Discretionary	13%	135%
GM	Consumer Discretionary	57%	215%	NWSA	Consumer Discretionary	40%	129%
TSLA	Consumer Discretionary	395%	994%	🟢 TPR	Consumer Discretionary	29%	191%
TSCO	Consumer Discretionary	49%	136%	🟢 PHM	Consumer Discretionary	1%	138%
NWSA	Consumer Discretionary	40%	129%	APTV	Consumer Discretionary	61%	356%
🔴 NWL	Consumer Staples	31%	97%	🟢 PVH	Consumer Discretionary	7%	178%
🔴 TGT	Consumer Staples	60%	85%	🟢 CCL	Consumer Discretionary	-51%	163%
🔴 MNST	Consumer Staples	31%	64%	🟢 LEN	Consumer Discretionary	24%	184%
🔴 MSCI	Financial Services	32%	95%	NWS	Consumer Discretionary	32%	147%
🔴 MKTX	Financial Services	63%	81%	TSLA	Consumer Discretionary	395%	994%
SIVB	Financial Services	87%	257%	CMG	Consumer Discretionary	60%	217%
PYPL	Financial Services	121%	218%	🟢 NCLH	Consumer Discretionary	-53%	242%
🔴 FRC	Financial Services	34%	93%	🟢 SEE	Consumer Discretionary	27%	148%
MS	Financial Services	30%	147%	🟢 UA	Consumer Discretionary	16%	159%
🔴 A	Healthcare	46%	86%	🟢 DHI	Consumer Discretionary	25%	176%
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ALGN	Healthcare	128%	312%	🟢 PXD	Energy	-7%	135%
🔴 ALXN	Healthcare	52%	89%	🟢 WMB	Energy	2%	144%
IDXX	Healthcare	72%	173%	🟢 FANG	Energy	-12%	324%

FEBRUARY				MARCH			
CTLT	Healthcare	91%	221%	DVN	Energy	-18%	283%
DHR	Healthcare	44%	83%	SYF	Financial Services	12%	172%
DXCM	Healthcare	36%	116%	AMP	Financial Services	18%	133%
BIO	Healthcare	48%	78%	SIVB	Financial Services	87%	257%
ZBRA	Industrials	72%	165%	CFG	Financial Services	5%	174%
ROL	Industrials	42%	47%	CMA	Financial Services	2%	140%
AOS	Industrials	33%	56%	COF	Financial Services	9%	169%
PWR	Industrials	88%	185%	DFS	Financial Services	21%	242%
PCAR	Industrials	31%	71%	LNC	Financial Services	-17%	178%
ODFL	Industrials	38%	92%	RF	Financial Services	16%	173%
CMI	Industrials	40%	100%	FITB	Financial Services	10%	192%
CAT	Industrials	40%	108%	PYPL	Financial Services	121%	218%
UPS	Industrials	52%	62%	KEY	Financial Services	-4%	144%
FDX	Industrials	56%	157%	MS	Financial Services	30%	147%
URI	Industrials	69%	311%	CTLT	Healthcare	91%	221%
DE	Industrials	86%	191%	HCA	Healthcare	21%	159%
TXN	Technology	31%	79%	HOLX	Healthcare	59%	162%
AAPL	Technology	72%	111%	IDXX	Healthcare	72%	173%
TER	Technology	86%	209%	ILMN	Healthcare	43%	132%
ANET	Technology	42%	74%	ALGN	Healthcare	128%	312%
IPGP	Technology	73%	100%	LH	Healthcare	17%	128%
AMD	Technology	54%	130%	ZBRA	Industrials	72%	165%
GOOGL	Technology	35%	93%	PH	Industrials	28%	167%
KEYS	Technology	44%	68%	FDX	Industrials	56%	157%
KLAC	Technology	74%	155%	URI	Industrials	69%	311%
TEL	Technology	40%	147%	DE	Industrials	86%	191%
ADSK	Technology	45%	117%	ALK	Industrials	-17%	148%
TTWO	Technology	78%	83%	PWR	Industrials	88%	185%
TWTR	Technology	48%	237%	TDG	Industrials	-5%	141%
AMAT	Technology	58%	213%	VTR	Real Estate	-19%	203%
SWKS	Technology	53%	167%	SPG	Real Estate	-32%	143%
FTNT	Technology	31%	122%	TWTR	Technology	48%	237%
ANSS	Technology	30%	78%	WDC	Technology	-13%	135%
FFIV	Technology	56%	120%	TER	Technology	86%	209%
MCHP	Technology	34%	179%	LRCX	Technology	60%	209%
LRCX	Technology	60%	209%	SWKS	Technology	53%	167%
MU	Technology	41%	161%	SNPS	Technology	66%	136%
MXIM	Technology	43%	120%	QRVO	Technology	62%	144%
GOOG	Technology	36%	94%	QCOM	Technology	68%	136%
NOW	Technology	65%	108%	NVDA	Technology	84%	196%
NVDA	Technology	84%	196%	MU	Technology	41%	161%
CDNS	Technology	74%	160%	MCHP	Technology	34%	179%
PAYC	Technology	35%	113%	KLAC	Technology	74%	155%
XLNX	Technology	53%	87%	DXC	Technology	-11%	180%
AVGO	Technology	51%	194%	CDNS	Technology	74%	160%
ATVI	Technology	45%	83%	AVGO	Technology	51%	194%
GLW	Technology	33%	77%	AMD	Technology	54%	130%
QRVO	Technology	62%	144%	AMAT	Technology	58%	213%
SNPS	Technology	66%	136%	TEL	Technology	40%	147%
QCOM	Technology	68%	136%	AES	Utilities	24%	197%

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