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The Impact of Factor Exposures on the McKinley Capital Equity Income Portfolios

In managing its equity income portfolios, McKinley Capital Management, LLC ("McKinley Capital") seeks U.S. traded stocks of companies that pay above average dividends and that the firm believes are likely to increase dividend amounts in the future. This portfolio strategy, if successful, is expected to generate considerable levels of current income along with some capital appreciation. Over the past thirteen years[1] (3/31/2001 to 3/31/2014), the annualized gross return of the U.S. Equity Income Wrap composite was 11.26% (10.54% net). Of that amount, the annualized dividend amount was 7.71%, with the balance due to capital appreciation. For comparison, over the same time frame, the S&P 500 index had an annualized return of 5.81%.

The McKinley Capital equity income portfolios are moderately defensive in nature. For the same thirteen years, the U.S. Equity Income Wrap composite return standard deviation was 12.28% compared to 15.25% for the S&P 500. The up capture versus the down capture comparison was 79.42% compared to 54.29% using S&P 500 returns as the calculation base over the same time period.

The performance of these portfolios can be explained through the use of factor exposures. Table 1 below shows important Barra factor exposures and contribution to active return for each of the six years from 2008 to 2013[2].

As intended, the most significant Barra defined exposure is yield, with a 2.29 annual average. Exposure to yield assists in explaining the defensive character of the portfolios. In four of the five positive market years from 2009 to 2013 the contribution to active return of the yield exposure was negative. In the down year of 2008, yield exposure provided a large positive contribution to active return. The exception was the strong up-market year of 2010, in which the search for income in this era of low interest rates led to increased purchases of high yielding equities.

The other intended Barra defined exposure is momentum, with a 0.26 annual average. As is the case for all McKinley Capital managed portfolios, the preference is for stocks that have already been outperforming prior to purchase. The contribution to active return for the momentum exposure has varied, but was significantly negative in 2009 when momentum, as a factor, was greatly out of favor.

In seeking U.S. traded equities with exceptional and growing dividends, McKinley Capital often identifies for purchase certain kinds of stocks in selected industries. The holdings often concentrate in Master Limited Partnerships ("MLPs"), Business Development Companies ("BDCs"), Real Estate Investment Trusts ("REITs"), and high yield U.S. common stocks and ADRs. This focus often leads to a concentrated exposure to energy and oil, real estate, brokerage, utility, tobacco, and telecommunications industries. In general, these kinds of stocks are smaller, less liquid, and more leveraged than the largest S&P 500 securities. While not strictly intended, McKinley Capital understands these industry and factor exposures are a by-product of selecting securities with the highest yield, and observes that these kinds of exposures often lead to positive active returns.

For example, the equity income portfolios are exposed to smaller stocks, with a Barra size factor exposure averaging -1.25 over the last six years. This small size exposure has added an average of 3.18% per year to the active return of the composite. The exposure to leverage averaged 0.72 annually and added an average of 0.30% per year to the active return.

[1] 2001 is when McKinley Capital began to compute monthly returns data.
[2] These are the years for which McKinley Capital has accurate Barra factor exposure and factor return data for the equity income portfolios. All active exposures data is versus the Russell 1000 Index.

The exposure to liquidity averaged -0.60 annually, but was not an important contributor to active return. Contribution to active return due to concentrated industry exposure varied year to year, but averaged a positive 0.83%. Finally, asset selection contributed an average of 0.55% per year to active return.

Interestingly, the portfolios were not significantly exposed to the Barra growth or value factors and these limited exposures did not yield a significant contribution to or detraction from active return. McKinley Capital is a growth manager whose process focuses on growth acceleration measures – upward analyst earnings and dividend expectations, earnings and dividend surprises, etc. The firm understands Barra growth definitions are, however, based primarily on absolute levels of growth and not on the consideration of acceleration.

McKinley Capital's Equity Income portfolios seek to provide a total return in excess of the S&P 500 over full market cycles with lower volatility and a considerable level of current income. These goals have been realized. In summary, the firm shows how the portfolio returns can be explained by analyzing Barra factor exposures like yield, momentum, size, liquidity, leverage, industry, and asset selection. As always, your McKinley Capital account representative is available to discuss the firm's research and investment process, and answer your questions.

TABLE 1: BARRA FACTOR EXPOSURE ANALYSIS

	2013	2012	2011	2010	2009	2008	Average
Composite Return (Gross)	24.39	9.09	8.17	27.11	27.54	-30.12	8.85
Russell 1000	33.11	16.42	1.50	16.10	28.43	-37.60	8.18
Excess Return (Russell 1000)	-8.72	-7.33	6.67	11.01	-0.89	7.48	1.37
S&P 500	32.39	16.00	2.11	15.06	26.46	-37.00	6.24
Excess Return (S&P 500)	-8.00	-6.91	6.06	12.05	1.08	6.88	2.61
Risk Attribution							
Yield Exposure	2.21	2.22	2.30	2.34	2.09	2.09	2.21
Return Contribution	-3.33	-7.26	-0.14	4.86	-1.70	2.98	-0.77
Momentum Exposure	0.25	0.24	0.33	0.34	0.21	0.21	0.26
Return Contribution	-0.35	-0.35	1.18	1.00	-6.21	-0.29	-0.84
Growth Exposure	0.25	0.30	0.28	0.07	-0.07	-0.05	0.13
Return Contribution	-0.23	-0.57	-0.12	0.05	-0.48	0.04	-0.22
Value Exposure	0.27	0.13	0.09	-0.05	-0.06	0.08	0.08
Return Contribution	0.18	0.04	-0.22	-0.18	0.10	-0.29	-0.06
Size Exposure	-1.53	-1.22	-1.33	-1.11	-1.02	-1.27	-1.25
Return Contribution	1.32	-1.40	1.81	6.59	6.14	4.64	3.18
Size Non-Linearity Exposure	-0.64	-0.45	-0.50	-0.33	-0.31	-0.45	-0.45
Return Contribution	-0.07	0.10	-0.42	-1.23	-2.02	1.04	-0.43
Leverage Exposure	0.97	0.72	0.70	0.66	0.66	0.61	0.72
Return Contribution	2.67	2.43	-0.16	1.04	0.01	-4.19	0.30
Liquidity Exposure	-0.30	-0.68	-0.75	-0.66	-0.66	-0.56	-0.60
Return Contribution	0.02	-0.32	1.77	-0.73	-3.33	1.97	-0.10
Industry Attribution							
Industry Selection Return Contribution	-4.33	0.49	-0.98	1.23	9.72	-1.16	0.83
Asset Selection Return Contribution	-3.40	-0.22	6.55	2.45	-4.50	2.42	0.55

Source: *Barra UB3, McKinley Capital Management, LLC., 5/24/2014.*

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