Eyes on the Fed

Investors have plenty to worry about nowadays, but the impact of inflation on the global economy appears to be at the top of the list. Central banks around the world, including the U.S. Federal Reserve, have been hiking interest rates aggressively to stem price increases. As a result, many economists have warned that a recession could be around the corner.

Inflationary pressures create a huge challenge for investors who want to participate in the markets but see an uncertain future ahead. What happens if the Fed raises rates too much or too little? How do investors position themselves appropriately? One possibility is to adjust portfolio holdings based on Fed policy actions. Economic Index Associates (EIA) has partnered with Nasdaq to introduce the Nasdaq *IFED* US Large-Cap Index™ (*IFED-L™*), which allows investors to do just that.

EIA was co-founded by three academics – Bob Johnson, Gerry Jensen and Luis Garcia-Feijoo – their research focuses on Fed policy and capital market investments. The three have worked in various capacities for the CFA Institute and have taught at Creighton University, but not all at the same time.

Academics are strongly encouraged to publish and the three liked working together, so, over the course of 25 years, they co-authored many articles. One notable article appeared in the CFA Institute's *Financial Analyst Journal*. The article showed that the small firm and value effects were concentrated in expansive Fed monetary environments. In other words, small-cap and value investors could benefit in periods when monetary policy was easy; however, the benefit disappeared when Fed policy was restrictive. Over time, they discovered a relationship between security returns and Fed policy in nearly every dataset examined, including stocks, commodities, real estate and bonds.

In 2013, they began distilling that body of knowledge into a book entitled, *Invest with the Fed™,* which presented the different ways that monetary policy effects the capital markets. The book gained much acclaim, including being covered by the *Wall Street Journal*. EIA's co-founders were subsequently invited to speak on the topic at multiple ETF conferences, where the book was distributed to attendees. The research was so well received that many investors expressed a strong desire to put these ideas into action.

"I would almost call us the reluctant indexers, because when we designed the *IFED™* model and created Economic Index Associates, we had to be pushed to do it," exclaimed Johnson, EIA's chairman and CEO.

The *IFED™* model relies on Fed policy signals to classify market conditions into one of three environments: expansive, restrictive or indeterminate. The model selects a portfolio of stocks best positioned to prosper during the identified market environment.

The process starts by assigning an *IFED™* score to all companies listed on Nasdaq and the NYSE that have a minimum of three years of required accounting data and price history. As of year-end 2021, 2,940 stocks had *IFED™* scores, which range from -4 to 4. The scores reflect twelve financial metrics that are commonly used by financial analysts. They are market cap, long- and short-term past stock performance, relative value, dividend yield, cash holdings, residual variability, level and change in net operating assets, equity issuance, debt ratio and gross profit margin. Stocks are then selected and weighted according to their *IFED™* score. This contrasts with the traditional approach of weighting by market capitalization. Furthermore, the approach also contrasts with smart beta and factor approaches, which are generally static. The *IFED™* strategy adjusts portfolio composition with changing market conditions, making it a dynamic strategy.

The *IFED™* strategy is transparent, rules-based and replicable. It rebalances when necessary to maintain alignment with changing market conditions, which equates to about twice a year on average. The strategy's design allows it to capture upside potential while limiting downside risk by being fully invested in equities that are environment-aligned and have robust firm-specific metrics. Moreover, it can be customized to meet client constraints and requests.

Unlike investment strategies that apply smart beta or factor approaches, which are invariant across market environments, the *IFED™* model recognizes that firm-specific return drivers contribute to returns differently across market environments. For example, in restrictive environments, when cash is tight and expensive to access, cash holdings on a company's balance sheet are viewed favorably. In contrast, during expansive environments, when cash is readily available and cheap to access, cash holdings are less important. As such, in the *IFED™* model, cash holdings are a counted factor in restrictive periods but not in expansive periods.

"The four most dangerous words in the English language with respect to investments are 'this time is different,'" Johnson warns. "What we found in our research is that these relationships have been consistent through time," he says, adding that the model is based on research that investigates return patterns going back to the 1960s.

Admittedly, the Nasdaq *IFED* US Large-Cap Index™ has not beat the market every year. There have been some periods of underperformance, especially when the markets have been under pressure from extreme events such as the pandemic, financial crisis and major trade tensions. That said, Fed actions are based on those events as well, so in some sense, the patterns are only temporarily obscured by such unusual events.

"Our model picks up a forward-looking element because the Fed is looking toward the future when it makes policy decisions," says Jensen, EIA's Director and Chief Investment Officer. "When the Fed signals a policy shift, it has an impact now, but it also reflects what is predicted to happen down the road."

IFED-L™ is EIA's first index with Nasdaq affiliation. The efficacy of the *IFED™* approach is supported by *IFED-L™*'s outperformance relative to the S&P 500. As of July 31, 2022, *IFED-L™* has produced a 21.30% total alpha since its launch over two years ago. Furthermore, over the past two plus years, *IFED-L™* has been the best performing large-cap equity index.

Year-to-date, through July 2022, *IFED-L™* has outperformed the S&P 500 by 12.62%. The index has also produced an impressive average annual alpha of 7.58% versus the S&P 500 over its 22+ year back-tested history. In September 2021, UBS launched two ETNs (*IFED and FEDL*) that track *IFED-L™*.

EIA has also developed several prototype indexes including: an all-cap, a large/mid-cap, a mid-cap and a small-cap. Ultimately, EIA and Nasdaq anticipate that several products – including ETFs, structured products and insurance products – will track their jointly created indexes.

Some strategies go in and out of vogue, but the *IFED™* strategy is an all-weather approach due to the adjustments it incorporates in response to changing market environments. The index provides an investment vehicle that allows investors to shift their strategy with market conditions. When Fed policy signals a shift in the market environment, the holdings in *IFED-L™* change. Investors may choose to focus on an array of factors – from growth and value to momentum, dividends and more. But as Jensen says, "We integrate all of those things. Based on the market environment, we decide which return drivers to emphasize. Instead of focusing on just one financial metric, we consider twelve different factors."

UBS and Nasdaq were convinced to partner with EIA based on the founders' rigorous research that backed the *IFED™* strategy and because the concept is intuitively appealing. For two years, Nasdaq and UBS put the strategy through a stringent due diligence process to ensure it was quantitatively robust and based on sound economic principles.

"One of the huge advantages of the relationship with Nasdaq is that it gives us exposure to a much larger audience," Jensen concludes. "It provides us with credibility and allows us to get traction in the marketplace."