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Transcript of the Mullooly Asset Management podcast #180, Our Interview with Christopher Gannatti, Associate Director of Research at WisdomTree

Tom: Okay, welcome back to the podcast. Our guest today is Christopher Gannatti. Christopher's the associate director of research at Wisdom Tree Asset Management. Christopher began at Wisdom Tree as a research analyst in 2010, he worked directly with Jeremy Schwartz, the director of research. Christopher is out there communicating Wisdom Tree's thoughts on the markets, and analyzing existing strategies and developing new approaches. Prior to Wisdom Tree, Christopher was at Lord Abbett, where he worked as a regional consultant. I'd also mention that he received his MBA in quantitative finance, accounting, and economics from the NYU's Stern School of Business, and is a graduate of Colgate University as well. Christopher, welcome to the podcast.

Christopher G.: Tom, thanks for having me today. It's a real pleasure.

Tom: Well we're glad you could join us and Christopher you're also a CFA, so I'll kick off with this one. With all your experience now on Wall Street, have you ever seen a market that's so baffling to so many?

Christopher G.: Tom, I appreciate that because, you know, it's that time of the year where those charter holders and not quite yet charter holders are getting those books out and studying. I certainly remember my own journey and process there. Looking at the markets, we're in a strange reality where you can point to these distinct events where prior to the events happening you would say unequivocally if this happens the market absolutely will go down. We can go ... Let's talk about Brexit. Basically almost a year ago at this point, Brexit happened, within a couple weeks market goes up. We look back at the Donald Trump election. At the time it, even though the polls were close leading up to it, we look back in hindsight and view it as a shock what happened. Maybe the markets went down in the overnight, but then ultimately went up.

The Italian referendum in December, markets went up. It seems each event that happens these days, the markets react to it and then proceed to go ever higher. A lot of people find that perplexing because it's not as though it's only been a year or so that the markets have been going up. The markets, especially the U.S. market, has been going up for the better part of a decade, and until more recently the U.S. market has, more or less, been outperforming most other markets out there, leading a lot of people to say, "Why would I own anything but the S&P 500 Index given ultimately what has transpired?" It created, what we feel, to be a lot of interesting opportunities, but you're absolutely right. At times, getting some of that political commentary in there, it feels downright perplexing.

Tom: Talking about perplexing and baffling, I forget if the old adage is, is it two steps and a stumble, or three steps and a stumble? The Federal Reserve's been on the sidelines for such a long period of time and now they finally started raising rates. There are so many opinions out there about this is, you know, they're moving too fast or they're behind the curve. What, in your opinion, will Yellen and her team have on equity prices at the rate they're moving now?

Christopher G.: It's a phenomenal question because we all can remember the 2016 year where we spent basically 12 months talking about what ended up as one interest rate hike. Even though throughout the course of the year, we were each meeting seemingly kind of waiting and thinking and debating, and in the last 10 years, we've seen three hikes, two of them within the last couple months. Most recently at the March meeting and there're kind of a couple lenses through which to look when thinking about the impact on equities. One, has to be the dollar, because the performance of the dollar obviously our U.S. large cap, multinational, export oriented companies, if the dollar is strengthening, that becomes a bit of a challenge for them and it also encourages the small cap companies, which definitely do not export anywhere near to the same extent, so in a strengthening dollar environment, small caps over large caps make a lot of sense and then additionally, the consensus view at the start of this year, which included two maybe three interest rate hikes throughout the course of 2017, was that the U.S. dollar would continue to strengthen.

What's been interesting is even though the Fed took what a lot of people view as the first opportunity, the March meeting, and did in fact raise the interest rate target on Fed funds, the dollar in 2017 thus far has been tending toward weakness and in a weakening dollar environment, some of the things that become interesting are places like emerging markets, which a lot of people would say, "Okay, if in fact a Fed tightening is accompanied by significant dollar strength, that could be a challenge to emerging markets," because we spend a lot of time reminding people if they're investing in emerging market equities, they're really making two investments. One is in the stocks, that's frequently the focused upon move, the other is in the currency, frequently much less focused upon, but in recent years, certainly no less important. In looking at dollar weakness at the start of 2017 and some of the performance of various emerging market indexes, it certainly points to the fact that after a long period of under performance, emerging markets might be doing particularly well, and certainly have been doing particularly well, for about the last 15 months.

Another lens through which to looks is the traditional lens. Thinking about why interest rates are going up. If we're thinking about the Fed, interest rates tend to go up because they're thinking about inflation and at least they're thinking about the potential for future inflation more so then they were when they weren't moving interest rates at all. If we think of the 10-year Treasury, also focused upon and related to the Fed funds. The 10-year Treasury will tend to go up if A, growth expectations are increasing or B, inflation expectations are increasing. We've certainly seen a lot of volatility in the 10-year Treasury but a huge move after the Trump election. In rising interest rate periods we've done the work on this, usually small cap stocks, which are poised to respond better to improvements in growth expectations, have tended be the initial outperformers in those rate hiking and rising rate cycles and we clearly saw that in 2013, when the 10-year Treasury went from 162 on May 2, to 3.03 at the end of the year in 2013.

Then last year, the 10-year Treasury was 136 on July 8, and then at the end of the year it was 244. During those two periods of basically six or seven months, sharp rising interest rates, small cap stocks outperformed in the U.S. Two things to think about, emerging markets outside the U.S., based on what the dollar's been doing this year and then inside the U.S., small cap stocks.

Tom: Okay, so I want to circle back to your comments about the dollar and emerging markets. The reason why is because the Trump administration is now kicking around the idea of a border adjustment tax. Would something like this make international markets, whether they're developed markets or emerging markets, does it make them a little riskier?

Christopher G.: It certainly does from the standpoint of what we have is a drastic change, or at least a potential drastic change, in the policy environment because for the longest time, and I graduated Colgate, as you mentioned in 2006, and remember my economics classes and free-trade was the key theme that was purported to be essentially one of the best things and best ultimate encouragers of global economic growth and prosperity across the board and the feel of late has been more towards trade openness and the breaking down of barriers, as opposed to trade protectionism and the old mercantilist model where ultimately markets think that they can only prosper if they're the ones exporting to the rest of the world and that's it.

A border adjustment tax, depending on how it's structured, the difficulty of analyzing a lot of policy today is it isn't really policy yet. It's kind of conjecture. It's kind of debate. It's kind of concept. But we don't really know the important details and the important footnotes of what that policy would look like. It would be very important for example to know which countries a border adjustment tax would impact. Which industries, which types of products? Would there be certain quotas that would have to be hit before it would be implemented? There're all sorts of open questions, because as of today we don't necessarily know with certainty if there would be such a thing.

One of the things we're looking at within the particular blog that I wrote was, if you think of the concept of developed market exporters, and those developed market exporters could be in Japan, they could be in Europe, they could be anywhere. What we were seeking to remind people was that it's true the U.S. is a huge market, 70% consumption driven in terms of GDP, but there are a lot of other big markets and the U.S. is certainly not 100% of global growth. When you think of large cap multinational exporters around the world, they might certainly export into the U.S., which depending on how a border adjustment tax is structured, might lead them to have to pay a little bit more or lead U.S. consumers to have to pay a little bit more ultimately.

They're also exporting into emerging markets and what's happening in emerging markets now is it seems that emerging markets are at a much healthier point in the cycle say then they were at the beginning of 2016 when times were tough and people were worried about China, and so emerging markets doing better. We have to remember there are billions of people in emerging markets, huge consumer potential, what you've got is these big markets with faster growth prospects than developed markets. If these global multinationals, including even U.S. global multinationals are selling into those markets, and those markets are doing better, it could cancel out some of the potentially negative effect of any sort of trade protectionism, if that's a border adjustment tax, or if that's something else entirely.

Tom: I guess we're going to have to wait and get the details probably in some late night Tweets or some other way to get the information. Switching gears, one of your recent posts made me actually stop and scratch my head. You posed a great question, "Why is it that the Russell 2000 Index is such a popular yardstick?" You know I read that and I stopped myself and I'm like, "You know what, everybody uses that."

Christopher G.: Everybody does.

Tom: Yeah, why has that become so popular because it's really, I hate to use the phrase garbage can, but it includes everything? The good companies, the bad companies, the ugly ones. Everyone's in there, even the red-headed stepchild. Why do people use this yardstick?

Christopher G.: If one of the things that you notice when you look at indexes and performance benchmarks is sometimes if you're viewed as being the first one on the scene, and sometimes you're not even the first one on the scene you're just the first one with the best marketing and you get the most attention on the scene, suddenly the inertia and the momentum is all that you need. People focus initially there and don't tend to focus anywhere else and that could have certainly played a role. I remember my first project that Jeremy Schwartz, our head of research, put me on when I joined Wisdom Tree as you said in 2010, research analyst, is I was looking at the difference between index construction methodology. If you think of Russell, exactly as you stated, they're just simply seeking to be as broad based as possible to hold any company and you're exactly right. We've done work on the Russell 2000 Index and indicated that there might be as many as 20% of the weight of that index in companies that may not have even generated positive earnings over the prior year.

It's one reason where if people are looking at the PE ratio on small cap indexes, in particular the Russell Index, it might look awkwardly high, and by awkwardly high I mean it might say 40 or 45 times earnings, the main reason for that is not that the index has recently performed just so well and the price level has gone up so much. When an index has negative earnings, what that can do is it can create an upward bias in terms of the PE, so important for people to be thinking about that when they look at any small cap index, but if you go from Russell to Standard and Poor's, which is another index provider, still market capitalization weighted, still offering large cap, mid cap, and small cap versions of its indexes, and you say, "What does S&P do in particular, at least in part, that Russell doesn't do?" It requires-.

Tom: This is where I think there's a big misunderstanding, because there's still a lot of folks that hear the S&P 500, oh the largest 500 companies, period.

Christopher G.: Exactly right. The interesting thing, and this is true in the S&P 500. It's true in the S&P MidCap 400. It's true in the S&P SmallCap 600. S&P interestingly actually publishes a study each year, their SPIVA study, where they look at their indexes against active managers and show that so few active managers ultimately beat the S&P indexes. One big reason for that is prior to initial inclusion, one of the criteria that's looked at is specifically the profitability of the underlying companies. They want to make sure that before companies make it into the S&P 500, or S&P 400, or SmallCap 600, whichever one, they want to make sure that the company's have least generated four cumulative profits, or four cumulative quarters of positive profitability, which is a huge difference, and it's almost like a quality control, relative to a Russell approach.

Tom: It really points out a huge difference then because as you mentioned, if you've got companies in the Russell Index that, just because they're in the Index, it doesn't necessarily mean they have positive earnings, you're going to have a huge skew then between what's in the S&P Index and a Russell Index.

Christopher G.: You can see initially the potential difference from merely the name. The Russell 2000 Index, the S&P SmallCap 600 Index so out of the gate, just looking at the titles of the indexes, there is a potential for a approximate 1400 company difference, and one can look at rolling periods of performance or standardized performance, whatever they want to look at. It is no accident and we can't just say, "Oh, it's a statistical anomaly and there's really no difference." The S&P SmallCap 600 has consistently outperformed, with a lower risk, the Russell 2000 Index.

Tom: As a side note, one of the things I also picked up in your work, is the Russell 3000 has actually over 3500 names in it.

Christopher G.: That's interesting, so what I was doing there was I was seeking to show the universes of different stocks and I was also referencing CRSP, which is another index provider and what the ... That is actually the Russell 3000E Index, the difference being the Russell 3000 Standard Index that we're all very familiar with, includes large cap, mid cap, and small cap, whereas the Russell 3000E would also include the micro cap names, so what you're getting there with the Russell 3000E Index, as I said in that piece, is actually the complete investible U.S. market, including basically any publicly listed security that meets any of Russell's criteria down to the micro cap stocks.

Tom: Interesting. Christopher, swinging back to the Trump administration. If they're successful in lowering corporate income taxes, who's going to be the winner in that debate? Is it going to be large cap stocks? Is it going to be small caps, mid caps? In your opinion, who's going to emerge victorious if that happens?

Christopher G.: That is one of the big things that it's quite clear the market has been hoping for since late night on November 8 there, and we certainly saw some initial moves and subsequent moves and of course, everyone is always questioning, what's been priced in based on those moves and what hasn't. One of the very notable things was small caps responded much more significantly and small cap value in particular at the end of 2016, and we think a lot of the small cap move is justified if, in fact, we can get the policies moving, get some policy momentum and see tax cuts. The reason for that, we mentioned it briefly at the beginning, is small cap companies do a lot more business and generate a lot more revenue inside the United States, and if you're generating revenue inside the United States, what are you not doing? You're not generating profits overseas, leaving the money overseas, and getting mired up in that repatriation discussion and ultimately having a much lower effective tax rate. Not because you're making less money but because you're simply choosing not to bring the profits back into the U.S.

The U.S. companies, small caps in particular, tend to pay much higher effective tax rates than large cap companies, on average, and so we believe that profitable small cap companies, all other things being equal, should be in the best position to see the biggest boost to their earnings, if in fact, you get a corporate tax cut. The reason we think that is because these are the companies that are on average paying higher effective tax rates today.

Tom: Good, great stuff. Christopher Gannatti of Wisdom Tree Asset Management, never ever enough time. Fascinating work. Be sure to check out Christopher's work at WisdomTree.com/blog and we want to thank you again for being our guest today on the podcast and hope you can join us again real soon.

Christopher G.: Tom, I'd love to. It's been an absolute pleasure and thank you to the audience for taking the time to listen in.

Tom: Thanks again Chris. I appreciate it.

Christopher G.: You too.