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One Of The Original Quants Has Still Not Lost His Touch: In-Depth Profile Of Robert Zuccaro

By Michelle Jones

Robert Zuccaro has been using quantitative investing strategies since before quant funds existed. In fact, he started one of the earliest quant funds at Axe-Houghton in 1978, 10 years before Morgan Stanley introduced its first quant fund.

Zuccaro has been researching the correlation between earnings growth and stock price changes since 1978, and he told ValueWalk in an interview that nothing has changed over the years. The stocks that produce the biggest earnings gains always end up leading the stock market every year, which he said means ratios like PE are irrelevant.

Today, Zuccaro's new Golden Eagle Growth Fund is thriving after a 121.1% net return in its 2020 debut. What makes that return even more remarkable is the fact that most quant funds, including Renaissance Technologies, which has an excellent track record, struggled with negative returns in 2020.

Zuccaro's background

He started in the hedge fund business as an analyst because, in those days, people in their 20s and 30s didn't manage money. A lot of people came back from World War II and the Korean War and were portfolio managers for many more years before they retired.

While Zuccaro was at Axe-Houghton, the firm's portfolios were underperforming the stock market, and he was asked to take over the Axe-Houghton Stock Fund in 1978. He knew the firm's research department wasn't doing a good job because every equity account was underperforming the stock market.

Analysts would make recommendations, and the firm had a buy list that portfolio managers would select stocks from. Zuccaro didn't follow their advice, which upset them, but his strategy proved itself. The stock fund beat the S&P 500 for six consecutive years. He finished at Axe-Houghton in 1983 with a 118% return, which was his first year of triple-digit returns. Zuccaro completed his fourth year of triple-digit returns in 2020.

Triple-digit returns

Zuccaro founded Target Investors in 1984 and was there until 2005 when he closed the business because the bear market of 2000 to 2003 caused most of the fund's assets to go away. Almost every momentum fund disappeared until 2015.

"During my stay at Target Investors, we introduced the Grand Prix fund in 1998," Zuccaro said. "It went on to post a return of 112%

and the following year, the fund posted another year of triple-digit returns at 147%. So at the end of 1999, I accomplished something no other fund manager in the investment business had ever accomplished: three years of triple-digit returns."

After he closed Target Investors, he realized that his research was very valuable, and there was no way to sell it because nobody would believe it or pay for it. Thus, Zuccaro found that the only way to monetize his research was to get back into the investment business, which he did in 2014.

Eric Nastri of FLX Distribution praised Zuccaro's research process.

"Robert has been a student of the markets for over 5 decades," he said. "His knowledge and perspective provide a historical context that only adds to his quantitative work. Not only has he been an analyst and portfolio manager but can now be considered a Wall Street historian. In the first and only of its kind, Robert has been able to capture the history of Wall Street from the 1792 through the present in his book, How Wall Street Reshaped America's Destiny. He is also a great friend, father, grandfather and a philanthropist, giving back to the causes that mean so much to him."

The beginning of Golden Eagle

A year and a half ago during the Democratic primaries, Zuccaro realized he had to come up with a different strategy, and that's when the idea for the Golden Eagle Growth Fund came about. During the Democratic primaries, candidates suggested taxing securities transactions at 0.5%, making Zuccaro's previous strategy unsustainable due to its high turnover rate. The Golden Eagle Growth Fund has a very low turnover rate, and thus, it is protected from any possible securities tax that could be passed during President Joe Biden's administration.

To develop the process for Golden Eagle, Zuccaro revisited one of his old studies on the correlation between earnings growth and price change, which he conducted on his portfolios from 1985 to 2000. The original research found 1,078 stocks which improved their earnings in a year by 20% or more, which he said translates into an average price gain of 62%.

"I looked further into this study and found that companies growing their earnings by 50% or more averaged a price gain of 105%," Zuccaro explained. "Thus, Golden Eagle Growth Fund was born. Not only are model results greater at 42.1% annualized over ten years but turnover was ratcheted down to 2-3x per year."

Zuccaro's investing process

What makes Zuccaro's investing process unlike those of most other investors is the fact that he buys many stocks with high PE ratios. Investors have generally been trained to look for low-PE stocks, but he says that investing philosophy is all wrong. The Golden Eagle Growth Fund buys and holds 25 of the world's fastest-growing companies.

To identify investments, Zuccaro starts with the 5,400 companies in his database. Then he looks for growth rates of at least 25% for three consecutive years, which brings the total down to 150. Next, he runs each of the companies through their other screens to narrow down the list to what he believes are the 25 best and fastest-growing stocks.

"The companies that we buy are insensitive or less sensitive to economic cycles they also sell at higher PEs, which most people don't understand," Zuccaro said. "In 1980 the stock market was selling at 10 times earnings. If you thought the market was undervalued, you were right because the return over the next 10 years was 265%. Today the stock market is selling at 23 times PE based on forward earnings. If you think that the stock market is overvalued, you're probably wrong."

Zuccaro noted that many investors though Amazon was overvalued last year when it was trading at a PE of 70. However, those that sold their shares missed out on a big gain. His strategy also involves looking for stocks that are making new recent highs. When any stock stops making new highs, he sells it.

Why PE is the wrong thing to look at

He added that investors "have a fixation with PE," which he said is misplaced in the current environment. Zuccaro pointed to a Merrill Lynch study which found that 80% of investors use PE as their primary investment tool, followed by debt to equity. He said PE ratios and other numbers don't say anything about stock price direction, so they are meaningless in stock valuation.

"They're looking at the tail wagging the dog," Zuccaro said. "Improving ratios are the product of strong earnings growth."

Zuccaro also said that Golden Eagle is a rarity among growth funds because it goes up more in up markets and down less in down markets based on their model's results. He noted that the S&P 500 went negative in September and October, but Golden Eagle was down less in those two months.

Where to look instead of PE

Further, Zuccaro said the average profit for their portfolio companies was 107%, while S&P 500 earnings fell 16% in 2020.

"We studied the biggest 10 winners over 10 years ending in 2019," he said. "Here's what we found. Every company grew its earnings much faster than overall profits growth. The biggest winner, Netflix, was up 4,011% over 10 years. Its earnings grew nearly 1,400% over this period. It's profits growth that drives stock prices, nothing else."

Zuccaro pointed out that Merrill Lynch has found that low-PE stocks underperformed high-PE stocks over the last decade. Meanwhile, fund managers are drawn to low-PE stocks.

"Our stock work demonstrates that profits growth trumps PE considerations in stock evaluations," he said. "We conducted a study on our portfolios for the years 1985-2000 and found stocks that grew their earnings by 20-25% each year returned 39% on average. Those that grew their earnings by 51% or more gained 105% on average. No consideration was given to PEs in this study."

Why Warren Buffett is wrong

Given Zuccaro's bias against PE, it comes as no surprise that he disagrees with Warren Buffett's approach. Years ago, Buffett remarked that trading would never be based on computers, but Zuccaro believes he has proven that computers do a better job than people at picking stocks.

"Warren Buffett has a bias toward low PE stocks," Zuccaro said. "He also has a bias against technology stocks. In the last 10 years, the QQQs returned 538%, and the SPDR ETFs returned 238%, so technology has done twice as well as the S&P."

Zuccaro pointed out that Buffett's bias against tech stocks has worked against him because of the tech sector's dominance in the stock market. Today, 33% of the S&P 500's weighting consists of tech stocks, while 62% of the NASDAQ 100 is made up of tech stocks. He added that the avoidance of tech stocks has proven costly for Buffett's Berkshire Hathaway because its stock has significantly lagged the S&P 500 return over the last 10 years.

The fact that 2020 was such a challenging year for quant funds suggests there could have been some truth to Buffett's bias against quant strategies. However, Zuccaro's fund proves that assertion wrong. When asked how his fund managed such a high return while Renaissance Technologies declined 30%, he said the variables they look at are historical and don't change. They use fewer variables than other managers, so their returns are more stable.

How times have changed

When Zuccaro introduced his first quant fund in 1978, there were no computers, so things looked quite different. He used pencil and paper back in the day, and the only reports he had were annual reports and brokerage reports. Zuccaro also used Investor Business Daily for data, especially the publication's relative earnings growth and relative price strength tables.

"I searched those two tables for stocks listed in the top decile in both categories and used a third factor, positive surprises, in building a portfolio," he explained.

Zuccaro added that he built proprietary databanks, although they were in danger of being lost. Today, his databanks can be replicated easily if they are ever lost. His proprietary databanks allow him to manipulate data in more ways than ever before and produce all kinds of helpful reports.

Inspiration

When asked who inspires his investing philosophy, Zuccaro chose William O'Neil of Investor's Business Daily for his study on 30 variables between 1959 and 1982. It showed that earnings growth was the best predictor of stock prices, followed by relative price. IBD reports the rank of each stock on these two metrics every day using a relative scale built on percentile rank.

Target Investors incorporated his work into managing institutional money for 20 years and again for Target QR Strategies starting in 2014. However, Zuccaro said they don't use IBD anymore because they have "built a better mouse trap" called the Golden Eagle Growth Fund.

Zuccaro also reads regularly. He recently finished Trend Following by Michael Covel for the second time. It talks about several legendary money managers like Bill Dunn, who pulled out a 24% annualized return over 28 years, and Ed Seykota, who recorded a 60% return per year between 1990 and 2000.

"Three things jumped out about the top managers in this book," Zuccaro said. "One, the managers who generate the highest returns experience many drawdowns—often 20% or more. Two, there was no mention of PE ratios by any of these managers. Three, they managed by looking at price patterns and made no predictions."

What Zuccaro does in his downtime

Zuccaro is obsessed with stock prices, but he stays active when he isn't thinking about stocks. He plays tennis almost every morning before the stock market opens. Zuccaro lives in South Carolina during the summer and Florida during the winter. Some afternoons when he is in Florida, he goes to the next town to play pickleball after the markets close.

"I try to stay as active as possible, which keeps me mentally sharp," Zuccaro said. "The ancient Greeks embraced 'a healthy mind in a healthy body,' to which I subscribe."

He also walks every day. He read in a medical journal years ago that those who walk 10 miles a week slow cardiovascular illness by 44%. As a quant guy, he decided to walk 30 miles every week to move that percentage even higher.

"When I'm physically fit, I can tell you it aids my thinking and my mental capacity," and I think that's true of everybody," Zuccaro said.

Colleagues about Zuccaro

James Vogelzang of Vogelzang and Associates and a colleague of Roberts recalled a couple of times when Zuccaro's wit won the day.

"In addition to being a disciplined investment profession, there is a humorous and clever side of Bob. Once while making a presentation to a group of union trustees, Bob fielded the question that was not particularly difficult," Vogelzang said. "However without batting an eye, he looked at the crowd and said, 'Does anyone have an easier question?' Everyone laughed, and Bob went on to answer the question adroitly.

"On another occasion, in a final presentation for an institutional account, Bob opened the meeting by saying, 'We're pleased to be here, but may have a problem with your 30-minute presentation time allocation.'

"All the heads snapped up at this seeming impertinence. Bob continued by saying, 'Our problem is that we may not be able make our presentation last 30 minutes. Would it be OK if we kept it short?' It was a brilliant move, everyone laughed, and Bob was awarded the $30mm account a day later."

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Target QR Strategies
Delray Beach, FL

funds@targetqr.com
www.TargetQR.com

+1 (561) 510 6606