

# PNC Multi Factor Small Cap Core I PLOIX

A solid quant fund that offers diversified, small-cap exposure.

## Morningstar's Take PLOIX

**Morningstar Rating** ★★★★★

**Morningstar Analyst Rating** Bronze

### Morningstar Pillars

Process	+	Positive
Performance	+	Positive
People	+	Positive
Parent	○	Neutral
Price	+	Positive

### Role In Portfolio

Supporting

### Fund Performance PLOIX

Year	Total Return (%)	+/- Category
YTD	4.84	-4.75
2017	12.53	-8.97
2016	17.55	6.35
2015	-0.91	1.50
2014	8.12	5.69

Data through 5-31-18

1-17-18 | by Linda Abu Mushrefova

We expect PNC Multi-Factor Small Cap Core to offer investors above-average risk-adjusted returns over the long term. Lead manager Hitesh Patel and comanager Paul Kleinaitis have been at the helm since this strategy's September 2005 inception and are founding members of the process that is utilized on this strategy.

The fund's quant approach has proved its worth. Patel and Kleinaitis developed the multifactor model in the late 1990s and have made enhancements along the way. It applies volatility, liquidity, and bankruptcy screens to stocks in the market-cap range of the Russell 2000 Index, including ADRs and master limited partnerships. The model then ranks each stock in the resultant universe. Fundamental factors account for 30% to 40% of the model's weighting, valuation 30% to 35%, and momentum 25% to 35%. It has resulted in impressive risk-adjusted returns from inception through December 2017, landing in

the top quintile of the small-growth Morningstar Category.

The fund's 110- to 150-stock portfolio is built through an optimization process applied to stocks scoring in the model's upper half, though most buys rank in the top quintile. That helps to reduce risk and allows sufficient diversification as well. Parameters limiting large bets further temper the risk profile of the strategy.

The model is not infallible, however, and it struggles if market conditions shift suddenly. It will also tend to lag peers in frothier markets. For example, steering the fund away from stocks with low price/book ratios during the depths of the credit crisis hurt in 2009's sharp rebound, when those stocks tended to gain the most. More recently, the fund struggled in 2017 as more-speculative biotechnology names in the index, but absent in the portfolio, led the charge.

Over the long haul, though, the team has proved that its approach results in performance that beats both bogies on an absolute and risk-adjusted basis. Over the trailing five-, 10-, and since-inception periods, the fund has managed to top its peers by at least 100 basis points and its index by at least 50 basis points annualized. Competitive fees should help the fund add to this record.

**Process Pillar** + Positive | Linda Abu Mushrefova 01/17/2018

The fund uses a multifactor quant model that has proved its worth over time, earning it a Positive Process Pillar rating. Lead manager Hitesh Patel and his team apply volatility, liquidity, and bankruptcy screens to stocks in the market-cap range of the Russell 2000 Index, including ADRs and MLPs. Their model then ranks each stock within the resultant universe of roughly 1,800-1,900 names. Fundamental factors, such as earnings estimates' dispersion and net margin change, account for 30% to 40% of the model's weighting. Valuation factors, especially

cash flow/price, compose 30%-35% of the weighting, and momentum makes up 25% to 35%. The model is run on a 12- to 18-month time horizon, which results in slightly higher turnover relative to peers.

The fund builds its 110- to 150-stock portfolio through an optimization process applied to stocks scoring in the model's upper half, though most buys rank in the top quintile. It initiates position sizes between 0.5% and 1.5% of assets and trims them at 2.0%. The fund rebalances the portfolio monthly or when a big cash inflow or outflow occurs. It sells or trims stocks when their rankings deteriorate or events affect their fundamentals, or because of portfolio constraints, such as a market cap of \$5.5 billion, which prompts a trimming of 25 basis points.

Annual portfolio turnover peaked at 189% in 2007 but has averaged just over 100% during the fund's lifetime.

Although the fund's multifactor model ensures that its portfolio hews closely to that of the Russell 2000 Index, the model's flexibility and its tracking error target of 4% to 7% still allow the fund to distinguish itself. The fund has often tilted more toward growth stocks than its core benchmark; however, the fund's core-growth placement resulted in subpar returns in 2017, landing in the bottom 10% of its category. These style tilts are a byproduct of the quant model.

The inclusion of ADRs in the fund's investment universe also allows for a hefty weighting in foreign-domiciled companies versus its domestic-oriented boggy at times. The fund's non-U.S. stock exposure peaked at 10% in late 2007, with 4% of those assets then invested in emerging-markets stocks. Overseas exposure has since ranged from 2% to 8% and is currently at about 3%.

Industry exposures stay within 3 percentage points of the benchmark's, but the fund's sector over- and

underweightings can be more substantial. As of November 2017, the largest sector deviation from the bogy's was a 212-basis-point overweighting in technology. Nevertheless, this trailed its average category peer's allocation by nearly 650 basis points.

The team imposes a restriction of 20% of assets under management that can be invested in names that exceed the upper bound of the Russell 2000 Index. Further, the team cannot purchase names priced below \$3.50.

**Performance Pillar** + Positive | Linda Abu Mushrefova 01/17/2018

The fund receives a Positive Performance Pillar rating for its impressive returns over the long term. From its late-2005 inception through December 2017, the fund's 9.0% annualized gain beat its Russell 2000 Index and typical small-cap growth category peer by 0.5 and 1.2 percentage points, respectively, with less volatility (as measured by standard deviation).

The fund ranks in the top quartile of its peer group over the trailing five- and 10-year periods while looking even more impressive on a risk-adjusted basis. More recently, however, it has struggled to keep pace. In 2017, the largest detractor was the team's underweighting in biotechnology names, which resulted in the fund landing below 90% of its peers for the year and demonstrated that the fund may lag in frothier markets.

The model struggles if market conditions shift suddenly. Steering the fund away from stocks with low price/book ratios helped the fund hold up better than the index and most peers during the 2007-09 credit crisis, but hurt in the subsequent rebound. Indeed, from the credit crisis' March 9, 2009 trough through year-end 2009, the fund's 51.5% gain lagged the index by nearly 30 percentage points. More recently, the fund underperformed in 2016 amid a sharp rotation toward value stocks, especially in the energy and financials sectors. The fund's 17.2% calendar-year gain trailed the benchmark by 4.1%.

**People Pillar** + Positive | Linda Abu Mushrefova 01/17/2018

The fund is backed by a stable and experienced team. It earns a Positive People Pillar rating.

Lead manager Hitesh Patel's transition from a doctorate in medicinal chemistry to investing began in 1994, when his employer at the time asked him to help build financial risk models. By the late 1990s, Patel had joined Harris Investment Management, where he, current comanager Paul Kleinaitis, Rob Roquitte, and Steven Greiner founded the structured equity team and developed the basic model that the fund still uses today. In April 2005, that four-person team joined the Cleveland-based bank National City, which launched under the Allegiant brand name a suite of quant small-cap core, growth, and value funds as well as related versions of the strategy, including a mid-cap growth fund. PNC acquired National City in late 2008 and subsequently renamed and reduced the number of quant funds, leading to the departure of Roquitte and Greiner.

Patel and Kleinaitis now work as part of a veteran five-person team. Chen Chen, who has a doctorate in business statistics, is the least experienced member and yet she has been in the industry for more than a decade.

Patel and Kleinaitis invest opportunistically in their multifactor small-cap strategies. As of the most recent Statement of Additional Information, neither had any money in this fund or its growth or value siblings.

**Parent Pillar** ● Neutral | Linda Abu Mushrefova 04/13/2018

PNC Capital Advisors has its origins in the late-2008 acquisition of National City Corporation and its Allegiant fund lineup by PNC Financial Services Group PNC. PNC offers a variety of products in both the equity and fixed-income space that are managed by six in-house investment teams located in Baltimore, Chicago, Cleveland, Philadelphia, and St. Louis. Boston-based Polaris Capital Management also subadvises half of the assets in PNC International Equity PIUIX. However, a combination of unimpressive performance and liquidated strategies leaves the firm with a poor 10-year success ratio, the percentage of funds that have both

survived and outperformed their category peers, of only 9%.

Each team is afforded autonomy which results in distinct cultures; however, efforts are made to unify the teams under one goal: delivering for clients. Other aspects are more encouraging, including capacity management. The firm closed PNC Small Cap PPCIX to new investors in July 2016 when the strategy had about \$2.5 billion in assets (as a result of recent outflows, it may be reopened). The firm's recent emphasis on consolidating its lineup and shifting its focus to new launches in international or factor-oriented strategies bears watching. Manager investment in funds is poor but retention is strong at this multi-boutique shop. On balance, the firm receives a Neutral Parent Pillar rating.

**Price Pillar** + Positive | Linda Abu Mushrefova 01/17/2018

Competitive fees earn the fund a Positive Price Pillar rating. Each of the fund's three share classes ranks in the cheapest quartile of similarly distributed peers'. The I shares' current 0.86% expense ratio applies to over three fourths of the fund's assets and is 14 basis points below the small-cap institutional peer median and cheaper than 81% of those peers. Most of the rest of the assets are in the A shares. Their 1.16% expense ratio is 16 basis points below the small-cap front load peer median and cheaper than 85% of peers'.

There is no minimum investment for the I shares. The A and C share classes each require a minimum investment of \$1,000, making all three options accessible to investors.