

Nationwide HighMark Small Cap Core Fund Class A NWGPX

Analysis

Above-average fees are the only thing holding this fund back.

By Kevin McDevitt, CFA 5/9/2017

Nationwide HighMark Small Cap Core has an experienced team, a differentiated process, and an impressive record. The only thing holding the fund back from Morningstar Medalist status is its above-average expense ratio. As it stands, the fund earns a Morningstar Analyst Rating of Neutral.

This fund follows a unique quantitative approach called knowledge-based investing. Led by Derek Izuel, the management team studies the behavior of informed agents such as company management, short sellers, and Wall Street analysts. Their models then try to discern what their activity says about future expectations and where opportunities may lie.

Such an approach can't be distilled to factors or styles. In fact, Izuel and his team try to minimize exposure to factors such as momentum, style, or volatility. The end result is a balanced approach in almost all respects. The portfolio's sector weightings don't stray far from those of the Russell 2000 Index. The portfolio's summary statistics also look similar to the index across average price multiples and debt/capital. Not surprisingly, the fund's tracking error relative to the Russell 2000 has also been low, just under 3% since Izuel fully implemented his strategy in 2009's third quarter.

However, the fund's results under Izuel have been anything but indexlike. Since month-end September 2009 through April 2017, the fund's 15.8% annualized return crushed the Russell 2000 Index's 13.3%. It has achieved these excellent returns by being remarkably consistent. During 56 rolling three-year returns, the fund has beaten the index 98% of the time. (Bear in mind, though, that this period does not yet cover eight full years.) The fund has also been roughly as volatile as the index.

This fund's greatest liability is its above-average

fee. The expense ratio for the institutional shares has fallen to 1.11% from 1.34% in 2013, but that's still 11 basis points above the median for small-cap institutional funds. Without a cost advantage, this offering will have a tougher time standing out.

Process Pillar: + Positive

This fund follows a unique quantitative approach called knowledge-based investing. It doesn't look for an informational advantage, but rather relies on what's publicly available. The team studies the behavior of informed agents such as company management, short sellers, and Wall Street analysts. Their models then try to discern what their activity says about future expectations and where opportunities may lie. This earns a Positive Process rating.

Such an approach can't be distilled to factors or styles. In fact, Derek Izuel and his team try to minimize exposure to factors such as momentum, style, or volatility, slightly favoring low-volatility stocks. Any risk-factor exposure is an outgrowth of their process. They do try to keep tracking error within 3% to 5% of the Russell 2000 Index.

The team does perform qualitative reviews to catch anything that the models may have missed. It tries to avoid companies with regulatory issues or those going through an acquisition.

One potential issue relates to capacity. Total assets are only about \$200 million at this point, but this is a fairly high-turnover strategy. The team's time horizon is usually just six to 12 months, and turnover has averaged 81% over the past five years. The portfolio is rebalanced in response to new data, which usually occurs monthly. Izuel believes the fund could handle up to \$2 billion, but that sounds aggressive.

This fund doesn't follow a particular style, but the portfolio has tended to land in the small-blend portion of the Morningstar Style Box. Not surprisingly, the portfolio's average price multiples tend to be close to those of the Russell 2000 Index.

The portfolio shares common traits with the index

Morningstar's Take

Morningstar Analyst Rating

Neutral

Morningstar Pillars

Process	+	Positive
Performance	+	Positive
People	+	Positive
Parent	●	Neutral
Price	-	Negative

Morningstar Analyst Rating

Morningstar evaluates mutual funds based on five key pillars, which its analysts believe lead to funds that are more likely to outperform over the long term on a risk-adjusted basis.

Analyst Rating Spectrum

 Gold  Silver  Bronze **Neutral**  Negative

Fund Performance

	Total Return %	+/- Category
YTD	2.86	0.50
2016	23.07	2.29
2015	-4.90	0.48
2014	11.25	7.46
2013	36.85	-0.54

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in other respects as well. Its sector weightings are mostly in line with the benchmark; the same could be said about the portfolio's average debt/capital and average market cap. Not surprisingly, the fund's tracking error relative to the Russell 2000 has been low, just under 3% since lead manager Derek Izuel fully implemented his strategy in 2009's third quarter.

In terms of factor exposure, the portfolio had a small overweighting to medium-term momentum at year-end 2016, although this was offset somewhat by an underweighting in short-term momentum.

The portfolio is quite diversified across issues, holding more than 170 stocks. Only 16% of the fund's assets are in its top-10 holdings versus 22.7% for the typical peer in the small-blend Morningstar Category. The fund's cash weighting fluctuates quite a bit, but it tends to be below 5% of assets.

Performance Pillar: + Positive

This fund's results are impressive. Since lead manager Derek Izuel fully implemented his strategy in 2009's third quarter through April 2017, the fund's 15.8% annualized return crushed the Russell 2000 Index's 13.3%. What's perhaps most impressive is the fund's consistency. Across 56 rolling three-year periods, the fund beat the Russell 2000 98.2% of the time. (Bear in mind, though, that this period does not yet cover eight full years.) This record earns the fund a Positive Performance Pillar rating.

It did this without being much more volatile than the index. During that same stretch, the fund's standard deviation was 17.7% versus 17.3% for the Russell 2000. This makes the fund's results look just as impressive on a risk-adjusted basis.

That said, the fund's record during the past two corrections was mixed. In 2011, it fell 29.6% peak to trough (July 7, 2011 to Oct. 3, 2011) versus a 27.6% decline for the Russell 2000. On the other hand, it fared better during the 2015-16 correction, dropping 23.5% peak to trough (June 23, 2015-

Feb. 11, 2016) versus the Russell 2000's 25.5% loss.

People Pillar: + Positive

This fund is subadvised by HighMark Capital Management. It was one of 13 HighMark-managed funds acquired by Nationwide in 2013. HighMark itself remains independent of Nationwide.

Lead manager Derek Izuel has run the fund since December 2008, but he didn't fully implement his process and portfolio until the end of 2009's third quarter. He joined HighMark to lead its equity effort in 2008. He previously worked at Invesco for 11 years and was a portfolio manager for nine of those years. There he managed Invesco Global Low Volatility Equity Yield GTNDX and Invesco Global Health Care GGHCX. He currently manages this fund's siblings Nationwide NWFAX and Nationwide HighMark Large Cap Core NWGHX.

Izuel works directly with Yanping Li, who became comanager in March 2016. Li was with Deutsche Bank before joining HighMark in 2011. Analysts Richard Ren and Justin Sheetz were both hired in 2014. Ren brings a credit perspective, while Sheetz focuses on equities.

Izuel's experience as a portfolio manager and his tenure earn the fund a Positive People rating. Furthermore, he has fully built out his team in recent years. Today, the newest hire has been on the team for about three years.

Manager ownership in the fund is modest. Izuel owns a stake that is worth \$50,000 or less, and Li's is \$10,000 or less.

Parent Pillar: ○ Neutral

Nationwide Funds, a subsidiary of privately held Nationwide Mutual Insurance Company, employs 14 investment managers to oversee all but its target-date and target-risk funds. The depth of its expertise and the strength of its research process don't stand out, earning Nationwide a Neutral Parent rating.

Nationwide's subadvisory mix includes industry behemoths such as BlackRock and Dimensional

Fund Advisors and smaller players like Bailard and Ziegler Capital Management. The firm has resisted the temptation to churn through subadvisors; its 90% five-year manager retention rate isn't industry-leading but beats many competitors with subadvised models. Avoiding high subadvisor turnover may be necessary for success, but it's not sufficient. It was only in June 2016 that the firm appointed a CIO to oversee its asset-allocation and manager research teams. The prevalence of middling-to-weak performers across Nationwide's lineup indicates the team hasn't always selected superior subadvisors: As of March 2017, the firm's five- and 10-year Success Ratios, which measure the percentage of funds in its lineup that survive and outperform their category peers over a given period, clocks in at 25% and 17%, respectively.

Nationwide's investment lineup is sensible and, aside from its expensive index funds, reasonably priced, but these favourable attributes don't make it an above-average parent.

Price Pillar: - Negative

This fund's 1.11% prospectus expense ratio is 11 basis points greater than the small-cap institutional median. Its Morningstar Fee Level is Below Average, but that rating mistakenly compares this share class with no-load rather than institutional funds. The A and C share classes both have Above Average fee levels, and the R6 share class' is Average. Thus, the bulk of assets are in share classes with above-average fees, earning the fund a Negative Price Pillar rating.