# AEQUITAS INVESTMENT ADVISORS

## INVESTMENT REPORT – THIRD QUARTER 2017

To: Aequitas Client

From: Aequitas Investment Advisors

**Subject: Focusing on Factors We Can Control**

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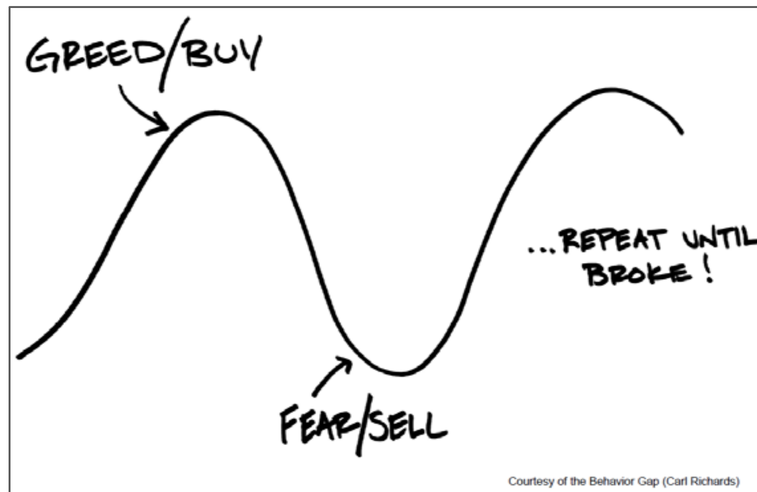
Dear Client,

Earlier this month, Professor Richard Thaler of the University of Chicago Booth School of Business, was awarded the Nobel Prize in Economic Sciences for his academic contributions to better understand the linkage between human emotions and economic decision making. His work on how the human mind reacts to information provided by the media is quite simply illustrated in Carl Richards' drawing about greed and fear. When economic reports are positive and the stock market is on a rising trajectory (as it has been over the past twelve months), investors often allow greed to drive their decisions by piling more money into stocks at a time when they should probably be trimming back on their stock allocation. When economic reports turn negative and stock prices are falling, investors often allow fear to drive them to sell at lower prices. While Carl Richards' simple drawing captures the self-destructive result of such reactionary decision-making, academic studies by Vanguard and Morningstar found that the average investor trailed the stock market by more than 2.5% *per year* due mostly to poor market timing (i.e., the result of buying high and selling low).

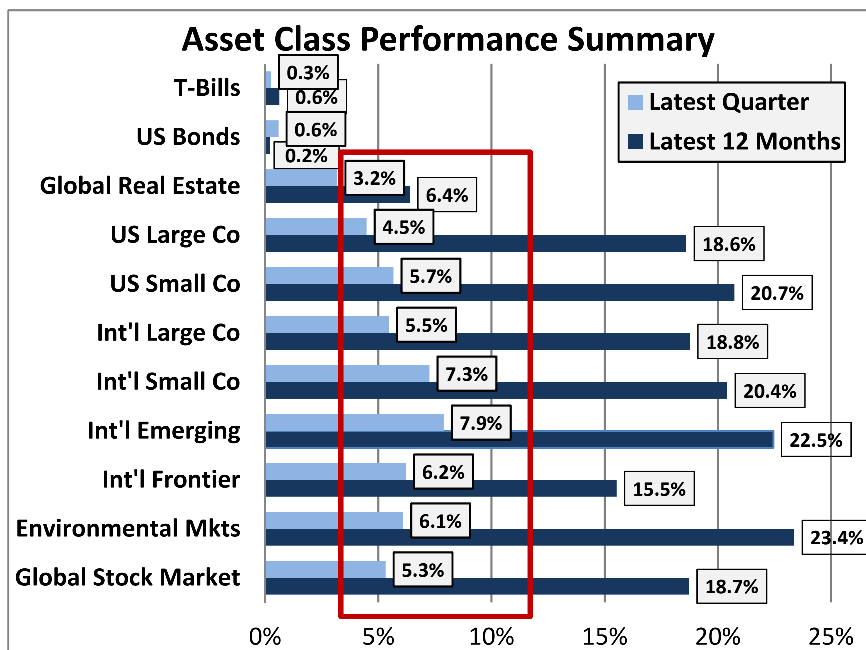
So where are we now on the stock market's emotional roller coaster? According to CNN Money's Fear & Greed Index, investors are in the greedy zone and perhaps for good economic reason (one year ago the reading was in the fear zone). Around the globe, consumer confidence is relatively high and economic growth indicators are flashing mostly green lights. In fact, the September results of the Global Purchasing Managers' Index for Manufacturing shows the highest reading in more than two years with the Eurozone displaying the strongest acceleration in manufacturing activity. Despite the spate of natural disasters, political uncertainty in the US and abroad, as well as troubling geopolitical developments, the positive direction of the global economy appears to be out-weighing the level of fear in the markets. Of course, things can change unexpectedly, which is the primary reason our portfolios are constructed with a healthy dose of bonds to mitigate risk. Furthermore, for disciplined investors with balanced bond and stock portfolios, trimming back excessive gains in certain asset classes and adding to those at lower prices which are under target, is a proven way to use the emotional roller coaster to our advantage (rather than the other way around).



Courtesy of the Behavior Gap (Carl Richards)

### Asset Class Performance Review

Over the past twelve-months, the Global Stock Market (i.e., the MSCI All-Country World Index) has risen by close to 19% with slightly higher gains in the International asset classes than in the US. Among the stock asset classes, the only laggard was Global Real Estate (+6.4%) which was weighed down by the prospect of higher interest rates (real estate investments tend to be negatively impacted by higher borrowing costs). The other stock asset classes gained between 15.5% and 23.4% with the Emerging Markets leading the way. Bonds, as would be expected, tend to lag when stocks are rising, but provide a cushion when stock prices fall. US T-Bills posted a 0.6% gain for the 12-months while US Bonds eked out a paltry gain of 0.2%.

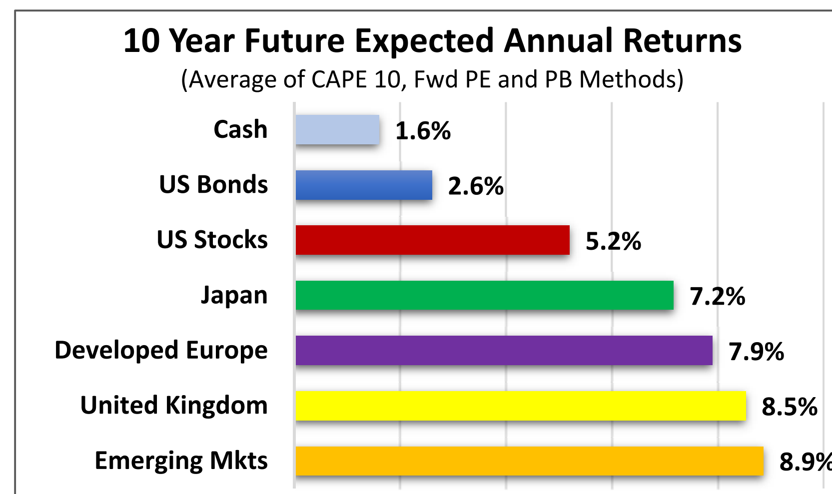



For the latest quarter, the returns were surprisingly positive and relatively uniform as indicated in the red box above. Gains in the stock asset classes ranged from a low of 3.2% (Global Real Estate) to a high of 7.9% (Emerging Markets). The Global Stock Market posted a 5.3% gain for the quarter. US T-Bills gained 0.3% and US Bonds were up by just 0.6%.

**Stock Market Valuations Provide Clues About Future Returns**

As financial planners, one of our most important responsibilities is to work with our clients to determine their short and long-term financial requirements and to construct a portfolio with a high likelihood of achieving their unique personal objectives. When creating long-term financial projections, we need to formulate future rate of return assumptions for the various asset classes in order to arrive at an overall rate of return estimate for each client's specific asset allocation strategy. To help in this exercise, we utilize three methodologies which have historically offered meaningful clues about future stock market returns: (1) the Shiller Cyclically Adjusted Price-to-Earnings Ratio based upon corporate earnings over the past 10-years (CAPE 10); (2) the Price-to-Earnings Ratio based upon the analysts' estimates of corporate earnings over the next twelve months (Forward P/E) and the Price-to-Book valuation method (i.e., the share price of a stock divided by the company's book value per share). We've compiled the average expected returns of the three methods in the chart below and have also included return estimates for Cash and US Bonds. Bear in mind, these rate of return figures are long-term expectations and are *not* intended to predict short-term movements in stock prices. (Of note, Professor Robert Shiller, of Yale University, was awarded the Nobel Prize in Economic Sciences in 2013 for his work in forecasting intermediate-term moves in asset prices, including the CAPE 10 methodology).

Current expectations are that US Bonds will provide a relatively low return of 2.6% over the next 10-years versus their historic average of 4% to 5% (inflation is expected to remain in the 2% to 2.5% range). Non-US stocks are expected to outperform US stocks by between 2% and 3% annually over the next 10-years, with stocks in the Emerging Markets offering the highest expected returns. Of course, various risks must be considered when investing beyond our borders, including currency and political risks; however, we believe that a well-diversified portfolio should include both US and non-US asset classes in order to achieve a desirable *risk-adjusted* rate of return. (We have made several adjustments to our recommended asset allocation strategy in light of the most recent valuation data.)




**Focus On What We Can Control**

Tim Nash, Principal, CFA, CAIA

This year has been unusually tumultuous with a new presidential administration, global concerns over the situation in North Korea, and numerous natural, and unnatural tragedies. With all of the uncertainties around the world, it is increasingly important to *focus on what we can control*, as we look forward and plan for the future for ourselves and our families.

One of the challenges associated with planning and investing for the future is sifting through all the investment noise and focusing on what might most positively influence this effort. Every day, we are peppered with information at an accelerating rate. Some is interesting, some not so interesting, and some is just plain wrong.

Here are some considerations which may help us sift through this noise:

- **Financial Headlines Can Be Both Distracting and Misleading:** As a classic example, a headline that simply says, "Buy Stocks Now," has historically proven to be more of a warning of a market top than a buying opportunity. Conversely, when the headlines are saying, "Sell Stocks Now," we might actually be near a buying opportunity.
- **It's Difficult to Time the Market** (probably impossible): Attempting to guess when to enter and exit the market can be counterproductive - and the process has proven to be exceedingly ineffective and costly for investors.
- **Trust Security Prices**: Millions of investors operating independently provide constant and opposing buying and selling pressures that result in the best estimate of a security's value. The result of this efficiency diminishes the potential to identify those "once-in-a-lifetime investment opportunities."
- **Be Wary of the Emotional Roller-Coaste**r: As Warren Buffett once said, "…be fearful when others are greedy and greedy when others are fearful."

With all this in mind, we recommend focusing on what we can control together to substantially improve the odds of a successful long-term investment experience:

- **Establish a Long-Term Financial Plan**: A sound plan is a core element of our fiduciary partnership with our clients. Beyond setting goals and objectives and future action steps, the plan helps determine the appropriate level of risk each client needs to assume in order to achieve his or her financial objectives. Regular reviews and adjustments to the plan are necessary as circumstances change and evolve.
- **Structure the portfolio around proven "dimensions" of returns:** "Tilting" portfolios toward securities with desirable characteristics, or dimensions, can increase the likelihood of long-term out-performance. For example, studies have demonstrated the long-term performance benefit of tilting portfolios toward smaller company stocks, stocks with lower prices (i.e., value stocks), and stocks which have demonstrated greater profitability relative to their book value.
- **Diversify Broadly Around the Globe:** At Aequitas, we have been advocating global diversification since our founding more than 25 years ago. Diversifying globally with an eye on relative valuations helps reduce portfolio volatility while improving the potential for higher returns.
- **Keep Expenses, Taxes and Transaction Costs Low**: Expenses and taxes are far more controllable than short-term returns and relative performance. One way to control expenses and improve performance is to select mutual funds with low expense ratios, such as funds offered by Dimensional Fund Advisors and Vanguard. Income taxes can be minimized by selecting funds with low turnover and by using asset location strategies to avoid the realization of unnecessary gains. Tax-loss harvesting is another method which can be used to offset realized gains. Minimizing the frequency of trades can also lead to improved performance.

The bottom line is that while there will always be uncertainties on the horizon which we cannot control, there are also many factors we can control which can significantly improve our portfolio's long-term performance and our future financial well-being.

**Closing Comment**

The English Philosopher, Julian Baggini, wrote, "Accepting that the world is full of uncertainty and ambiguity does not and should not stop people from being pretty sure about a lot of things." Some of the most important "sure things" are outlined above, but we would also stress the importance of regular portfolio rebalancing to *take advantage of* the emotional roller coaster, i.e., trimming when prices are high and adding to asset classes where prices are lower. Applying those factors you can control and repeating the rebalancing process throughout your investment lifetime will improve the odds of achieving your financial goals. As your financial partner, the Aequitas team is committed to serving your best interests and providing guidance and counsel along the way.