Factors In Focus

August 2017

Market Misdirection

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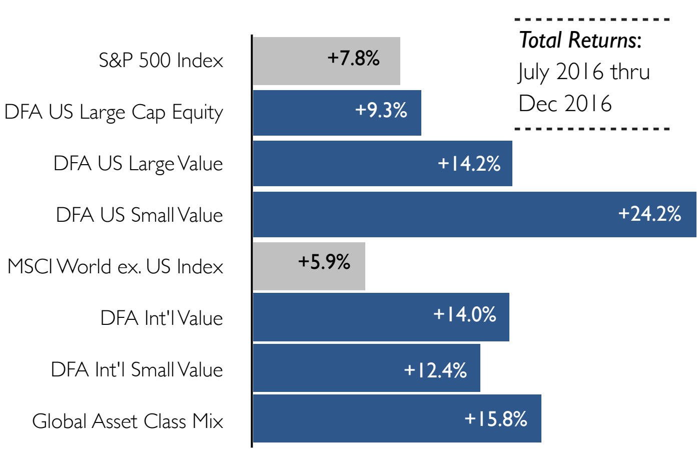
Factors In Focus isn't normally the place to discuss short-term market or asset class returns. These discussions in "normal" times are much more appropriate on a one-to-one basis and in the context of your unique long-term goals. "Corrections" and bear markets usually warrant a few words, but it's been almost two years since we have seen a steep sell-off in stocks.

However, the pattern of returns since last summer has been highly erratic. Depending on your perspective, you're either pleased with your diversified portfolio or wondering why you would even bother venturing outside the confines of large cap global stocks. Rarely do we see such opposing short-term asset class trends. So let's review recent investment results to gain a practical perspective and to highlight a few investing principles that are critical to achieving long-term success.

2016: The Reversal

After a few years of sub-par returns, value and small cap stocks globally came alive in July of last year, immediately following the surprise UK referendum to withdraw from the European Union. Another surprising outcome—the election of Donald Trump in November—had no ill effects on this momentum. The chart below lists total returns on basic stock indexes (the S&P 500 Index and MSCI World ex. US Index), as well as some of our core asset class mutual funds, through year-end 2016.



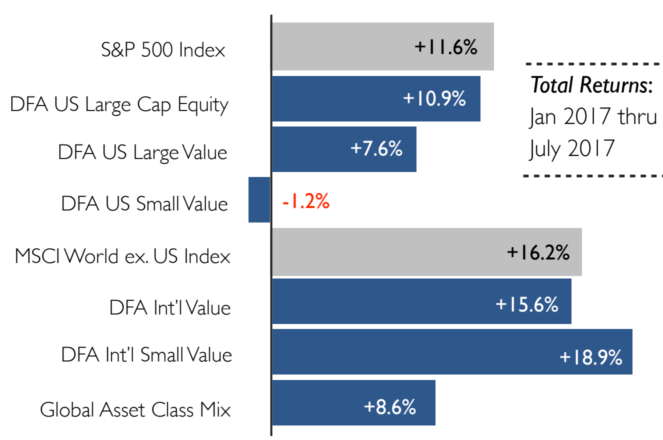
The S&P 500 performed well, with a +7.8% return, outpacing non-US stocks by about 2% (the MSCI World ex. US Index returned +5.9%). But this wasn't the whole story. US large and small value stocks appreciated much faster, returning +14.2% and +24.2%, respectively. International large and small value stocks didn't quite keep pace with their domestic counterparts but produced significantly better-than-index results of +14.0% and +12.4%.

Our conversations at the end of the year were a mixed bag: it was nice to see US large and small value stocks finally take the lead, but diversifying globally continued to be a struggle. While the small/value-tilted Global Asset Class Mix more than doubled the return of the S&P 500 Index, a few noticed that they would still have been better off with a US-only version.

2017: Reversing The Reversal

We were just beginning to settle in for what seemed like the start of a prolonged run for higher-returning value and small cap stocks, if only in the US. But 2017 has not lived up to expectations.

Since the start of the year, the S&P 500 has matched its return from 2016, but US large and small value stocks have fallen behind. Their +7.6% gain and -1.2% loss, respectively, noticeably trail the market's advance.



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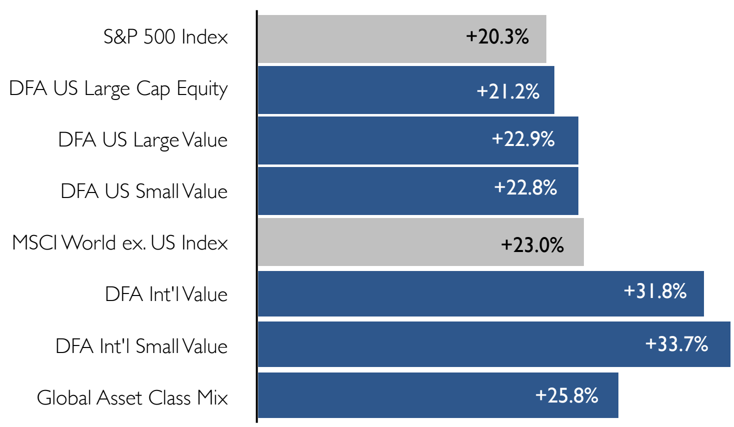
This year, however, international stocks have finally shown some life. The MSCI international index is +16.2%, international large value stocks are +15.6%, and international small value stocks have gained +18.9%. Not a huge spread for value and small stocks relative to the international "market," but the rising tide for non-US stocks has certainly lifted all boats. Despite significant underperformance for US value and small cap stocks, the Global Asset Class Mix (this time, thanks to foreign stocks) is within a few percent of the closely watched S&P 500 Index.

Reversal + Reversal = ???

The entire 13-month period resulted in a more acceptable outcome. Stocks have done well at home and abroad—the S&P 500 returned +20.3% and the MSCI World ex. US Index did +23.0%. Value and small cap stocks globally did considerably better—+22.9% and +22.8% for US large and small value asset classes, and +31.8% and +33.7% for international versions. The small/value-tilted Global Asset Class Mix returned +25.8%, well ahead of both basic indexes.

Total Returns: July 2016 thru July 2017



If you're feeling a bit whipsawed, that's understandable. To see US small value stocks march ahead by over 24% last year and lose ground this year, while international small value stocks are up almost 19% is pretty extreme. So let's focus on what matters and what we can take from the market's recent misdirections.

Markets are unpredictable. Few would have assumed we would see such generous stock market returns over the last year considering the surprise political events in Europe and the US, plus continued slow economic growth. There seemed to be little catalyst for renewed interest in foreign stocks or the value and small cap shares that had languished recently.

Successful investing requires a combination of long-term perspective and short-term patience. Specifically, you need to understand and align your wealth according to long-term asset class risk/return behavior—stocks have outperformed bonds, value stocks have outperformed growth stocks, and small stocks have outperformed large stocks. In the short run, results often fail to match long-term expectations, so tuning out the noise and accepting the inevitable randomness are essential.

Consistency is key. How many investors threw in the towel on small cap and value stocks a year or so ago? How about international diversification? More than you can imagine.

Our process had us staying disciplined, sticking to these core asset classes, and even rebalancing away from US small cap value stocks at year end by redirecting fund dividends and capital gains distributions towards underperforming international shares. Rebalancing isn't always a panacea, but it helps keep our portfolio in-line with its initial intentions, ensuring that we receive the full return of the allocation and asset classes that we have agreed to hold.

Smart Investing Is Simple, But Not Easy

None of these principles is complicated. They're intuitive, and that's the point. But that doesn't make adhering to them easy. We regularly see the justification for abandoning sensible investing or postponing actions that are in our best interest. Rarely do these urges result in anything but regrettable mistakes. To get ahead, ***avoiding errors is essential***. So that's where our focus remains.

Remember…

- ✓ Markets are unpredictable.
- ✓ Successful investing requires a combination of long-term perspective and short-term patience.
- ✓ Consistency is key.
- ✓ Avoiding mistakes is essential.

Source of data: DFA Returns Web

DFA US Large Cap Equity Fund = DUSQX, *DFA US Large Value Fund* = DFLVX, *DFA US Small Value Fund* = DFSVX, *DFA Int'l Value Fund* = DFIVX, *DFA Int'l Small Value Fund* = DISVX,

Global Asset Class Mix = 21% DFA US Large Cap Equity Fund, 21% DFA US Large Value Fund, 28% DFA US Small Value Fund, 18% DFA Int'l Value Fund, 12% DFA Int'l Small Value Fund, rebalanced annually.

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