WILLIS INVESTMENT COUNSEL

Principled Investing

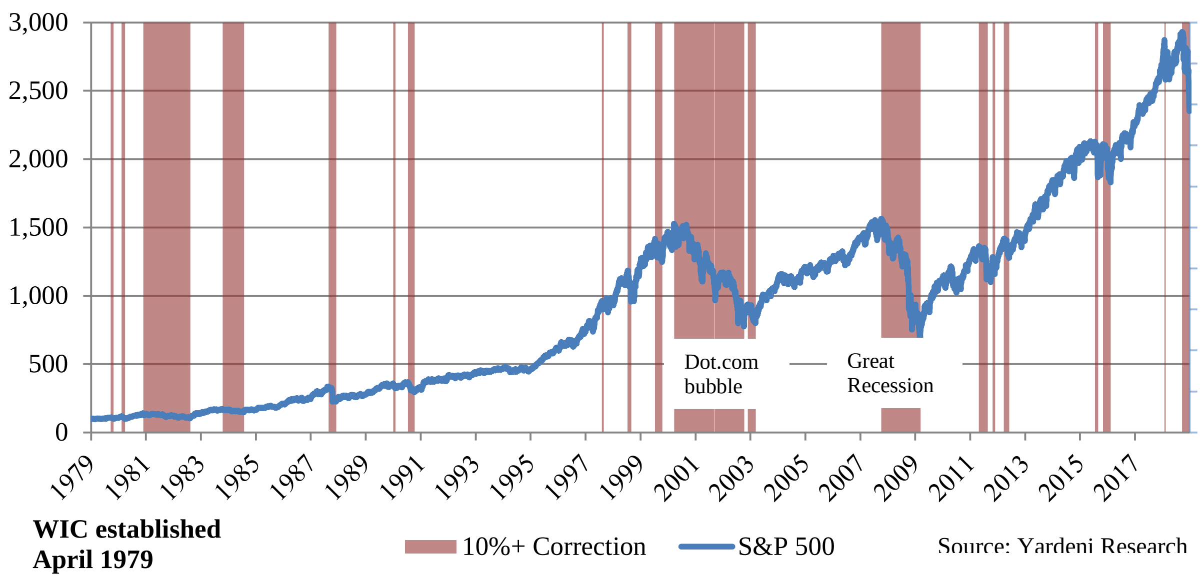
January 8, 2019

Is it Worthwhile?

BASIC FACTS

One may ask "Is putting up with the market's 14% decline from September 20 through December 31 worthwhile?"[1] Is the anxiety, stress and worry sufficiently rewarded, adequately compensated? If the measuring period is only 1-3 years, the reward will often not be worthwhile. But if the measurement period is appropriate – a period of 5-10 years – the financial reward will usually be worthwhile. The next page shows the last 3, 5, and 10 year rewards have indeed been worthwhile.

Throughout WIC's 40 years, we have experienced and dealt with 22 market corrections.[2] The red bars on the below graph point out these 22 corrections. This graph not only shows how frequently WIC has dealt with corrections, it shows how common, and therefore "normal", such corrections are:



[1] "Market" refers to the average decline of the Dow Jones Industrial Average, the NASDAQ, and the S&P 500.
[2] WIC's 40th anniversary is this April; during the last 40 years the market has declined 9.50% or greater 22 times.

THE DATA IS CLEAR – IT HAS BEEN WORTHWHILE

To evaluate if it has been worth the effort and anxiety, study the following table of returns. The following table shows that even though 2018 saw negative stock market returns in the U.S. and across the globe, over time the average return for most markets has been very worthwhile and meaningfully greater than bank deposit and bond returns. Remember, if long-term returns do not exceed inflation, capital is eroded.

Market or Benchmark Annualized Returns for Years Ended December 31, 2018[3]

All data gross of fees	2018	Last 3 Years	Last 5 Years	Last 10 Years
Cash, Bonds, and Inflation[4]				
Money Markets (~ bank CD yields)	1.75	0.85	0.68	0.50
U.S. Bond Market	0.01	2.06	2.52	3.48
Inflation – CPI	2.21	2.13	1.53	1.82
Stock Markets[5]				
U.S. Dow Jones	-3.48	12.92	9.69	13.15
U.S. S&P 500	-4.38	9.26	8.49	13.12
U.S. Nasdaq	-2.81	11.16	11.05	16.85
U.S. Wilshire 5000	-6.10	8.70	7.50	13.11
U.S. Small Cap Index (RTY)	-11.01	7.36	4.41	11.97
All Country World Index (ACWI)	-8.93	7.18	4.82	10.05
EAFE (Europe, Aus, Asia)	-13.79	2.87	0.53	6.32
China (Shanghai Composite)	-26.91	-10.84	3.05	5.40
Emerging Markets (M2EF)	-14.25	9.64	2.02	8.38
Hedge Funds (HFRIEHI)	-5.66	3.61	2.32	5.66
Diversified Portfolios, including Stocks and Bonds[6]				
Globally Diversified Portfolio	-4.32	4.75	3.83	7.01
U.S. Dominant Portfolio	-4.20	4.51	3.96	7.28
U.S. Only Portfolio	-3.05	5.38	5.01	8.30

Source: Advent/Axys and Bloomberg

The above table includes the most prominent industry standard benchmarks. These benchmarks (or market indices) represent those markets that most individuals, pension funds, endowment and foundation funds, and institutions invest in.

[3] Total returns, excluding management fees and transaction costs. These are market index returns, not WIC returns.
[4] The U.S. Bond Market is the *Barclays Aggregate Bond Index* – a broadly diversified investment grade bond index.
[5] The Stock Market indices that are not commonly known: *Wilshire 5000* contains several thousand stocks, including growth and value, large and small cap; *U.S. Small Cap Index* only contains smaller, lesser known companies; *EAFE* contains Europe, Australia, and the Far East stock markets; *China* is Shanghai Composite.
[6] *Globally Diversified*: 50% Barclays Aggregate Bonds/50% MSCI All Country World Index Equities; *U.S. Dominant:* 50% Barclays Aggregate Bonds/35% U.S. Wilshire 5000 Equities/15% EAFE International Equities. *U.S Only*: 50% Barclays Aggregate Bonds/50% U.S. Wilshire 5000 Equities. For all three Diversified Portfolios, 60% stocks not used as unrealistic to assume no cash component, and to reflect leakage discussed on page 4.

Because global diversification is the industry standard for portfolio composition, non-U.S. markets are included in the above table. The yellow highlighted row on the previous page is essentially the Dow Jones Industrial Average, or S&P 500, for the world (the MSCI ACWI). It represents a globally-diversified equity portfolio.

For many years now, WIC has followed an index that we believe is very representative of institutional portfolios (e.g., endowment and pension funds), and family portfolios that are designed by wealth management firms; not necessarily in terms of composition, but in terms of outcomes. Our research indicates this index provides a very close approximation of the performance of such portfolios. The blue highlighted row on the previous page is a proxy for the industry standard of global diversification and consists of the above globally-diversified equity portfolio (ACWI: 50%) and investment grade bonds (Barclays Aggregate Bond Index: 50%). We believe the returns shown on the Globally Diversified Portfolio row are very close to most professionally managed portfolios (gross of fees).

<u>ASSET/STRATEGY ALLOCATION DECISIONS ARE THE PRIMARY DRIVERS</u>

For decades, academia has studied the drivers of portfolio outcomes. Countless research articles in academic journals have examined what factors and decisions most affect portfolio returns. It is well settled that asset allocation (including geographical diversification) is responsible for the majority of long-term portfolio returns.[7] Most academics agree that 50-80% of long-term returns are connected to the asset allocation decision – the decision which strategy, market, geography, etc. to allocate to, <u>and not allocate to</u>. The decision to <u>not</u> allocate to international markets, for example, is a portfolio construction decision. These ongoing decisions include how much to weight the included markets and strategies. All these asset and strategy allocation decisions, and their weighting, have more influence on long-term returns than anything else.

Referring to the table on the previous page, four asset allocation decisions over the last ten years had a significant positive impact on investment outcomes:[8]

- Underweighting bonds
- Underweighting international equity markets
- Overweighting U.S. equity markets
- Resisting the dot.com-like affinity for high-fee hedge funds

Consistent with academic theory, these four asset allocation and portfolio design decisions were key drivers. Before we describe our current thinking on asset allocation, we must discuss another important driver of portfolio outcomes – *leakage*.[9]

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[7] Ibbotson, R. "The Importance of Asset Allocation". *Financial Analysts Journal*, Volume 66, Number 2, 2010.
[8] This same theme is described in two WIC client memos on our website: *The Drivers of Portfolio Outcomes* and *The Road Not Taken.*

LEAKAGE

Several weeks ago, we mailed our clients a white paper describing the chronic and persistent portfolio return *leakage* that most investors experience. Our research paper contains numerous academic studies, including research by Vanguard and Morningstar, documenting the significant loss of return due to impatience and excessively changing strategy and asset class weights.

WIC's research paper - *The Investment Highway* – provides compelling evidence that a primary reason many, if not most, investors fail to realize the markets' long-term return potential is associated with *leakage*. This return *leakage* often averages ~2.00% per year.

Before we turn to our portfolio design thinking for 2019 and the years ahead, we want to assure you we will remain very cognizant of *leakage* risks. We know unnecessary complexity and excessive changing of strategy weights are primary causes of harmful *leakage*. Contact us if you did not receive *The Investment Highway*; it was a feature story in the January 4 edition of *Institutional Investor* (www.institutionalinvestor.com).

2019 STRATEGY – THE ROAD AHEAD

Of course, it is not just 2019 we are focused on; it is the economic, political, corporate profitability, and relative value/risk/reward landscape for the years ahead that we are focused on. What we want to discuss here is the conversation and debate that is going on inside of WIC about whether we need to slightly adjust our clients' asset and strategy allocation. We are debating if, and to what extent, the following factors are sufficiently material to alter our clients' asset and strategy allocation, and related weights:

- Cash yields approaching 2% are becoming a much lower opportunity cost
- Higher bond yields are changing the risk-reward equation for bonds vs. stocks
- Political risks with a new Congress
- Political risks with threats to the independence of the Federal Reserve
- Tariffs and trade war risks
- Growing possibility of a U.S. recession; and a slowdown in China's economy
- The wildcard of the Federal Reserve unwinding quantitative easing

There are always risks such as those listed above. To be clear, we are not in the camp that the world, or America, is more unstable or risky today than ever before. Nonetheless, as always, we will continue asking ourselves if the potential rewards from our strategies appear sufficient to compensate for their risks.

[9] WIC seeks to manage *leakage* risk by owing companies versus ETFs, and through effective counsel. We believe this approach is more reliable than attempting the more theoretical tactical asset allocation approach that embraces forecasting, correlations, and the efficient frontier.

Uncertainty constantly surrounds our portfolio decision-making. The more we judge the investment landscape and the source of returns to be relatively more uncertain, the more we will move toward a relatively defensive posture.[10] One way we reflect our concern about the heightened risk of the expected return from a given strategy is to reduce that strategy's portfolio weight.[11] WIC employs four strategies for our clients:

- Bonds (fixed income)
- Defensive equities – dividend-oriented stocks hedged with covered call options
- Core equities – large cap, value-oriented stocks, mostly U.S. companies
- Small cap value equities – small "non-blue chip" companies[12]

WIC does not use a model or template or formula to decide on a client's strategy allocation. Instead, we always start with a blank canvas and think about what is most appropriate for each client's circumstances. One can think about WIC's basic strategy in terms of two distinct portfolio components that have very different objectives:

- The ballast component – protect capital
- The growth component – grow capital

The Ballast Component. WIC's ballast component contains our defensive strategies – strategies focused more on capital preservation and volatility containment than growth. Our fixed income (bonds) strategy, and our managed volatility and income strategy, are used for this foundational, ballast purpose. Relatively speaking, our bond strategy is more reliable and generally has a smaller range of potential outcomes (less risk) than our managed volatility and income strategy; accordingly, bonds will likely provide a lower return and an inferior inflation hedge over time compared to our managed volatility strategy; yet another trade-off.

The Growth Component. WIC's growth component contains our strategies that are focused more on long-term capital growth than on downside protection (to more than offset inflation and tax diminution). Our core equity strategy (large cap value), and our small cap value strategy, are used for this capital growth purpose. We expect over very long periods of time our small cap value strategy will provide a greater rate of return, coupled with greater volatility. This is another trade-off; potentially greater growth along with the inherently greater risk (i.e., wider distribution of potential outcomes).

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[10] *Uncertainty* is that which is unknowable and unquantifiable. *Risk* is also about uncertainty with unknowable outcomes; but one can sometimes make reasonable guesses about outcome probabilities and thereby somewhat measure-estimate risk and the magnitude of potential shortfalls to expectations. Because risk is theoretically more quantifiable, it is somewhat more "manageable" than uncertainty.

[11] For example, several years ago we believed bonds carried excessive risk for the paltry yield (return) they provided; accordingly, we reduced their portfolio weight and have continued with a low weight until now.

[12] Our *small cap value strategy* is a concentrated portfolio of 20 companies, many of which few would recognize the name of the company. In some ways, the smallest companies are similar to private equity that trades.

<u>Baseline Strategy</u>. WIC's framework for thinking about portfolio construction, and evaluating the inherent and unavoidable trade-off between growth and risk management objectives, is along these lines:

- Maintain at all times a lot of skepticism about what is knowable
- Accept and reflect that inputs into our equations can only be rough estimates
- Read economic forecasts but do not rely on them
- Reduce equity exposure as the margin for decision error declines
- Increase bond exposure as the odds of meaningful bond returns rise
- Prefer broader diversification when our confidence in the *source of return* wanes

The last bullet is where we are currently spending a lot of our debate time. By *source of return*, we mean dividends, interest income, net option cash flow, and capital gain or loss; all of which can be significantly affected by interest rate direction, corporate earnings, price-earnings multiple (P/E) expansion or contraction, and crowd psychology. When we have very low confidence in the level and/or direction of these factors, and the magnitude thereof, we might consider equally weighting each of our four strategies:

- The defensive, ballast component
    - 25% bond strategy
    - 25% managed volatility and income strategy
- The offensive, capital growth component
    - 25% large cap core equity strategy
    - 25% small cap value equity strategy

Equal 25% weights provide a baseline when WIC's conviction about any given outcome or return source is not compelling enough to weight a given strategy more or less than 25%.

<u>Prima Facie Strategy</u>. An equal weight essentially says we are insufficiently confident in one strategy over another, in any one path, or in any one outcome – at least not confident enough to overweight it vis-à-vis the others. In this context, *prima facie* (accept as correct until proven otherwise) acknowledges the near futility of forecasts and the difficulty of assigning probabilities to possible outcomes. An equal 25% prima facie weight is an attempt to require a compelling argument to weight the strategy more or less than 25%. Simply put, this baseline suggests we should be more broadly and evenly diversified unless there are convincing arguments not to be (e.g., could be client specific).

<u>The Road Ahead Conclusion.</u> We will be working on an effective balance between reflecting the risks on page four and not over-reacting; while all along remembering the near futility of forecasts and *leakage* risks. During 2019, we envision (i) increasing our allocation to bonds if yields on moderate duration investment grade bonds resume rising and approach 4.50-4.75%, (ii) continuing deploying excess cash as company stock prices decline more than their fundamental cash flow generation capability warrants,

(iii) slightly increasing the allocation to our small cap value strategy to improve diversification, and (iv) slightly decreasing our allocation to our managed volatility strategy if bond yields continue to rise and inflation expectations do not.

<u>For decades, I have known there is an invisible line between the virtue and purity of discipline and the intellectual contamination of dogma.</u> We know being disciplined and methodical is critical. We know market timing and excessive tactical asset allocation do not work. We know forecasting is unreliable. We know our valuation models are very important tools, but they are merely tools. But, we do not want to be dogmatic, rigid or formulistic in our thinking. To stay on the virtuous side of this invisible line, years ago I began collecting quotes on <u>*unlearning*</u>:

> "The conventional view serves to protect us from the painful job of thinking." John Kenneth Galbraith.
>
> "It is what we already know that keeps us from learning." Claude Bernard.
>
> "The important thing is to not stop questioning." Albert Einstein.
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> "…the great enemy of truth is very often not the lie – deliberate, contrived and dishonest – but the myth, persistent, persuasive, and unrealistic … too often… we hold fast to the clichés of our forebears. We subject all fact to a prefabricated set of interpretations. We enjoy the comfort of opinion without the discomfort of thought." President John Kennedy.
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> "Unflinching creeds and consuming worldviews could lead to catastrophe, for devotees of doctrine tended to fall in love with their own righteousness, ignoring inconvenient facts." Jon Meacham on President George Herbert Walker Bush in *Destiny and Power*.

Unlearning is unnatural, but necessary to keep learning.

Robert T. Willis, Jr., CFA
Chief Investment Officer

For more commentary, we invite you to visit our website at www.wicinvest.com.

Contact Information

WILLIS INVESTMENT COUNSEL
Principled Investing

710 Green Street
Gainesville, GA 30501
P: 770.718.0706 | F: 770.718.0805