Fiduciary Financial Group

Halloween Market Update

Markets have been “spooky” this fall so we found it fitting to put together a special Halloween global market update with year-to-date returns reviewed through 10/31/2018.

RETURNS OF MARKETS AROUND THE WORLD
AS OF 10/31/2018 MARKET CLOSE
Less Than 1 Yr Returns are Total Return, 1 Year or More is Avg. Annual Return
*** Note - These Returns Do Not Pertain to Your Portfolio. They Are Broad Market Indices Displayed For Reference Purposes Only***

Category	ETF Ticker	Description	YTD
Major World Stock Indices	SPY	S&P 500 Index	2.89%
	DIA	Dow Jones Industrial Avg Index	3.25%
	MDY	S&P 400 Mid-Cap Index	-2.99%
	IWM	Russell 2000 Small Cap Index	-0.61%
	QQQ	Nasdaq 100	9.61%
	IWF	iShares Russell 1000 Growth	6.46%
	IWD	ishares Russell 1000 Value	-1.61%
	IEV	S&P Europe 350 Index	-10.01%
	EWJ	MSCI Japan Index	-7.25%
	GXC	S&P China BMI Index	-19.31%
	EEM	MSCI Emerging Markets Index	-16.02%
Bonds Indices	AGG	Barclays Aggregate Bond Index	-2.41%
	IBND	Barclays International Corp Bond Index	-6.72%
	TFI	Nuveen Barclays Municipal Bond Index	-2.24%
Commodities	DBC	DB Commodity Tracking Index	2.21%
	GLD	Gold Bullion	-6.61%
Benchmark Funds	AOR	iShares Core Growth Alloc ETF (~65% Equity)	-3.21%
	AOM	iShares Core Moderate Alloc ETF (~45% Equity)	-2.74%
	AOK	iShares Core Conservative Alloc ETF (~30% Equity)	-2.51%
Sectors	XLY	S&P Consumer Discretionary Select Sector Index	7.81%
	XLP	S&P Consumer Staples Select Sector Index	-1.20%
	XLE	S&P Energy Select Sector Index	-4.98%
	XLF	S&P Financial Select Sector Index	-4.72%
	XLV	S&P Health Care Select Sector Index	8.65%
	XLI	S&P Industrials Select Sector Index	-6.30%
	XLB	S&P Materials Select Sector Index	-11.85%
	RWR	S&P REIT Index	-0.20%
	XTL	S&P Telecom	4.18%
	XLK	S&P Technology Select Sector Index	9.58%
	XLU	S&P Utilities Select Sector Index	4.66%

data pulled from www.morningstar.com >> performance >> trailing returns as of 10/31/2018.

US Growth stocks continue to be the prevailing sector in 2018 (and really the last decade since The Great Recession) but have given back over half of their gains for the year in October alone. Outside of this asset class, almost all major groups are in the red for the year, with the exception of commodities (excluding gold).

The result? Our long-term “return generating” factors haven’t helped our results in 2018:

a) Small stocks have underperformed large stocks despite the opposite being true over the long-term
b) Value stocks have underperformed growth stocks despite the opposite being true over the long-term
c) Being globally diversified hasn’t reduced volatility, but actually increased it due to significant depreciation in both Asian and European stock markets as well as bonds in both the US and foreign markets.

How lopsided have the results been for small/large, value/growth, and domestic/globally diversified? Let’s take a look…

Return Disparities YTD and last 10 years as of 10/31/2018
Using Factor Diversified Investing

a-1) **Large vs. Small Company Stocks** *as measured by S&P 500 (SPY) vs. Russell 2000 Small-Cap Index (IWM)*

	YTD	Trailing 10 Yrs.
o US Small:	-0.61%	+12.46%
o US Large:	+2.89%	+13.13%
o **Disparity:**	**-3.50%**	**-0.67%**

b.) **Value vs. Growth Stocks** *as measured by Russell 1000 Value (IWD) vs. Russell 1000 Growth (IWF)*

	YTD	Trailing 10 Yrs.
o Value:	-1.61%	+11.11%
o Growth:	+6.46%	+15.24%
o **Disparity:**	**-8.07%**	**-4.13%**

c.) **US Only vs. Globally Diversified** *as measured by Vanguard Total US Stock Market ETF (VTI) vs. All-World ETF (VT)*

	YTD	Trailing 10 Yrs.	10 yr Stnd. Deviation (Volatility)
o All-World:	-4.16%	+8.11%	15.02
o US Only:	+2.29%	+13.40%	13.91
o **Disparity:**	**-6.45%**	**-5.29%**	**+1.11 (more volatility)**

What Does This Mean for Disciplined FFG Investors?

Really, in the short-term, these types of disparities are common, and we don't feel that they should influence the strategy of long-term investors. However, what's uncommon is for all of these strategies to simultaneously underperform and to do so for a sustained period of time. As the data above shows, investing in smaller vs. larger companies, and those with lower relative prices (value stocks), with exposure across the globe has resulted in lower returns with heightened volatility.

Now, we *have not* invested deploying these rules for the last 10 years (thankfully given how poor it's been). That said, we have emphasized these strategies (small over large companies and value over growth companies) more in the last 12 months given that we don't believe that these anomalies illustrated in the table above can persist for another decade. In other words, it's partly BECAUSE these strategies have lagged for so long that the probability of this trend continuing decreases as time goes on. But why do we have so much faith in value and small company investing? Quite simply, it's the risk premium they have been shown to provide.

The #1 rule of investing is that investors who absorb more volatility risk are usually compensated by higher returns in the long-run. *This is known as the risk premium.* We believe that small stocks will therefore outperform large stocks because they tend to be more volatile (i.e. riskier). And, wouldn't you know it - that over the last 80 years, small company stock investing has drastically outperformed large company investing. The same rule applies to value vs. growth stocks. Value stocks actually tend to be more volatile (i.e. risky) than growth stocks. They are cheaper because they don't grow revenue as fast or have other perceived challenges that make investors willing to pay less to own them. Again, over the long-run, we expect value stocks to provide higher returns to compensate their investors for taking on the additional risk over growth stocks. And, don't just trust our gut, it's been historically true with value indices outperforming growth indices over the last 90 years by a margin of more than 2%/yr.[i]

Not all risk should be viewed equally… This leads us to diversification and how it relates to rule #1. Taking risk in a reckless fashion may not result in higher returns because such actions can result in PERMANENT losses. Reckless risk taking usually comes in the form of taking on CONCENTRATED positions, or, put another way, putting all of your eggs in one basket.

Need an example? If you own a global value small stock fund with 5,000 companies operating in different industries and countries all over the globe, you are likely going to see that fund fluctuate significantly from time-to-time in terms of price as market conditions ebb and flow. On the flipside however, what are the odds that the fund will go to zero? Well, what are the odds that all 5,000 of those companies operating in such vastly different segments will go belly up? You guessed it, pretty low. This is intelligent risk taking. You'll likely have a wild ride owning a fund like this (because small value stocks are very volatile) but we'd expect you to receive greater long-run returns for absorbing the more volatile ups and down relative to large cap growth companies domiciled in the most trusted market of all, the United States.

Our Ask – Stay with It – Stay Disciplined – We Are with Our Own $$

Trevor and I are both overweight value stocks in our retirement accounts relative to the overall market. We are also both overweight small company stocks relative the market as a whole. We still believe in the risk premium and we still believe in diversification… our research has convinced us that even a 10-year anomaly is far too insignificant a time period to count as evidence sufficient to shift our money away from diversifying across the globe with a bias to value stocks.

As of late we have been speaking with more clients and prospective clients that are pushing for a pure allocation (or at least extreme over-allocation) to US large company growth stocks. They have seen all the headlines that the S&P 500 has outperformed almost all other investments in the last decade. So why wouldn't you go with that then?

How many axioms and facts can we list as counterarguments to this logic? A lot – but to spare you, we will list a few of our favorites:

- *Skate where the puck is going, not to where it has been* – Wayne Gretsky
- *The four most dangerous words in investing, "This Time It's Different"* – Sir John Templeton

We realize that seeing a strategy not play out for 10 years may lead you to question if it still has merit. Our response to this is that 10 years, in the life-span of investing, is very insignificant. The core principals of investing will persist over the long-run:

- What price you pay for as security still matters. All else being equal, the more you pay for a stock, bond, or piece of real estate, the lower your future return on that asset.
  - *As measured by The Vanguard US Total Stock Market Index (VTI) vs. The Vanguard All-Word Excl-US Stock Market Index (VXUS) – the foreign stock market trades at a 31% discount based on earnings, and a 49% discount based on equity to the United States stock market.*
- Chasing recent high performing assets does not get you better returns in the future. In fact, by constantly chasing past performance, you'll increase your chances of losing money in the long-run. There are a number of studies to support this – the most popularly cited one being a Vanguard report that showed investors who chased 5-star Morningstar rated funds from year-to-year tended to underperform buy and hold investors by more than 2%/yr.
- Don't put all of your eggs in one basket. In this case – US growth stocks. Diversification across multiple asset classes is paramount to long-term success.
- Take on responsible (and varied) volatility risks which should be clearly understood as different from permanent loss risks.
- Don't make short-term decisions with long-term money. This is usually a sign of someone giving into their emotions.

If you have any questions for us or need additional information to share in our conviction for how your capital is invested, don't hesitate to send us questions!

Sincerely,
/s/
Richard & Trevor

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[i] 2018 Dimensional Index Matrix Book measuring S&P 500 performance back 80 years to the S&P 500 (starting in 1938)