Our Belated Memorial Day Market Update

Fiduciary Financial Group

We hope you had an enjoyable long weekend. In 'normal years' Memorial Day marked the start of summer. In 2020 we are seeing it as the beginning of a phased re-opening of the US economy and with it, a significant, yet highly varied recovery in stock prices since the bottom in late March.

Before we get into that, a Memorial Day movie recommendation about a true story of a fallen Air Force soldier. William H Pitsenbarger was KIA in Vietnam. He was passed over for the Medal of Honor only to receive it three decades later due to the dogged determination of a Pentagon staffer and a handful of those troops who served with him, some whose lives he saved.

The Last Full Measure came out in 2019. Strongly recommended. A great reminder of the heroism of some of our soldiers lost in battle and particularly appropriate for Memorial Day.

Now, let's dig into this "varied recovery" we mention above:

US Stocks Continue to Outperform Most of the Globe

US Stocks Vanguard Total US Stock Market Index (VTI)		**Global Stocks** Vanguard Total World Stock Market Index (VT)	
8.43% ⬇ **Year-to-Date** (YTD)	**12.53%/year** **10-Year Average** (April 2010 - April 2020)	**12.61%** ⬇ **Year-to-Date** (YTD)	**8.40%/year** **10-Year Average** (April 2010 - April 2020)

What Does This Tell Us? Diversifying across the globe has dragged down returns both this year and since the 2008 recession when compared to a USA-only stock strategy. It is easy to focus on the negatives in our country, particularly the rampant & extreme political divisiveness which renders our government inefficient and unproductive. It is a problem cited by those on the left, in the center, and on the right. Even with these systemic issues, the US has been "the best game in town" in the eyes of investors. Clearly, for those allocating capital, Europe faces greater roadblocks to quality investment returns in the form of demographic challenges, Eurozone instability, and non-existent GDP growth. For Asia, political instability, export dependency, and distrust in financial accounting & reporting standards have weighed on returns relative to the US stock market.

Growth Stocks Are Still Dominating Value Peers in This Cycle

Growth Stocks iShares Russell 1000 Growth ETF (IWF)		**Value Stocks** iShares Russell 1000 Value ETF (IWD)	
2.93% ⬆ **Year-to-Date** (YTD)	**15.64%/year** **10-Year Average** (April 2010 - April 2020)	**19.28%** ⬇ **Year-to-Date** (YTD)	**9.24%/year** **10-Year Average** (April 2010 - April 2020)

What does this tell us? Investors are placing an ever-higher price-tag on *potential* future revenue and market share growth vs more quantifiable fundamental measures of value. An example of the former, Amazon, trades at over 100X trailing 12 month earnings based on the assumption that a ~$1.12 trillion company can continue to grow at its current clip for the foreseeable future. In other words, investors are currently paying >$100 for their share of $1 of Amazon's annual profits! To us, these prices are hard to justify. We have trouble imagining a scenario where this growth rate is sustained for the next decade given Amazon's already massive size, intense competition in delivery, retail, grocery, cloud computing, etc and anti-monopolistic regulatory pressures that Amazon will surely face as it gets larger and tries to gobble up more industries. The latter will be necessary for AMZN to maintain its current growth rate which is necessary to justify such a rich valuation. Now, what's an example of a more concrete valuation metric – one that looks at the current financials of a company vs what may or may not come to fruition in the future? Price-to-book value is a widely known ratio that measures the current market price of a stock relative to its current (i.e. known) assets & liabilities.

In this post-2008 cycle, value stocks (those with low price-to-book value ratios) have been performing just below "average" even after a historically poor start to 2020. As such, we do not see value stocks so much as "out of favor" as we see growth stocks in "relative bubble territory" with returns 4% higher/year than the long-run average since 1979.

Multi-Nationals / Large Company Stocks Beating Small Companies

Large Companies Russell 1000 Index	In the last 10 years, small companies have lagged by a margin of: **3.5%/year**	**Small Companies** Russell 2000 Index
7.82% ⬇ **Year-to-Date** (YTD)		**19.28%** ⬇ **Year-to-Date** (YTD)

What does this tell us? In the near term, investors have sought the perceived "strength" of larger companies vs smaller companies as being more capable of surviving a pro-longed COVID shut down. Over the last 10 years, larger companies have benefited from cheap money (low interest rates) which has allowed them to buy-back stock, acquire smaller competitors, and "go global" boosting returns.

Our Strategy

The philosophy of Fiduciary Financial Group has been consistent and will remain as such. With the abnormally high returns in the growth segment of the stock market coupled with very rich valuations in large cap growth stocks (Shiller P/E as an example) we have a strong conviction that these discrepancies will normalize / mean revert over the coming decade. Because of very robust returns data going back ~100 years, we will continue to emphasize the themes below with clients' long-term investments while making sure we have worked with them to adequately address short-term needs with more conservative investments like investment grade bonds, gold, and cash. In addition, a "reserve" needs analysis should weigh the existence of income replacement insurance (disability) for those working and chronic senior care insurance (long-term care) for those retired among other factors to quantify how much of a portfolio can be allocated to these types of long-term assets. With "risk-on" investments we will continue to emphasize:

- Diversified investing across the globe (vs. a pure USA strategy).
- Lower-priced value stocks (vs growth stocks).
- More small cap exposure than what traditional index funds would normally allocate for small companies.
- **{New}** Exposure to stocks with a wide economic moat identified by Morningstar Research.
    - Companies with a wide moat are defined as (1) those with sustainable cost competitive advantages, (2) where customers face high switching costs away from their products or services, (3) who have substantial intangible assets, (4) enjoy network effect benefits, and (5) who have the ability to scale size/capacity efficiently.

Why Diversify Across the Globe?

- Going back to 1970, when US stock returns have been below 4%/year for a 10 year period (45 instances of this happening), international stocks (as defined by the MSCI EAFE index) have outperformed the US all trials.
- In the same timeframe, if you expand the study to include all 10 year periods where the US stocks returned less than 6%/year, the same foreign index outperformed the US in 94% of those instances (62 of 66 trials).
  - In short, diversification may lead to suboptimal results when times are good in the US, but it reduces our chances of irreparable harm to your portfolio if we experience a sustained US stock market decline.
  - See the Exhibit #1 below for the Blackrock study that demonstrates this.

EXHIBIT #1

Source: BlackRock Student of the Market Q1'2020 Highlights

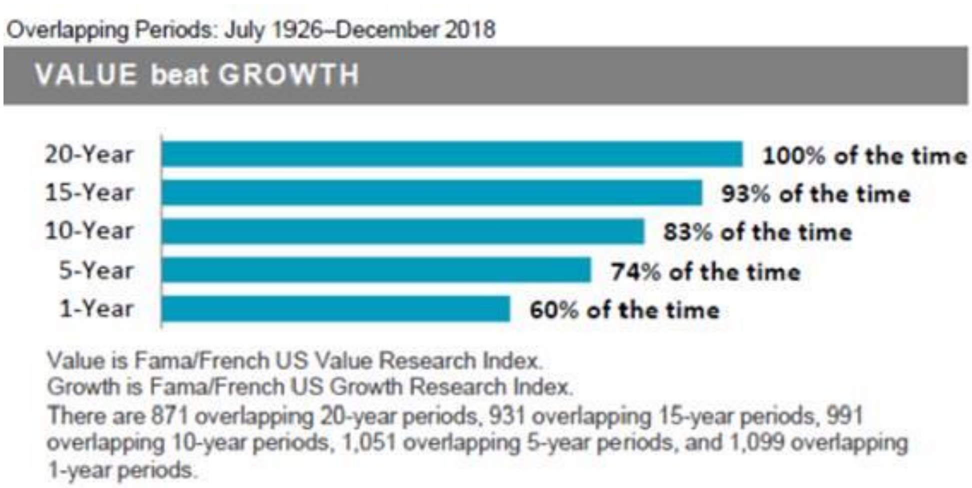
Data: Morningstar as of 12/31/19. U.S. stocks represented by the S&P 500 and International stocks represented by the MSCI EAFE Index. Past performance does not guarantee or indicate future results. Past performance does not guarantee or indicate future results. Index performance is for illustrative purposes only. You cannot invest directly in the index.

Why Value Stocks?

- Since 1926, looking at all 10 year rolling periods through 2018, value stocks (as measured by low price-to-book value ratios) have outperformed growth stocks in the US 83% of periods studied. Over that total timeframe, value stocks have returned 3.30%/year more on average vs. growth stocks. Why? With lower prices, comes more volatility risk assumed, and more risk premium baked into returns. It is for this reason, why we only allocate value stocks in client portfolios if we truly feel confident a client can absorb the increased volatility of owning these types of investments. Absorbing this volatility over long timeframes has been the most reliable way to generate higher long-run returns over the last century.
  - See Exhibit #2 below for Dimensional Funds and Fama/French study on small vs large company stocks.

EXHIBIT #2

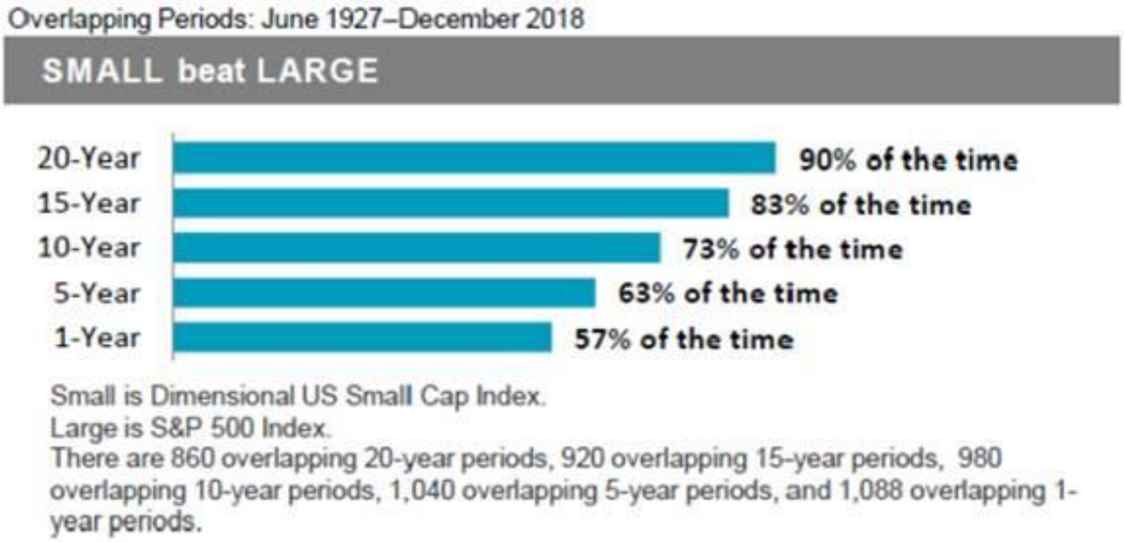
Source: Dimensional Fund Advisors 2018 Performance of Premiums



Why More Small Stocks?

- Since 1926, looking at all 10-year rolling periods through 2018, small companies have outperformed large companies in 73% of trials by an average of 2.16%/year. Why? Like value stocks, smaller companies tend to be more volatile and with that extra volatility, investors have been compensated with significantly more appreciation over the long-term as compared to large company investors. Again, we must feel confident that client funds invested in smaller companies have long-time horizons for this strategy to work.
    - See Exhibit #3 below for Dimensional Fund Advisors and Fama/French study on value vs. growth.

EXHIBIT #3



Why Stocks with a Wide Economic Moat?

- While the data here is less robust (back to 2002), Morningstar's wide economic moat index has significantly outperformed the S&P 500 over the last 18 years.
    - See Exhibit #4 for details.

EXHIBIT #4

Growth of $10,000 in Morningstar Wide MOAT Index (Red) vs. S&P 500 SPY (Blue)

In Conclusion: We have seen a *very significant divergence* in the last 10 years from what has historically been true for long-term investors. The result? Many investors are growing weary (or some might say complacent) when it comes to sticking to these long-term historical truths. Diversify, emphasize lower priced companies, and invest in small companies that have more "room to grow". Increasingly we are hearing different anecdotes for why these "truths" may no longer be relevant.

- In a low interest rate world, growth matters more and thus higher prices for growth companies are justified.
- Passive index investing perpetuates expensive companies getting even more expensive.
- Due to more bureaucracy, globalization, and cheap access to capital, large companies have a material "competitive advantage" over smaller companies.
- The US is exceptional and will continue to outperform the rest of world despite more expensive valuations.

To us, these are narratives. Our goal is to stick to evidence-based strategies. In other words, there is **persistent** (true over long-time periods consistently) and **pervasive** (true across the globe, not just in the US) data supporting the methodologies deployed.

If you have questions about your own portfolio and how these strategies can be more effectively implemented in a suitable way for your own financial situation, we are here to help.

Sincerely,
/s/ FIDUCIARY FINANCIAL GROUP

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