INVESTMENTNEWSLETTER

With US stocks outperforming non-US stocks in recent years, some investors have again turned their attention towards the role that global diversification plays in their portfolios.

WHY SHOULD YOU DIVERSIFY

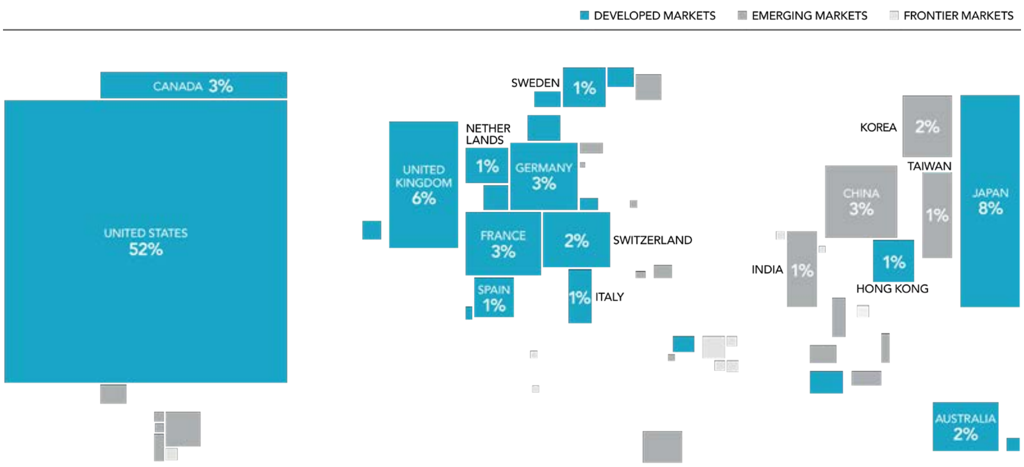
DECEMBER 2018
Dimensional Fund Advisors

For the five-year period ending October 31, 2018, the S&P 500 Index had an annualized return of 11.34% while the MSCI World ex USA Index returned 1.86%, and the MSCI Emerging Markets Index returned 0.78%. As US stocks have outperformed international and emerging markets stocks over the last several years, some investors might be reconsidering the benefits of investing outside the US.

While there are many reasons why a US-based investor may prefer a degree of home bias in their equity allocation, using return differences over a relatively short period as the sole input into this decision may result in missing opportunities that the global markets offer. While international and emerging markets stocks have delivered disappointing returns relative to the US over the last few years, it is important to remember that:

1. Non-US stocks help provide valuable diversification benefits.
2. Recent performance is not a reliable indicator of future returns.

Exhibit 1. World Equity Market Capitalization



As of December 31, 2017. Data provided by Bloomberg. Market cap data is free-float adjusted and meets minimum liquidity and listing requirements. China market capitalization excludes A-shares, which are generally only available to mainland China investors. For educational purposes; should not be used as investment advice.

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You above all.

Exhibit 2. Global Index Returns
January 2000–December 2009

	Total Cumulative Return (%)
S&P 500 Index	−9.10
MSCI World ex USA Index (net div.)	17.47
MSCI World ex USA Value Index (net div.)	48.71
MSCI World ex USA Small Cap Index (net div.)	94.33
MSCI Emerging Markets Index (net div.)	154.28
MSCI Emerging Markets Value Index (net div.)	212.72

 Indices are not available for direct investment. Index performance does not reflect expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results.

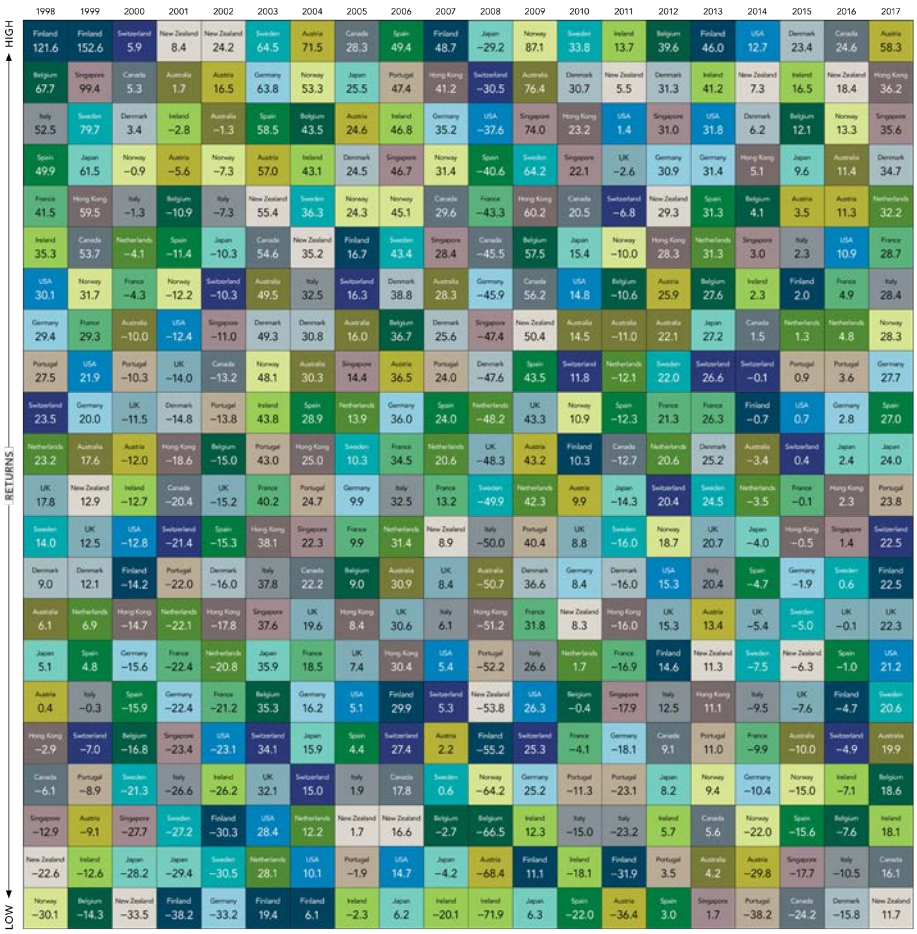
THERE'S A WORLD OF OPPORTUNITY IN EQUITIES

The global equity market is large and represents a world of investment opportunities. As shown in Exhibit 1, nearly half of the investment opportunities in global equity markets lie outside the US. Non-US stocks, including developed and emerging markets, account for 48% of world market capitalization[1] and represent thousands of companies in countries all over the world. A portfolio investing solely within the US would not be exposed to the performance of those markets.

THE LOST DECADE

We can examine the potential opportunity cost associated with failing to diversify globally by reflecting on the period in global markets from 2000–2009. During this period, often called the "lost decade" by US investors, the S&P 500 Index recorded its worst ever 10-year performance with a total cumulative return of –9.1%. However, looking beyond US large cap equities, conditions were more favorable for global equity investors as most equity asset classes outside the US generated positive returns over the course of the decade. (See Exhibit 2.) Expanding beyond this period and looking at performance for each of the 11 decades starting in 1900 and ending in 2010, the US market outperformed the world market in five decades and underperformed in the other six.[2] This further reinforces why an investor pursuing the equity premium should consider a global allocation. By

Exhibit 3. Equity Returns of Developed Markets



Source: MSCI country indices (net dividends) for each country listed. Does not include Israel, which MSCI classified as an emerging market prior to May 2010. Past performance is no guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

1 The total market value of a company's outstanding shares, computed as price times shares outstanding.
2 Source: Annual country index return data from the Dimson-Marsh-Staunton (DMS) Global Returns Data, provided by Morningstar, Inc.

holding a globally diversified portfolio, investors are positioned to capture returns wherever they occur.

PICK A COUNTRY?

Are there systematic ways to identify which countries will outperform others in advance? Exhibit 3 illustrates the randomness in country equity market rankings (from highest to lowest) for 22 different developed market countries over the past 20 years. This graphic conveys how difficult it would be to execute a strategy that relies on picking the best country and the resulting importance of diversification.

In addition, concentrating a portfolio in any one country can expose investors to large variations in returns. The difference between the best- and worst performing countries can be significant. For example, since 1998, the average return of the best performing developed market country was approximately 44%, while the average return of the worst-performing country was approximately –16%. Diversification means an investor's portfolio is unlikely to be the best or worst performing relative to any individual country, but diversification also provides a means to achieve a more consistent outcome and more importantly helps reduce and manage catastrophic losses that can be associated with investing in just a small number of stocks or a single country.

A DIVERSIFIED APPROACH

Over long periods of time, investors may benefit from consistent exposure in their portfolios to both US and non US equities. While both asset classes offer the potential to earn positive expected returns in the long run, they may perform quite differently over short periods. While the performance of different countries and asset classes will vary over time, there is no reliable evidence that this performance can be predicted in advance. An approach to equity investing that uses the global opportunity set available to investors can provide diversification benefits as well as potentially higher expected returns.

Source: Dimensional Fund Advisors LP.

HERE'S THE PRESCRIPTION

DECEMBER 2018
Dimensional Fund Advisors

As much as I value the unfettered access to information the internet provides, I recognize the potential harm that too much information can cause. Take, for example, a friend of mine, who was experiencing some troubling medical symptoms. Typing her symptoms into a search engine led to an evening of research and mounting consternation. By the end of the night, the vast quantity of unfiltered information led her to conclude that something was seriously wrong.

One of the key characteristics that distinguishes an expert is their ability to filter information and make increasingly refined distinctions about the situation at hand. For example, you might describe your troubling symptoms to a doctor simply as a pain in the chest, but a trained physician will be able to ask questions and test several hypotheses before reaching the conclusion that rather than having the cardiac arrest you suspected, you have something completely different. While many of us may have the capacity to elevate our understanding to a high level within a chosen field, reaching this point takes time, dedication, and experience.

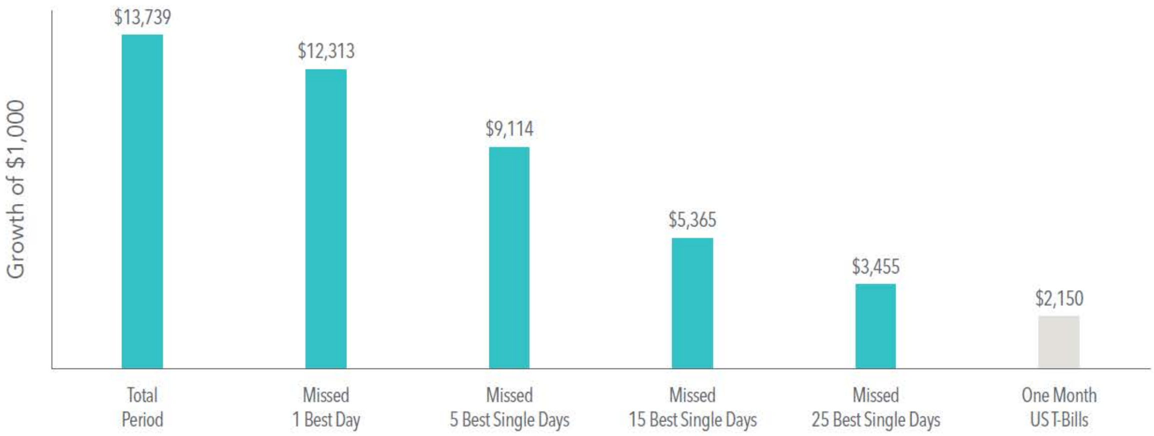
My friend, having convinced herself that something was seriously wrong, booked an appointment with a physician. The doctor asked several pertinent questions, performed some straightforward tests, and recommended the following treatment plan: reassurance and education. Not surgery. Not drugs. But an understanding of why and how she had experienced her condition. The consultative nature of a relationship with a trusted professional—both when a situation arises and as we progress through life—is one of the key benefits that an expert can provide.

There are striking parallels with the work of a professional financial advisor. The first responsibility of the doctor or advisor is to understand the person they're serving so that they can fully assess their situation. Once the plan is underway, the role of the professional is to monitor the person's situation, evaluate if the course of action remains appropriate, and help to maintain the discipline required for the plan to work as intended.

Like my friend's doctor, advisors may have experienced conversations with clients that are triggered by news reports or informed by unqualified sources. In some cases, all that is required to help put the client's mind at ease is a reminder to focus on what is in their control as well as providing reassurance and (re)education that they have a financial plan in place that is helping them move toward their objectives. The benefits of working with the right advisor are demonstrated through the ability to both help clients pursue their financial goals and to help them have a positive experience along the way.

Trouble might arise when we confuse simple and complex conditions. Probably no harm is done when a person, recognizing the onset of a common cold, takes cold medicine, drinks plenty of fluids, and rests. But had my self-diagnosing friend not made an appointment with a specialist, and instead moved from self-diagnosis to self-medication, she may have caused herself real harm. Similarly, thinking that all aspects of your own financial situation can be handled through a basic internet search or casual conversation with a friend might result in a less than optimal financial outcome.

Exhibit 1. Reacting Can Hurt Performance
Performance of the S&P 500 Index, 1990-2017



Annualized Compound Return	9.81%	9.38%	8.21%	6.18%	4.53%	2.77%

In US dollars. For illustrative purposes. The missed best day(s) examples assume that the hypothetical portfolio fully divested its holdings at the end of the day before the missed best day(s), held cash for the missed best day(s), and reinvested the entire portfolio in the S&P 500 at the end of the missed best day(s). Annualized returns for the missed best day(s) were calculated by substituting actual returns for the missed best day(s) with zero. S&P data © 2018 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. "One-Month US T-Bills" is the IA SBBI US 30 Day TBill TR USD, provided by Ibbotson Associates via Morningstar Direct. Data is calculated off rounded daily index values. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results.

Without the guidance of an advisor, the self-medicating investor might overreact to short-term market volatility by selling some of their investments. In doing so, they risk missing out on some of the best days since there is no reliable way to predict when positive returns in equity markets will occur.[1] One might think that missing a few days of strong returns would not make much difference over the long term. But, as illustrated in Exhibit 1, had an investor missed the 25 single best days in the world's biggest equity market, the US, between 1990 and the end of 2017, their annualized return would have dropped from 9.81% to 4.53%. Such an outcome can have a major impact on an investor's financial "treatment" plan.

Improving someone's financial health is a lot like improving their physical health. The challenges associated with pursuing a better financial outcome include diagnosis of the current situation, development of the appropriate course of action, and sticking with the treatment plan. Many advisors are trained on the intricacies of complex financial situations and work to understand how their clients feel about money and how their clients might react to future events. By providing the prescription of reassurance and education over time, we believe the right advisor can play a vital and irreplaceable role in investors' lives.

1 The 2018 Mutual Fund Landscape report compiled by Dimensional showed that for the 15-year period through 2017, only 14% of US equity mutual funds and 13% of US fixed income mutual funds survived and outperformed their benchmark after costs. Refer to us.dimensional.com/perspectives/mutual-fund-landscape-2018 for more information.

IS THE VALUE FACTOR REALLY DEAD?

DECEMBER 2018
OBS Financial

A LOOK AT THE RECENT HISTORY OF, AND OUTLOOK FOR, THE VALUE PREMIUM

The "value premium" is the higher return historically earned by value stocks over growth stocks. Why would this be? Because investors are human, and humans are … human!

Most consumers love exciting stories about stocks – like the next super drug, smartphone, or electric car. They also hate disappointment, underperformance, and failure. This often leads stocks that have disappointed, or are not expected to outperform, to be shunned beyond what is warranted by their financial performance. As a result, exciting stocks are overvalued, and boring stocks are undervalued. Over the long term, buying exciting, overvalued "growth" stocks underperforms buying boring, undervalued "value" stocks. It's what humans do!

Since being popularized as a cornerstone factor of prudent investing, however, value has attracted wide interest from investors. Whether for a portfolio, an exchange-traded fund (ETF), or an equities sub-index, the value factor has earned headliner billing in the factor-based investing discussion.

Lately, after the global financial crisis of 2008, it has been widely rumored that the value premium is all but deceased. All factors experience cyclical patterns of returns, so it isn't surprising to see value recede with the crisis. Yet a continued, and lengthy, slide has raised alarm bells, especially relative to the performance of growth, a rivaling factor of sorts. Having some large-cap stocks soar toward $1 trillion valuations is a highly visible representation of how growth has become the market's favored factor.

But is the value factor really dead? Unlikely. Could it be in a sustained period of underperformance? Possibly. Can trends reverse in a relative instant? Absolutely. Might factors – other than pure value – be having an effect? Let's review.

VALUE AND GROWTH PERFORMANCE DIVERGE

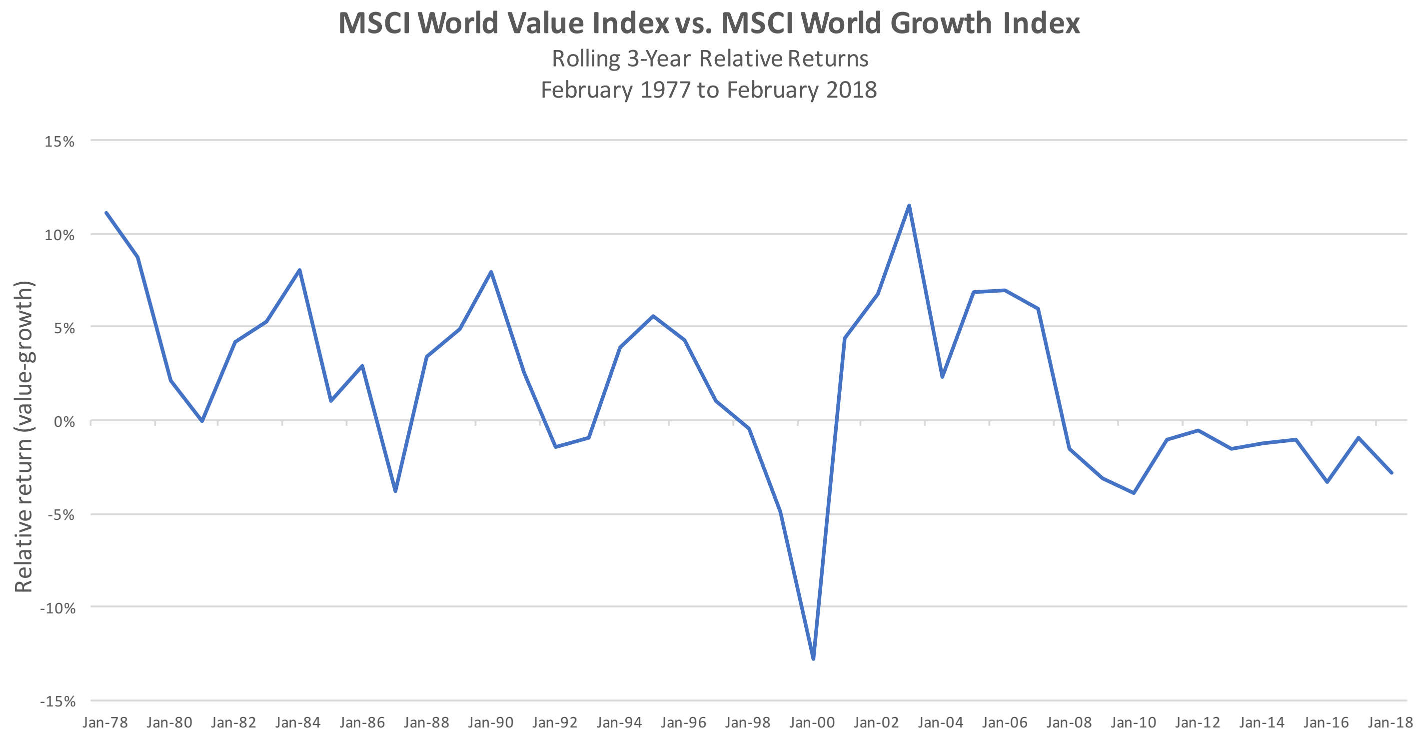
Value investing seeks excess returns from stocks or other assets that are undervalued relative to their intrinsic value. In essence, their current market prices are low relative to the future cash returns they are expected to provide or less than the net asset value of their balance sheet.

We can't predict exactly what future cash returns will be, so how can we identify a value stock? One measure is the price-to-book ratio. A company might be trading low relative to the accounting-based value of its assets minus its liabilities over the short term, but remain fundamentally strong. Value investors seek to buy such lower-valued stocks that therefore appear to offer less risk and are expected to rebound.

Opposite principles are at play in growth investing strategies. The growth factor appears in stocks that may be relatively higher priced compared to traditional measures of intrinsic value. They may seem to offer a greater capacity for capital appreciation based on high expectations for earnings or revenue and unit growth that will hopefully produce future earnings growth. Growth stocks tend to be more expensive relative to book value, current earnings, and other standard measures, and therefore may involve greater risk, but also a big upside. Think of the FAANG stocks today (Facebook, Apple, Amazon, Netflix, Google – at least prior to their drawdown in October/November 2018).

The performance of these and other potentially high-earnings growth stocks has led growth-focused indexes to rise well above value indexes. In the trailing 12 months through September 2018, the Russell 1000 Growth gained 26.3 percent, while the Russell 1000 Value mustered 9.5 percent. That variance was also present in the Russell 2000 Growth and Value index returns (21 percent and 9.3 percent, respectively) and the Russell 3000 (25.9 percent and 9.5 percent). This value underperformance is seen in the longer term as well, with the Russell 1000 Value trailing Growth over the last 10 years, 9.8 percent to 14.3 percent, respectively.

The recent performance gap can also be seen in a comparison of rolling three-year relative returns for the MSCI World Value and Growth indexes. Dating back to 1977, growth and value took turns outperforming[1]. However, that trend stopped abruptly after 2008, with value underperforming in every three-year period since.



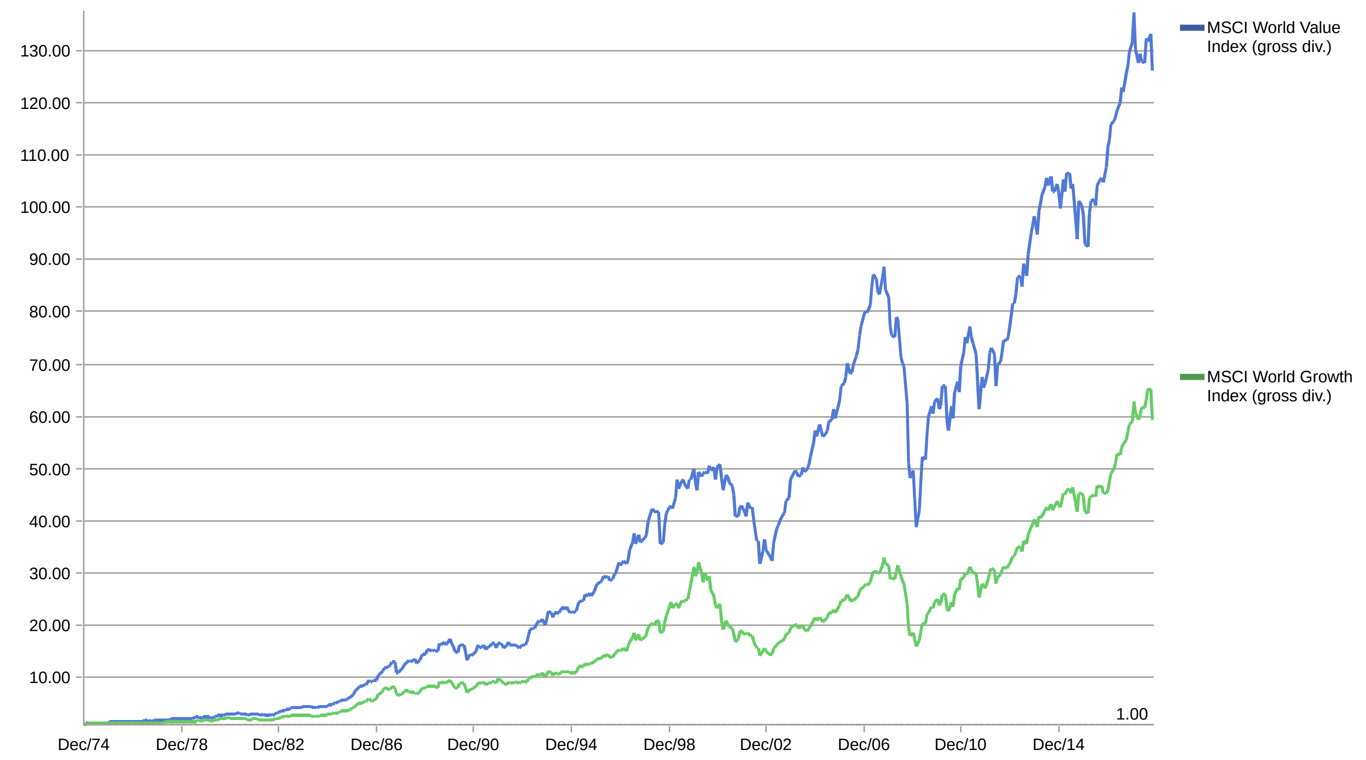
Source: Bloomberg. Relative returns reflect rolling 3-year net total returns of the MSCI World Value Index and MSCI World Growth Index in USD. Data February 29, 1977 to February 28, 2018.

HOLD OFF ON THE LAST RITES

It is this post-recession flatlining that has many adherents fearing the potential demise of the value factor. Recent results may justify the doom and gloom, but it's worth bearing in mind that value has proven itself dating back to the 1930s, weathering periods of underperformance and emerging on the other side to lead the next market cycle. Cumulative performance of the MSCI World Value Index (gross of dividends) since its 1975 inception through September 2018 has approached 12,500 percent. In that time, the MSCI World Growth (gross of dividends) has gained over 5,800 percent[2] or less than half the cumulative wealth of value including reinvesting dividends and no taxes.

Growth of Wealth

Monthly: 01/1975 - 10/2018; Default Currency: USD



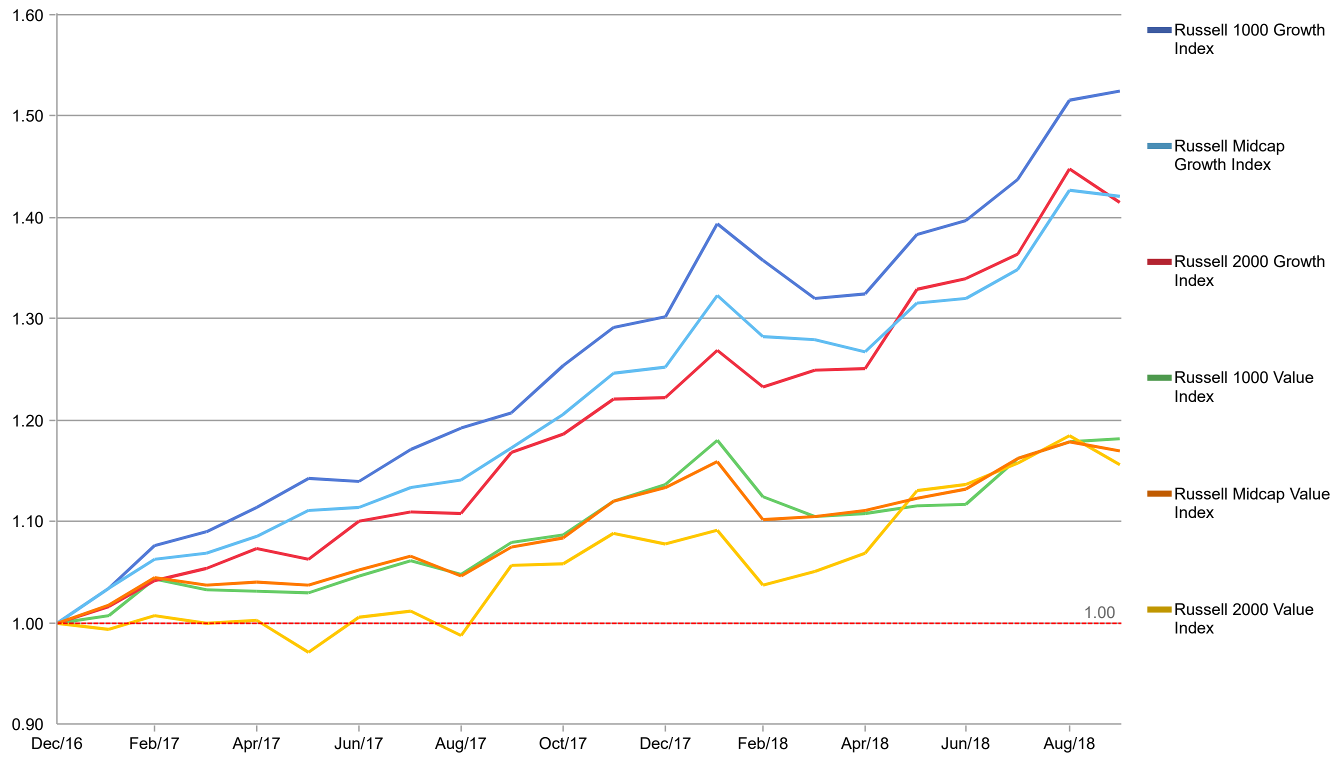
Selection of funds, indices and time periods presented chosen by client's advisor. Indices are not available for direct investment and performance does not reflect expenses of an actual portfolio. Past performance is not a guarantee of future results. Graph represents a hypothetical investment of $1. Performance includes reinvestment of dividends and capital gains.

Further, there are myriad factors that could belie the actual current performance of the value premium. A just rejoinder to the comparison of recent value and growth index performance is that over and under exposure to technology stocks is largely to blame. Almost a quarter of the Russell 1000 Growth is comprised of five companies: Alphabet (Google), Amazon, Apple, Facebook, and Microsoft[3] Overweighting of technology stocks that have boomed has had an outsized effect on the rise of growth indexes, while underweighting of tech in value indexes has limited the beneficial impact. Indeed, the higher concentration of financial stocks that is seen in value indexes was a drag on performance through the recession and years after. The technology sector is where revenue growth has exceeded expectations for almost a decade. That growth isn't guaranteed to continue, however, and the earnings of financial stocks could rise if Fed policy continues to push interest rates higher.

Looking back, it wasn't that long ago that value was edging out growth – at least over the shorter term. In calendar year 2016, the Russell 1000 Value index outperformed its growth counterpart by over 10 percentage points (17.3 percent vs. 7.1 percent) while the Russell 2000 Value index returned 31.7 percent – or over 20 percentage points more than the 11.3 percent return of the Russell 2000 Growth index2. Surprisingly, much of value's return occurred after the 2016 election, as markets priced in anticipated pro-growth initiatives (Russell 2000 Value rose nearly 18% in two months). However, since January 2017, growth, across all U.S. capitalization sizes, has vastly outperformed value, as indicated in the below chart.

Growth of Wealth

Monthly: 01/2017 - 09/2018; Default Currency: USD



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Cutting out other subfactors clarifies the value premium. Causeway Capital used a model that isolated returns attributable to the overall market and returns attributable to a style (i.e. factor-based investing) and found "pure value" investing has returned twice that of "pure growth" investing since 1991. Stripping away the overall market shows that except for a brief period during the tech bubble, value has consistently bested growth[4].

ALL VALUE STRATEGIES MAY NOT BE OPTIMUM

Value investing can take many forms and employ many different tools and instruments designed to reflect the value factor. How well these vehicles succeed in capturing value, however, can affect the overall perception of the premium.

Besides the sector exposure asymmetry in indexes described earlier, value-based strategies have also been shown to result in over- or under-weightings in other areas, whether due to sectors, competing factors, or asset type. The net effect is that these influences can sometimes marginalize or overwhelm whatever premium is actually earned from value.

Northern Trust, using MSCI World Index data, isolated factor performance and found value actually outperformed from 2008 to 2018[1]. Yet it wasn't the only factor that produced superior returns during the decade: Momentum registered returns ahead of value, while quality wasn't far behind value. The problem that some value premium strategies could encounter is that the value factor has relatively inverse relationships to quality and momentum, which would limit the presence of such factor-themed investments in a value-focused portfolio. Further, Northern Trust analysis found that negative momentum bias and negative quality bias combined to detract from excess returns nearly as much as the value premium added to them in performance of the MSCI Value Index compared to the MSCI World Index.

Another oversight that value-based strategies may exhibit is in focusing solely on the value factor in equities. Stocks have an essential place in any portfolio, and various metrics like price-to-book, price-to-earnings and price-to-sales make quantifying value in equities an easier task. However, value can be found elsewhere. This is the argument that researchers from the University of Lisbon and London School of Economics and Political Science made in a paper examining value premia across asset classes[5]. The writers said the value factor can also be measured, expressed, and manifested in currencies, global government bonds, and commodities similar to how it appears in equities.

CAPTURING THE VALUE DIMENSION

The growing view among investment news outlets and social media commenter is that the value premium could be history. The research we cited, however, finds the opposite. Investors must also consider the time frame. Recency bias can have a distorting effect, but separate Northern Trust research estimated the value factor had a usual cycle of 47 months, the second longest of all factors analyzed[5]. So even if it currently feels like an endless valley for value proponents, the value premium could very well be preparing to scale the upcoming peak.

Knowing that the value premium endures, but due to its recent significant underperformance it is under-represented in portfolios, should alert investors to a different problem than the death of the value factor. Instead, the challenge is to discern offerings and allocations that best reflect value investing, but also consider the various other factors and market effects at play.

Appreciating the impact of these dimensions and capturing their premium is at the core of the Dimensional Fund Advisors mutual fund building blocks currently used by OBS Financial. By constructing equity portfolios that focus on the value, size, and profitability factors across the global investment opportunity set, OBS can implement factor-based investing principles and blend them effectively with risk management, diversification, and fixed income volatility dampening strategies designed to capture the various forms of factor performance that markets have historically made available over time.

SOURCES

1 https://pointofview.northerntrust.com/the-value-factor-isnt-dead-just-misapplied-224dde2049f2

2 Dimensional Funds Returns 2.0 available for Dimensional Advisors only

3 https://www.bloomberg.com/opinion/articles/2018-03-14/growth-and-value-stock-indexing-are-both-broken https://www.causewaycap.com/wp-content/uploads/2018/02/201802-TheCompellingCaseforValue-1.pdf

4 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3054017

5 https://www.northerntrust.com/documents/white-papers/asset-management/factor-investing-not-which-but-when.pdf?bc=25409663

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