Mills Wealth Q4 2018 Market Commentary

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We used recent market volatility combined with new technology to adjust our portfolios. Below you will find our rationale on the changes, and our thoughts on the current and future market environment.

Rationale Behind the Trades We Executed:

Sold real estate: Since the financial crisis real estate has performed similarly to equities, and long-term, we believe this performance is unsustainable. Our analysis has led us to believe, real estate values are fully valued. In the recent pull back, REITs have not declined relative to equities, so we used this as deviation in performance to shift some of the public real estate that had climbed into equities which had declined in value. Long-term we think this will be more profitable.

Adjusted our bond holdings: With the flattening of the yield curve, we used the shift to household trading to reshuffle our taxable bond holding to tax deferred accounts when possible. Because of the tax inefficient nature of bonds, we attempted to move much of the taxable fixed income into tax deferred accounts. Where we did not have enough tax deferred assets, we continued to own municipal bonds which pay tax free interest for clients with higher taxable incomes. We eliminated two fixed income positions and rebalanced assets in to "TEI" a Closed End Fund owned and operated by Franklin Templeton that buys Emerging Market Bonds. This fund is trading between 10-12% below is assets' book value and this asset class is projected to be one of the highest returning assets. Also, there is a strong body of evidence that suggest buying closed end funds at a discount provides above market rates of return. If the discount narrows by to about 6%, its long-term average, it is the equivalent of having the fund managed for free for 5-6 years. We are very excited about this trade's potential.

Equity trades: As you will read below for conservative and income investors, we maintained our risk exposure and just rebalanced per our policy. For opportunistic investors, we both rebalanced and slightly increased equity given the recent pullback and overall opportunity worldwide. While we do not know what short-term returns will be, we feel long term investors will be rewarded for owning equities (stocks). While value has underperformed growth for the last several years, our funds have kept pace with indexes despite their additional tilt to undervalued securities. Over time this strategy has rewarded investors, and we think these tilts to value worldwide will deliver. We still have some defense that we can utilize if needed, but we feel that the current portfolio these trades will add value toward reaching your long-term objectives.

There has been a lot of noise in the markets surrounding Brexit, a slow-down in earnings, the impact of the government shutdown, tariffs, etc., but long-term we think most of this noise points to buying or holding equities. The recent pull back did not make US markets crazy cheap, but it did bring valuations down to reasonable levels, however in emerging markets valuations are still near crisis levels and we continue to recommend that long-term investors not underweight them.

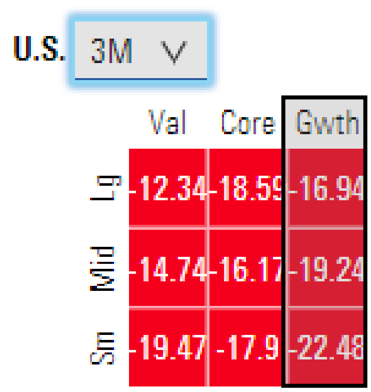

Figure 1

I thought it was interesting that in the recent pullback, the most expensive assets were the biggest decliners. I think you will continue to see institutional assets migrate toward value worldwide. In Figure 1, you can see that in the fourth quarter, growth stocks had the lowest returns of any asset class of stocks in the United States. And that the US had lower returns than any of the other categories, see figure 2.

Figure 2

Over the last quarter global equity markets have continued to weaken (until December 27th when markets bounced over 5% in one day posting the biggest point gain ever). Why? Up until then, there had just been more sellers than buyers, however we think markets overreacted and just became too cheap compared to market fundamentals, which is why they bounced back, so fast.

In early December, we realized all meaningful losses in taxable accounts, then on December 24th, we took the opportunity to realize losses again. I know most investors hate looking at red on a brokerage statement, but volatility is the tradeoff investors must exchange if they want to receive the permanent ups that come from owning a diversified portfolio of publicly traded stocks, real estate and bonds. If possible, look at these losses opportunistically, for nearly 10 years markets have barely provided a downturn to allow long-term investors a decent buying opportunity. Over the last 24 months, we have patiently built up adequate reserves awaiting a buying opportunity (like we just experienced.) We think Equity prices are now attractive enough to warrant deploying additional equity from bonds (our defense) for investors that can stomach a little more volatility and that have 3-5 years before they need to touch any of the money added to equities.

As I have explained in the past, MWA portfolios are comprised of defensive assets that are designed to protect the offensive assets in your portfolio. In the last few months our fixed income assets have done their job (they have not declined) and now the trades you have seen in your accounts are "rebalancing portfolios." This is the systematic process of selling the winners and buying the portfolio's losers. Our **CORE+ Model's** utilize a **threshold based rebalancing policy** that is triggered when stocks experience greater than a 20% decline. You will notice that we sold a portion of the bonds in your accounts and we added those proceeds back to the parts of the equity markets that have declined and therefore need additional funds to bring them back in line with our model's targets.

For investors that are more opportunistic or willing to tolerate greater levels of variability, we are going to slightly increase the equity exposure in long-term accounts. If you would like to revisit your investment policy or risk and return profiles, please shoot us an email or give us a call and we will be happy to review portfolio characteristics with you.

While I do not know when markets will rise, I do feel that stocks are oversold and money that is put to work at these levels will be rewarded over the next 36-60 months (and maybe sooner). I'm sure you know all the reasons investors are nervous: Tax Loss selling, the trade war, rising interest rates, the government shutdown, Brexit, falling oil prices, tight labor markets, a deceleration in growth rates, etc., but at some point these events all get factored into market prices and investors just need to deploy extra funds and follow their policy. Remember markets are a forward-looking pricing mechanisms and money put to work today will receive better pricing than money put to work in the recent past. Fund flows into US equities slowed in 2018, and funds poured into money markets. There are now lots of funds sitting on the sidelines that could continue to fund future growth as markets climb walls of worry.

Here are a few of the reasons why we think global stock markets are now cheap enough to begin deploying some reserve funds (the funds we hold in bonds/cash value):

Positive reasons to add to Global Stock Markets:

- Sentiment negative (I would rather buy stocks when there is more fear than optimism)
- Fundamentals are still strong & in the end, fundamentals win over emotion
- 2.75% Yield on the 10-year US Treasury Bond
- Current Prices already reflect a more than a 50% chance of a US recession (this is a fairly pessimistic assumption)
- Earnings/Profits are still strong (despite slowing slightly)
- Interest rates are down 50 bips (.5%) from a few months ago
- The Dividend Yield on Equities is close to or exceeds the 10-year Treasury (depending on which asset class you are looking at.)
- US Multiples at or below their 10-year average
- Emerging Markets are trading at 1.1x their book value

Many of you may remember me saying that US stock markets had been somewhat expensive by historical standards, but now US Markets are trading at about 14x next year's earnings (This is slightly below their average for the past 10 years). If the S&P 500 is anywhere near $2250 we think it is a buy. This is a very reasonable valuation given the low interest rate / low inflation rate environment that we are in. Even if growth slows further (as many market traders are worried about), the future expected profits from companies should eventually push markets higher as profits are realized.

As we look back on 2018, I think one of the biggest stories of 2018 might just have been the U.S. economy. GDP looks set to come in around 3%, and unemployment as of November stood at 3.7%, with more than 2 million new jobs created this year. (4)

While sentiment has been negative (until yesterday), fundamentals are strong. Interest rates on the 10 years treasury bond are nearly .50% less today than a few months ago. Rising rates have been one of the big long-term negatives causing concerns, just a few weeks ago the yield curve was very close to inverting (a situation that is typically viewed as a negative, where short-term interest rates are higher than long-term interest rates). Based on our analysis, we think it is likely that the Fed will begin to stop or slow the rate increases as rates approach 3%-3.25%.

Resources Around the Web

Understanding Why Emerging Markets must be a component of your portfolio: This article by Larry Sweadloe dives deep into emerging market valuations relative to the US. https://www.advisorperspectives.com/articles/2019/01/14/new-research-on-the-value-of-global-diversification

Remembering Jack Bogle: Jack Bogle, the found of Vanguard, and known as the father of indexing. This article discusses his impact on investing and thoughts from his peers and CEOs of rival companies, we think you will enjoy it. https://www.bloomberg.com/news/articles/2019-01-17/-patron-saint-of-the-investing-business-remembering-jack-bogle

Growth of Passive Investing: We have been asked why do we use DFA's slightly higher cost mutual funds over ETF's or Indexes? The simple reason is that DFA's approach is less expensive because of cost of trading. This article shows the increase in indexing (also referred to as passive management) and it also looks at results of ETFs vs mutual fund indexing in Europe. The data shows ETF's advantages have not outweighed their cost. This article is just one reason we favor DFA's flexible asset class structure of indexing over rigid index fund investments.
https://www.ifa.com/articles/some_interesting_data_from_2014_investment_company_fact_book/#ChartFlashID1606

PowerPoint Slides on 4th Quarter Performance: https://www.millswealthadvisors.com/markets-across-world-performed-4th-quarter-2018/

We think the best course of action is to ignore all the noise in markets because history has shown that stocks climb walls of worry. I would much rather buy when everyone is selling rather than buy when everyone is buying. Buffet's quote, "***Be Greedy when others are Fearful, and Fearful when others are Greedy***" is one of my favorite quotes and a key to long-term success in investing. We will continue to buy US, International, & Emerging Equities now on and on future weakness. 2019 may give us a slight de-acceleration of growth domestically and overseas. My gut says as we get through the tax loss selling that occurred near year end 2019 is set up to be a better year for investors despite increased volatility.

Thanks for trusting us with your families' financial resources. Please let us know if you have any questions, we are always available to meet or discuss your questions or concerns.

Here's to a great 2019,

Mike Mills
Managing Principal

1. https://www.advisorperspectives.com/commentaries/2019/01/02/emerging-markets-equity-investing-never-waste-a-crisis
2. https://www.advisorperspectives.com/articles/2019/01/14/new-research-on-the-value-of-global-diversification
3. https://www.vanguard.com/pdf/ISGQVAA.pdf Advisor's Alpha
4. WSJ email Matt Murray Editor in Chief WSJ