Quarterly Market Update

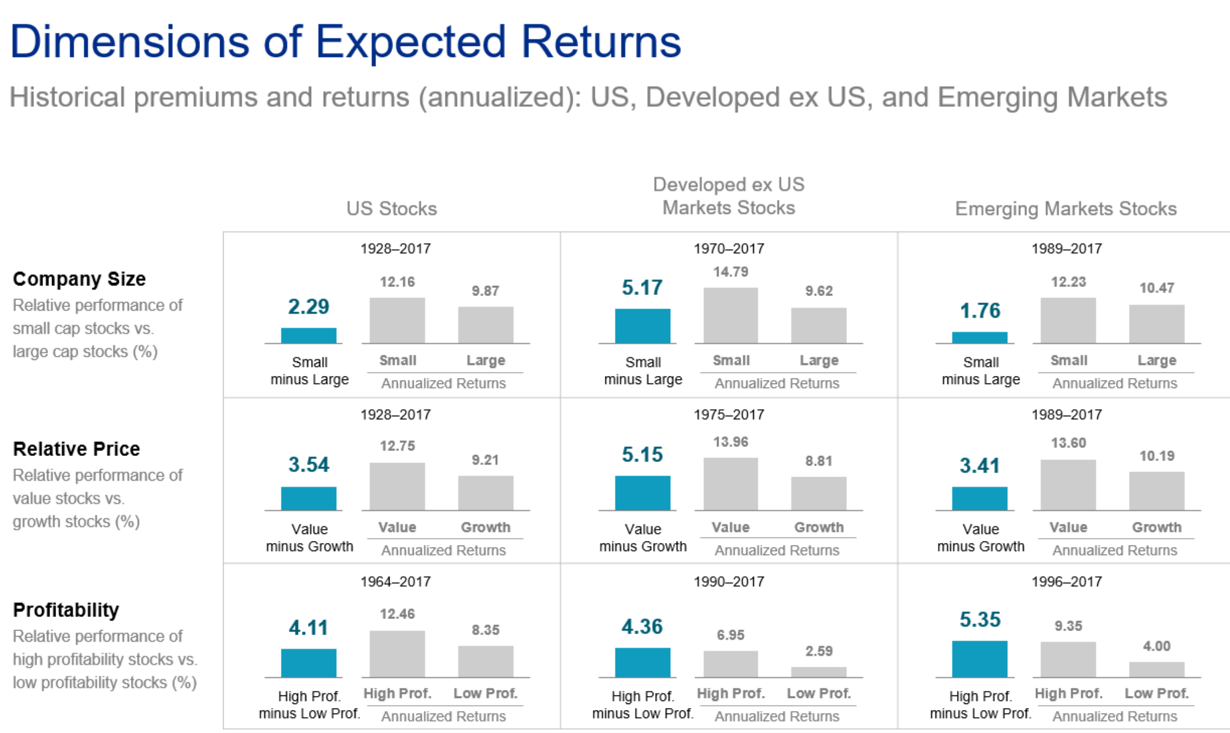
Here is a link to the MWA quarterly market report that lists all of the asset class returns and a short article on the Uncommon Average. It discusses how the average return is rarely the return that the market provides. Click here for a link directly to the article.

MWA Market Commentary

Overall the 2nd quarter was a good quarter for most investments (especially very large, fast-growing US multinationals that trade at high valuations). Stocks & Bonds continued to rebound from the pullback that bottomed over the Christmas holidays; as interest rates fell, due to concerns for slowing global growth mostly from the trade war, bond values rose. Our portfolios were positive for the quarter and many of the trades we placed in January have added value. While our portfolios hold all Large Cap US stocks, we tilt away from and under-own large growth stocks (indexes like the S&P 500).

Your portfolio returns may look lower than some of the returns you see on TV due to the tilt away from big US stocks. If risk and return remain related (as it has been since the beginning of time), eventually smaller, undervalued companies should post higher returns than larger, high valuation companies. I am not smart enough to know when this will happen, only that it will happen. If you are a long-term investor, we feel that continuing this strategy is a prudent decision.

To further this discussion, let's look at one of my favorite pictures (It may look a little busy), but the grey numbers are the long-term average returns (as an annual percentage rate) of the different areas of the markets. The blue number on the left is the total premium "EXTRA" that has been earned as an annual percentage rate above the other section of the market to which it is compared.

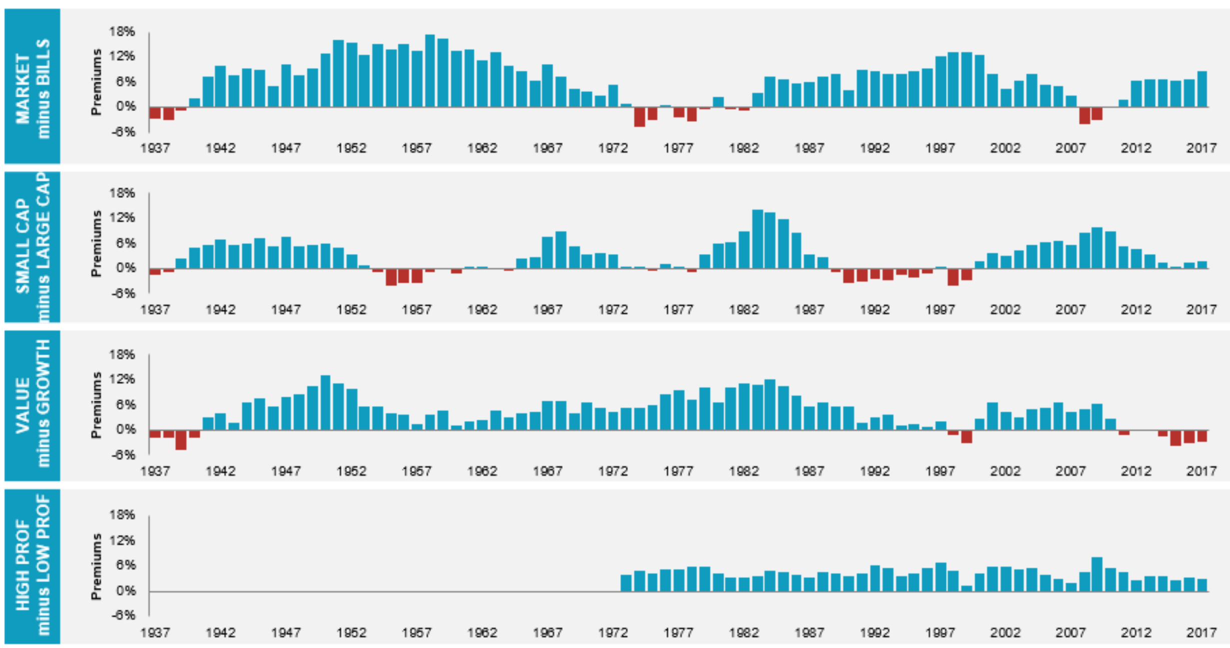


As you can see, owning a greater weighting of the left column (grey numbers) of these 3 Factors (globally) leads to significantly higher returns in the long run. I've been asked how long is the long run? In 10-year rolling periods, the 3 Factors above are positive about 80% of the time and the longest run without them being positive was about 12 years. Remember each factor is independent, so it is unlikely that each one underperforms at the same time which leads to higher chances of achieving the desired return over various market events. While 12 years may feel like a long time, most investment horizons are 20-40 years, so as advisors, if we can help our clients think longer, then we are doing our job.

Below is a graph that shows the results of the premiums in 10-year increments, in the US market (we chose the US because it has the longest track record, all the way back to 1927.) The blue lines are positive years, and red lines are the years it was negative in a 10-year period ending that year. Thus 1937 on the graph is the returns from 1927-1937.

Historical Observations of 10-Year Premiums

Equity, size, relative price, and profitability: US Markets



Most studies I've seen (like Dalbar, a popular annual survey that tracks the returns of investors in their 401k accounts) tend to estimate that most average investors take a lot of risks to earn just a little bit more than the rate of inflation (2-4%/year) because of market timing, high-cost, low "stick-to-itiveness", etc.

MWA portfolios use ***Modern Portfolio Theory*** and other evidence-based strategies to increase the chance of achieving a certain return for a level risk. The low-cost, globally diversified strategy we implement (mostly with Dimensional Fund Advisors (DFA) asset class funds) is popular among Institutional investors and is invested in compliance with the "***Uniform Prudent Investor Act***".

I would like to point out a few of the trades that we have made throughout this year to further capture the premiums discussed above. We added a High-Profit fund in both the US market as well as the International Developed market. Along with this, we added Small Cap Value in the US and International

Developed markets. In the long term, we firmly believe these new positions will be very profitable trades; however, in the short term, the two High-Profit funds have been some of the best performers in our portfolios since their addition, while the two Small Cap Value funds, even though they have both returned 10+% year-to-date, have lagged behind.

I would like to again refer to the graph above that shows that sometimes in the short run one, or two of the premiums don't work out. But in the long run each of them has returned a premium over the market, so we are not currently concerned with the short-term results of the trades. But we would like to report that the highest performing asset class in the portfolio was the US High Profit, and the lowest performing asset was the US Small Cap Value. US High Profit returned 3.94% last quarter, while US Small Cap Value returned -0.79%. As you know, the funds that we use are index funds that track specific indices. So, to go along with our funds, the best performing index was the index that the US High Profit tracks and the worst performing index was the one that the US Small Cap Value tracks.

With Brexit, a divided America, and all the other noise, I think many investors are nervous and rethinking their investment strategy. **Should you adjust today**? It is hard to know, but my advice is if you are worried about the market then lower your risk to a point that the market doesn't worry you anymore. Remember the ***MWA's 5-year rule***, if you won't need money for more than 5 years, think long-term and buy investments that match your tolerance for risk and that will likely produce the return you want/need. If you are thinking that you would like to make an adjustment, give us a call and we can walk through the options with you.

Concept to Understand

Mean-reversion is the tendency of stocks to revert toward their average return, it is the strongest force in finance. If you believe, as I do**, that risk and return are directly related,** then the chart above regarding ***Dimensions of Expected Returns*** is the foundation for why we construct our **CORE+ portfolios**, to own a greater weighting of these 3 Equity Factors (Undervalued Companies, Smaller Companies, and High-Profit companies) over other areas of the market. Factor research is based on the research of Noble Prize-winning professor Eugene Fama (University of Chicago) and his research partner professor Kenneth French (Dartmouth University). **Here's the takeaway**: Portfolios that own more of the 3 Factors listed above, have tended to result in higher expected returns, albeit with more volatility. There is no free lunch in investing.

Common Questions

What's the major disadvantage of investing in a 3 Factor Portfolio Strategy? A portfolio that tilts toward the 3 Factors listed above will have different weights than a portfolio like the S&P 500, so the tradeoff is the portfolio will rise and fall at different times than the what investors see on TV. The good news is the portfolio should succeed more consistently in different market cycles. With any investment policy, the key is to buy into a strategy that you can stick with over multiple market cycles.

How Does MWA Build its portfolios? Since your portfolio owns the entire global market, maximum diversification, the likelihood of success is very high. Portfolios are grouped based on risk and objective, but generally, when we are investing in public markets our portfolios are normally built with over 10,000 positions.

The classes of investments are weighted toward the Factors described above and exclude other areas of the market that offer lower returns. This inclusion and exclusion attempt to give us the highest chance of achieving the desired return over a market cycle as different areas of the market rise and fall at different times. In portfolio construction, we want to have the highest probability of achieving success over an investing lifetime that we will capture market returns. We monitor our portfolios to ensure that we are capturing the returns equal to the weightings established. We are happy to report that the funds are indeed capturing the returns.

This quarter our portfolios' tilt was not rewarded, but please don't lose faith, it is not different this time. Markets are forward-looking and adding money to what has struggled has been a better long-term strategy than buying what did the best. As you can see from the **best and worst slide** below we are well within our expected returns, and with higher dividend yields and higher returns from bonds, we are comfortable with our current allocation and the portfolios ability to deliver returns that exceed what is needed to achieve your goals the ultimate measure of success no matter what type of market is around the corner (up, down, or sideways).

Quarterly Market Summary

Index Returns

	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
Q2 2019	**STOCKS**				**BONDS**	
	4.10%	3.79%	0.61%	1.29%	3.08%	2.75%
Since Jan. 2001						
Avg. Quarterly Return	2.0%	1.5%	2.9%	2.6%	1.2%	1.1%
Best Quarter	16.8%	25.9%	34.7%	32.3%	4.6%	4.6%
	2009 Q2	2009 Q2	2009 Q2	2009 Q3	2001 Q3	2008 Q4
Worst Quarter	-22.8%	-21.2%	-27.6%	-36.1%	-3.0%	-2.7%
	2008 Q4	2008 Q4	2008 Q4	2008 Q4	2016 Q4	2015 Q2

I think it is interesting to look at pages 5 & 6 which shows the big headlines that occurred during the quarter (link). I think the United States' growth rate is the biggest news and as one would expect this has been reflected in US market prices, especially the large tech companies. Both small companies and value companies trailed in the recent quarter.

Markets have done well for nearly a decade with all the political instability, don't you think the market is about to take a big nosedive? Should I sell stocks now move the money to a money market and wait for "the crash" in cash? While market pullbacks are painful, trying to time when you get in and out of the market is a hard way to consistently win. Even investments made right before the financial crisis or the 1973 correction made good returns over time (but it was painful right after the correction occurred). ***MWA's 5-year rule:*** We believe if you will need a portion of the money within 5 years, we don't want to own stocks with that portion of the money. In the long run, being out of the market is a bigger risk than being in the market, so it doesn't matter when you invest; if you diversify, rebalance, and increase exposure to assets that fall (after a decline), investors should be rewarded as markets rebound. Typically, buying the lowest valued assets (often trading below their asset value) has produced the highest long-term gains. I think it is important to remember that capital flows based on changing information can change course very quickly and most of the gains that occur at changes go to the investor that maintained consistent exposure.

How much impact does the last return have on a series of data? It is also important to remember the impact the last return has on a series of returns. Look at the following example:

8, 8, 8, 8 = avg return of 8%
Vs
8, 8, 8, 8, -10 = avg return of 4.4%
Vs
8, 8, 8, 8, +10 = avg returns of 8.4%

The takeaway is where we draw the line greatly affects the results. Your portfolio owns 10,000 positions from Amazon & Apple the biggest positions to 3,500 of the smallest positions. Historically, small companies earn about 3% more than big companies and undervalued companies earn about 5% more per year than growth companies. These premiums are not constant but occur nearly 80% of the time over rolling 10-year data and are independent of each other.

This quarter we have seen an inversion in interest rates where short-term rates are higher than long-term rates and recession fears or slower global growth outlooks resulting from the trade war and Brexit fears have caused the US to continue to post strong returns. The pullback in interest rates caused bonds to post a great quarter, our short-term high-quality portfolios were up, but a few extra percent is hard to get excited about. Bonds are not yielding much so we are staying short and maintaining some exposure in floating-rate bank debt and a small amount in emerging market debt. Long-term value-oriented investors will continue to use recent US gains to rebalance portfolios back toward cheaper areas of the market that should eventually post bigger returns. I want our investors to remember that equities are the primary driver of long-term returns and bonds provide the defense. The more you are worried the more we should shift to defense, but small changes are usually better than big bets.

Thank you for the trust and confidence you have placed in us and please call with any questions. We look forward to getting you set up with our new software this quarter.

Best Wishes,

Mike Mills,
Managing Principal