MWA 2020 Decade in Review and 4th Quarter Update

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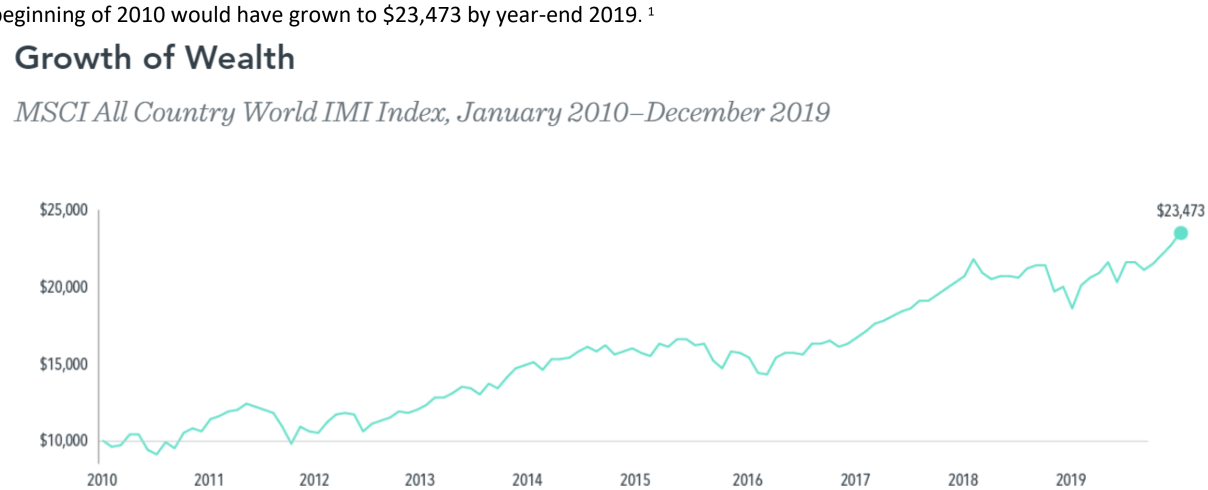
The year 2019 offered investors strong returns in many major asset classes and capped off an attractive decade of gains. Figure 1 below shows the 10 year returns for a global stock portfolio. Large US growth stocks, the major type of stocks owned by many investors, especially inside their retirement accounts, have performed even better than a globally diversified portfolio, and well above their historical averages. The same is true for commercial real estate. A common lesson we can pull from history, is that nothing can last forever. With global growth slowing, political uncertainty brewing, and more tension likely to surface with the trade war, I think all investors need to be comfortable with their defensive resources available in their financial plan, should a reason surface that warrants turning to it.

Here are common assets we believe can provide portfolio protection: Cash/Money Market/Cash Value, High Quality Fixed Income, HELOCs, some alternative assets, and future savings. When markets pull back, and they eventually will, we want investors to view the decline as an opportunity to invest their defensive funds in addition to portfolio rebalancing. These strategies should add to long-term returns because they force investors to buy lower and sell higher. Because taxes can be one of the bigger costs that can siphon off gross investment returns, these strategies tend to be more tax efficient than dancing in and out of markets. For clients who are approaching retirement or who are currently in retirement, now is a good time to reassess how much cash or short-term savings to have on hand. If you would like to review or create a formal withdrawal policy or an MWA Lifetime Income Plan (LIPP)™ we are here to help.

Figure 1:
The MSCI All Country World IMI Index, which includes large and small cap stocks in developed and emerging markets, had a 10-year annualized return of 8.91%. From a growth-of-wealth standpoint, $10,000 invested in the stocks in the index at the beginning of 2010 would have grown to $23,473 by year-end 2019. [1]



1 The 2010s a Decade in Review, https://us.dimensional.com/perspectives/the-2010s-a-decade-in-review

In regard to the recent **US/China trade deal** that was signed, we would caution investors that in spite of the agreement being signed, the risk that tensions flare up with China in the new year still exists. This is especially the case if China fails to follow through on its commitment of goods purchases, commitments they had said they would adhere to, only if there is market demand and conditions supported them. As such, we would characterize the Phase 1 deal as welcomed, but more of a fragile truce than a permanent settlement.

I know everything you read or see in the media is cautious and warns of a market pullback, but don't forget markets don't have to go down soon just because valuations are high. Take 1877-1907 for instance. That bull market lasted for 29 years. More recently, the great bull market of 1982-2000 lasted for 18 years. When I started investing in college in 1995 markets were extremely expensive, but 1996-1999 were incredible years for the US stock market as judged by the S&P 500. According to Slick Chart.com[2], in these 4 years the S&P500 increased by 22.96%, 33.36%, 28.58%, 21.04% (that would have been tough years to miss. An article from Advisor Perspectives states, "...by comparison, the current bull market is only 10.7 years old – still a relative youngster in historical terms." Is that an argument for going all-in at this point? No, because that would be just as dumb as going all-out."[3] We recommend that investors, leverage diversification and build up enough defense that they can easily stomach and tolerate the inevitable declines that will eventually occur.

Information gleaned from, Research Affiliates in their article: ***Forecasts or Nowcasts? What's on the Horizon for the 2020s***[4] explores future investment returns and the dividend yield from the major investable asset types. The top 3 highest expected returning assets are Emerging Market Equity, Developed International Small Companies, and the Emerging Market Bond categories. In Figure 2 below, I think it is easy to see that over the long run Emerging Markets have offered higher returns than US markets.[5] This is mostly because these markets are riskier as judged by annual market volatility. Over the last decade, a stronger dollar combined with trade instability has caused emerging markets to underperform US stocks (Figure 3), making them a much better relative value going forward for risk tolerant investors that can stomach swings up in down in the market price. Portfolios owning emerging markets should boast greater diversification, higher dividend yields, and higher expected returns than those that exclude this unloved area of the market in the future. From a strategy standpoint, as value investors we want to own more of unloved areas of the market. I think investors should ask themselves how much can I stomach?

2 S&P 500 Returns, https://www.slickcharts.com/sp500/returns

3 The Dice Man Cometh, *https://www.advisorperspectives.com/articles/2020/01/20/the-dice-man-cometh*>

4 Forecasts or Nowcasts, https://www.advisorperspectives.com/commentaries/2020/01/17/forecasts-or-nowcasts-whats-on-the-horizon-for-the-2020s

5 Emerging Markets Underperformed, http://stansberrypacific.com/asia-wealth-investment-daily/emerging-markets-underperformed/

Figure 2: Performance of Asset Classes inside and outside the US.[4]

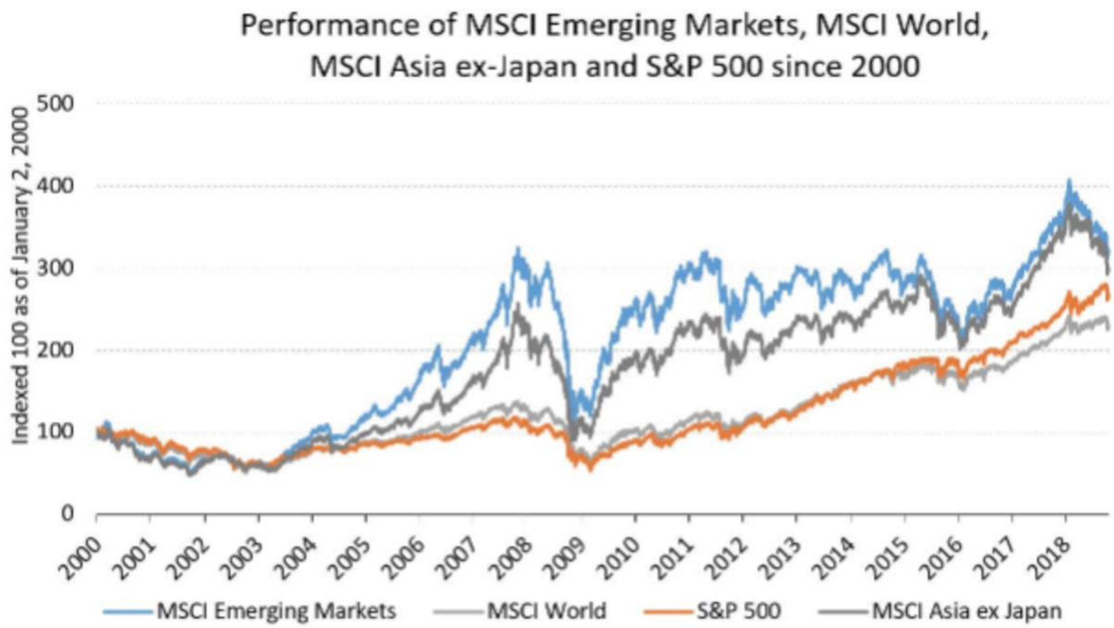
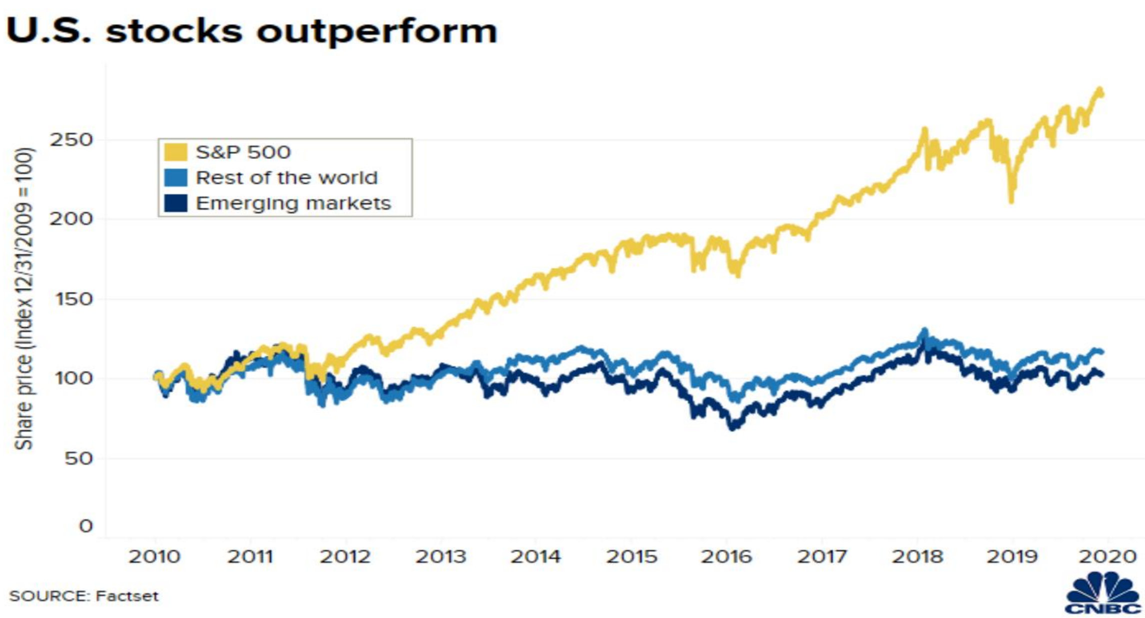


Figure 3: US Stocks outperformed the rest of the world in the 2010s [3]



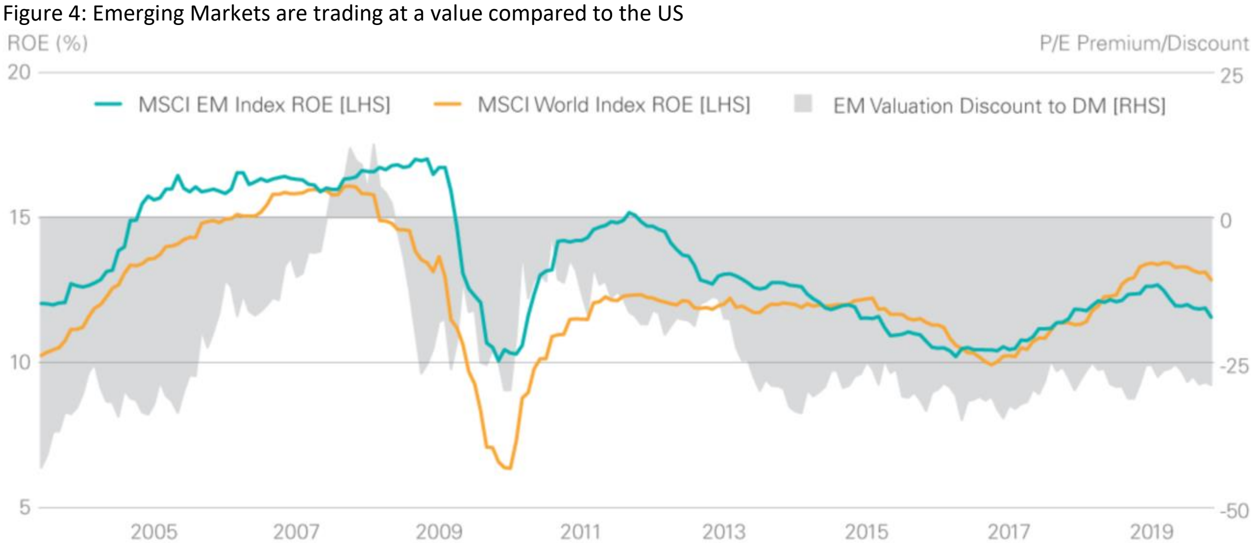
Historically non-US asset classes are considered higher risk assets, because they exhibit higher volatility in dollar terms. According to projections from Research Affiliates, their research suggests that investors who have the typical 60/40 US heavy portfolio allocations are unlikely to generate the 4-6% expected returns needed to cover most retiree withdrawal rates, because US valuations are higher than normal, so future returns are likely to be lower than normal at some point. If inflation were to resurface causing interest rates to rise, that would likely create another headwind that may lower long-term returns. If

4 Forecasts or Nowcasts, https://www.advisorperspectives.com/commentaries/2020/01/17/forecasts-or-nowcasts-whats-on-the-horizon-for-the-2020s
5 Emerging Markets Underperformed, http://stansberrypacific.com/asia-wealth-investment-daily/emerging-markets-underperformed/

the Research Affiliates long-term estimates turn out to be near the actual returns realized in the future, in order to generate 4-6% net of fee returns, undervalued investments such as emerging markets, international small companies and emerging market bonds must be owned in greater quantities than normal. Higher valued assets like real estate & US large growth companies will need to make up lower than normal weightings.

As you can see from Figure 4[6] below when viewed from the Return on Equity metric both the MSCI Emerging Market Index and the MSCI World Index trade at significant discount to the US and more developed markets.

Figure 4: Emerging Markets are trading at a value compared to the US



To counter-balance higher volatility that is likely to come from holding greater weighting of international or emerging markets investments, investors might consider holding more cash or liquidity than normal. Doing so might make riding through portfolio volatility easier to stomach. If you equate investing in stock markets like riding a roller coaster (like the Texas Giant), the only way to get hurt is to get off in the middle.

In an effort to save you time, I have linked to several additional articles of interest that you can come back to later if desired. If you have time, please read these articles as they are chalked full of good information, stories, and lessons. Below, I have included descriptions and explanations of why I included these articles or links in this report. Enjoy and thanks for letting us help you and your family create your plan to accomplish your goals.

--Michael Mills

6 Emerging Markets Outlook, https://www.lazardassetmanagement.com/docs/sp0/145/LazardOutlook_EmergingMarkets_2014Q1.pdf

Section 2: Articles of Interest:

- **Investment Lessons from 2019** by Larry Swedroe, 1/16/20
  In this outstanding paper, Larry outlines 12 Investment lessons the market taught investors in 2019. You may have heard me discuss Larry before, Larry is a talented writer and researcher. I think he does an excellent job at explaining important concepts that investors need to know in easy to understand language. He uses a Factor oriented investment approach, like our CORE+ strategy. He is on the short list of writers I like to read.

- ***All Asset All Access, January 2020*** by Robert Arnott, Chris Brightman, Brandon Kunz, Jim Masturzo, Omid Shakernia of PIMCO. 1/14/20
  In this paper Mr. Arnott and his team help the reader understand that value investing is not dead and by using various quotes and examples from history, along with stories of mistakes investors have made in the past they help readers grasp histories effects on valuations, strategy, and mistakes to avoid. This article is worth the time.

- ***Forecasts or Nowcasts? What's on the Horizon for the 2020s***

  This article lays out expected future returns using Research Affiliates valuation methods. I think it is always a good idea to have an idea of what long-term future returns could look like as you create your investment policy frameworks. For instance, if you are an aggressive investor and the United States is like to produce lower than normal returns in the future what is the maximum or minimum you would want to own in your portfolio?

- ***Value Judgments: Viewing the Premium's Performance Through History's Lens***

  This short paper looks at the history of the value premium, to understand why investors need to own the value premium & the tradeoffs that must be accepted in order to monetize the 4-5% per year premium. This article will help investors know value has underperformed growth globally the last decade and that these trends are well within normal tolerances.

Section 3: Q&A on MWA Core+ Portfolio

Q&A: MWA CORE+ Portfolio Strategy or Investment Policy Questions surrounding the MWA CORE+ global Portfolio

Q: What's MWA's goal when building a prudent investment policy:

A: This is a question we spend a great deal of time discussing with clients. I think the answer could be different depending on your specific stage of life and personal situation, but I think it is safe to say for a portion of your portfolio, what I'll refer to as the CORE Portfolio, I believe the objective is to have the highest long-term risk adjusted rate of return, after taxes and net of implementation cost with the least chance of failing the objectives the client outlines in the investment policy or the goals the investment policy is constructed for in the financial plan. As I've aged I wish I had been more conservative when I was younger and was told that was the time to take more risk because the reality is if you ever have a permanent loss of capital those dollars can never work for you again. Losing money early in a career is detrimental because just think how much growth assets saved in your early 20s could grow to if they had been there to compound at 6-8%/year instead of trying to get more but losing it instead of earning a lower return. Warren Buffet's Rule #1 is to never lose money, and rule number 2: **Never forget rule number 1.**

Q: Why do MWA CORE+ Portfolios hold between 33-50% investments outside the US?

A:US & International markets rise and fall at different times, so modern portfolio theory teaches that owning non-correlated assets improves portfolio returns. A negative change to US economic policy can cause capital to flee US Markets in search of higher returns or better economic policies. Therefore, diversifying across the globe is a prudent strategy that tends to reduce risk and protect against country specific problems. Dissimilar market movements combined with rebalancing (selling the winners and buying the losers) will help produce higher investment returns especially if volatility is higher and money is added to portfolios systematically. Because emerging markets and tilts to factors like small companies, undervalued companies, or high profit companies globally increases the number of companies owned and the expected risk, compared to just owning US investments only, having more securities and more securities that are perceived as riskier makes owning international assets offer portfolios higher expected returns over long-run market cycles. Currently the US is 54% of the world market value as determined by the size of the world market. Market size seems like a good starting place for determining the Investment Policy Weighting of a portfolio.

Q: How did MWA arrive at 50% International weighting for its HI-Vol accumulator portfolios and 33% weighting for its LOW-Vol retiree portfolios?

A: Retirees often need lower volatility than accumulators that are saving money. Because retirees expenses are spent in US dollars not foreign currency, we tend to own a lower weighting to international investments for retirees because doing so reduces risk of needing the money while the market is down. International diversification helps all investors, but if international markets don't perform and a retiree needs the money before the markets rises, the retiree could be forced to sell while the market is down eating into principal or causing a retiree to approach 100% equity as other assets are spent. That is why we typically have a 50% initial policy weighting for accumulators and a 33% initial weighting for retirees. In portfolios that are withdrawing money, we need to have a smaller overseas allocation to lower volatility as compared to portfolios that expect to add money or just hold constant.

Q: Why do we under-own growth stocks relative to the weighting in the S&P500?
A: Because risk and return are related, we know that if we diversify and keep exposure to the 3 equity factors, smaller companies will eventually offer investors higher expected returns than larger companies.

Q: Why do we under-own Utilities?

A: Utilities are often seen as a defensive form of equity and are perceived as less risky than equities of non-regulated businesses. Utilities typically have higher dividend yields and like REITs and resemble both equity and fixed income. Research in portfolio construction has shown that it is possible to create safer higher expected return portfolios by combining negatively correlated high quality bonds with a broader array of higher volatility diversified global stocks covering the entire world with greater exposure to the 3 factors (undervalued companies, high profit companies and small companies) which offer higher expected returns than Utilities or REITs.

Q: Why don't we recommend dividend investing as opposed to total return investment:

A: Dividend investing offers lower returns than total return investing. Dividend Investing captures about 60% of the value premium, but not all of it, so it is less efficient than total return strategy.

Q: Why do we use shorter-term high-quality fixed income?

A: Because the yield curve is flat, investors are not being paid to lock up money for a long-time. In this environment we believe it is better to take risk in equities not in bonds. Bonds are our defense. We want our bonds to rise when markets fall. By avoiding low credit quality high yield bonds, the majority of our bond portfolios will rise if equity markets fall.