Q3 Update: Elections and Valuations

It is a beautiful fall day here in Texas. If COVID has had you couped up in the house or has prevented you from traveling with friends and family, I hope the beautiful fall weather has allowed you to get out of the house and enjoy the cooler October weather.

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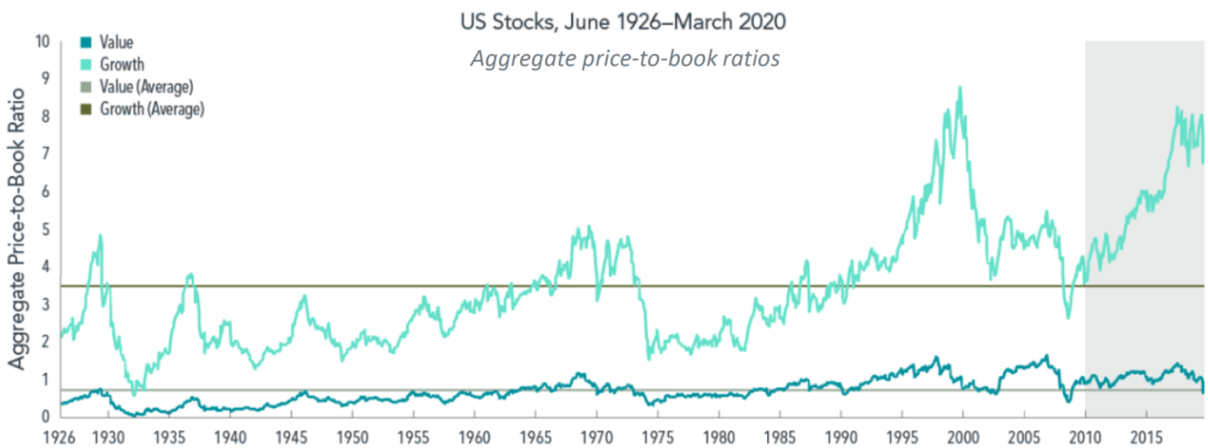
Section I: Market Update Report

The 3rd quarter was a strong quarter for our investors, as markets continued to climb the wall of worry and trend higher. If you glance at the ***MWA Quarterly Market Review*** slide deck (LINK) you will notice that most major stock and bond asset classes that we invest in were positive this quarter. Technology stocks, despite extremely high historical valuations, received a continual inflow of money most of the quarter, and finally sold off on valuation concerns at the end. Institutional funds have continued to widen out of just a few tech stocks into less expensive areas of the market. I don't know if this trend will continue through the election season, but when a vaccine hits the market and if additional stimulus gets handed out, we believe funds should eventually flow to areas outside of giant US growth companies (i.e Facebook, Apple, Netflix, etc.). Historically these types of rotations occur very quickly, and the best time to capitalize on the cheaper valuations is when they are "unloved" by the retail marketplace. Reversion to the average return is one of the strongest forces in finance, so we will continue to maintain global diversified exposure to the factors that have historically driven long-term returns.

Section II: MWA Quarterly Commentary

Last weekend, I went to buy a 4x4 truck because my wife is tired of me riding my bike (it has been a fantastic way to exercise in the beautiful weather). The local dealership was 20% higher than the specialized truck dealer I found on the internet. In this situation, most people would choose the lower cost online retailer. This reminded me of today's valuation gap in Large US Growth stocks vs literally everything else but large US Growth. The local dealership is like the growth stock with higher valuations on the truck compared to the online dealer with lower valuations. However, we are finding that a lot of people are continuing to choose the "overvalued local dealership trucks" or growth stocks.

To explain the difference in why valuations are important, allow me to use one technique known as Price-to-Book Value, as an example, to help illustrate my point. If we buy value companies in the United States there are 2,491 companies I can spread my risk across trading at 1.55x their book value, but when you compare these companies to a portfolio of growth companies there are only 253 companies with a Price-to-Book value of 23.60x (which his up from the already high 16.54 in Q2 2020). This would be the equivalent of paying **FIFTEEN** times as much for the truck and getting fewer options because over the long run value companies tend to return an estimated 2.5% - 3% more per year than growth companies (2). I think this picture explains these numbers better. You can see that growth valuations (light blue) are reaching levels hit in the late 1990s/early 2000s. This is well above their long term average.



Source: CRSP, Compustat, and Bloomberg. Aggregate price-to-book value computed as the inverse of the weighted average book-to-current month to date market value.

When these types of hockey-stick changes in valuation occur, we believe it is prudent to expand our diversification away from assets that have performed well above their historical returns and into assets that seem to be favorably priced. The moral of the story is simple, history has shown the lower the price investors pay, the higher the long-term returns tend to be, albeit not year to year.

Section II-A: The Elections and Market Timing

One of the Investment Lessons I want to review today is the strategy of **Market Timing**. Let us evaluate the market timing discussion using election years and which political party wins as a real-life (and timely!) example.

Client Question: We have received several calls about selling out before the election and buying back in after the election is over or holding on to cash today and waiting until after the election to invest it. Are these strategies we should consider?

Answer: My first question to that question is, "what is your time horizon?" Are we talking about money we will need within 5 years? If you need it in less than 5-years, we believe it should not be invested in stocks in the first place. If it is long-term money that you expect to need in 10, 20, 30 years, then this election is not going to have any meaningful effect on the return in your portfolio. To illustrate this point, please take a look at the graphic below.

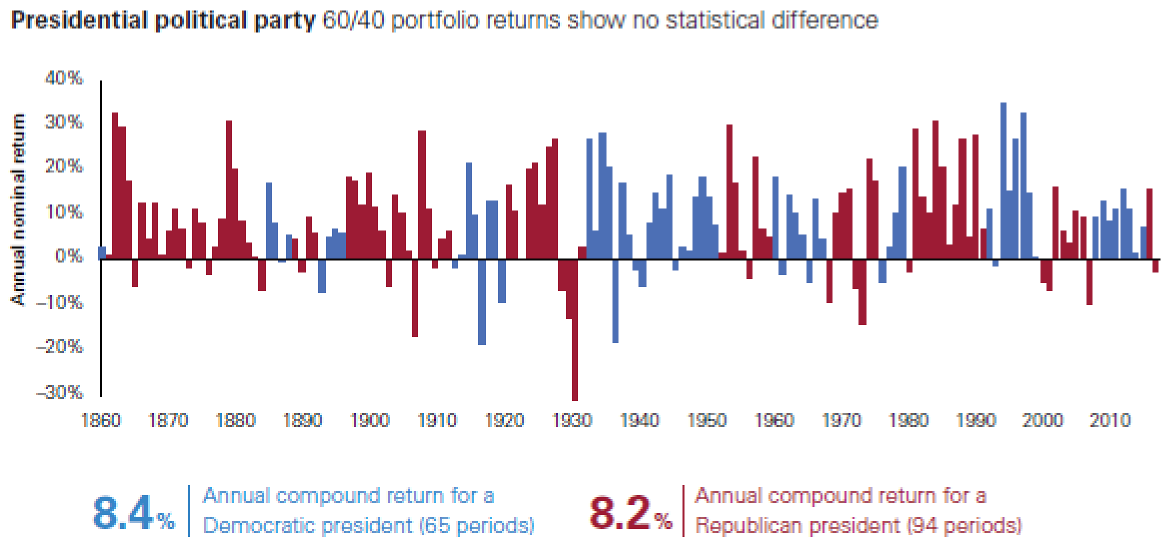
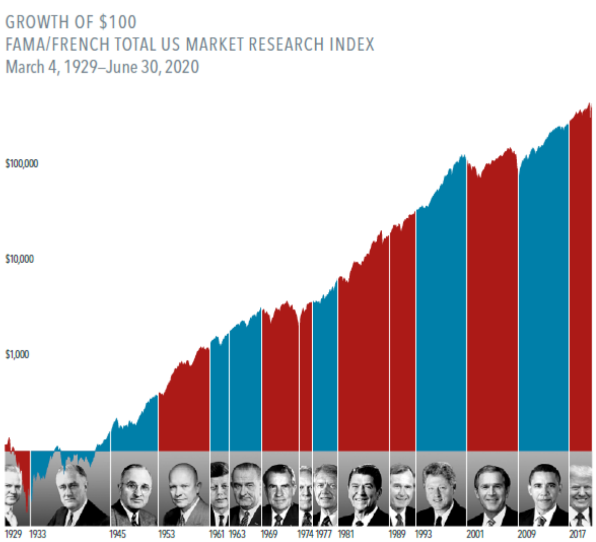


Figure 1 – Note that since the mid- to late-1800's, the annual return for the Democratic vs. Republican party is only 0.2%.

My second question would be, "how much risk can you handle without jumping off the ride?" If risk and return are related, we want to confirm that the portfolio you are invested in matches the returns you will need and that the portfolio will not drop below the amount you are willing to lose temporarily amid market volatility.

Client Question: I am worried about what will happen if the Democrats win the presidential election or gain control of Congress. What do you guys think?



Answer: History has proven to us that markets tend to be agnostic to either side of the aisle, and over time, move in a positive direction, regardless of which party holds office or gains control over Congress. During election years there are historically heightened levels of volatility, but over time, "stocks have trended upward across administrations from both parties" (per DFA in Figure 2 below). Our philosophy will be to remain disciplined and not reactive to short-term volatility to help our clients achieve their long-term objectives.

Figure 2 – Note that while US Presidents may have an impact on markets, so do a myriad of other factors, such as "… a global pandemic, interest rate changes, rising and falling oil prices," etc.

When it comes to market timing, many studies have been done on this subject, and I think the results of most of the studies line up with what I have experienced personally. When an event pops up that could move markets, it is human nature to try and place bets on your interpretation of that event, I know I like to do that. However, trying to jump out of the market and into safety (i.e. bonds or cash) before an event like the election usually results in a greater loss due to the opportunity cost of being out of the marketplace.

Over my 21 years as an independent advisor, I have had about a dozen clients decide to get out of the market in an attempt to forgo the pain of a market decline. So far, I have never had one of those clients end up making more money than the investors that just rode out the ups with the downs. This is especially true when you compare it to the investors who consistently add more money after a decline occurs. As we have discussed before, when you jump out of the market and move to the sidelines, you must be right twice: once on when to get out, and second, when to get back in. Equity markets rise much more than they fall, as we learned in the 2008 Financial Crisis and again this year with COVID-19, and in both instances, the government was able to intervene and force markets to rise. Money printing combined with pushing interest rates to zero pushed markets to an all-time high and forced investors to buy into “risk” (i.e. equities).

With a market timing strategy, If you get the direction of the market right, but miss the exact time or duration of the selloff, you can still harm your returns, and this doesn’t even consider the impact of taxes or other frictional costs. Much of equity markets large gains are clustered around just a few days, and if an investor is uninvested or under-invested when those days occur, it is possible to severely damage a portion of the long-term permanent returns that are virtually guaranteed to investors that maintain properly diversified equity exposure to the factors that drive investment returns.

Markets will rise much more than they will fall over time, so resist the temptation to get completely out of the market. If you must remove risk, resist the temptation to make an all or nothing bet. Instead, make partial adjustments. As an advisor, I know I am much more fearful of missing the ups than I am of riding through the temporary declines. The COVID-19 pullback was a great example of how fear can sweep through markets. In this pullback, the time to recover losses was relatively short, making it an incredible long-term buying opportunity or a 40% off sale.

This is probably a good time in this commentary to move on to another important investment concept that I know I beat up like a drum in these quarterly letters. Make sure your **portfolio matches your risk tolerance.** One way to do this is by abiding by the “**5-year rule**”. If you know you will need money for a planned expense within 0-5 years, the funds intended to be used for that expense should not be in stocks, but instead be in defensive assets like short term bonds, money markets, etc.

After these funds are earmarked, the remainder of your portfolio can be allocated to offensive assets that are designed to facilitate growth and higher returns over time. The tradeoff here is that these “offensive” assets will typically come with more ups and downs but are pivotal in the long-term to growing your portfolio. If you would like to review your portfolio allocation and strategy to confirm it matches your risk and return objectives, expected expenses, and goals, we think this is a great use of time. Just let us know and we will make this an agenda item at our next meeting.
Finally, please remember the more we lower risk, the more we must eventually lower investment returns which will eventually impact the amount of money we have available to spend or give away.

I have long believed linking portfolio returns to the goals in your financial plan is a great way to help think longer-term and help focus on what is important, what you intend to do with the money you have saved.

Section III: Around the MWA Office

Just like many of you, we have been dealing with friends, family, and ourselves coming down with COVID-19. Please know if you would like to have a review with us in the office, we will do everything we can to keep you safe and healthy. In any event, we are available for video-calls. We have been hosting video calls with our out of town clients (and some in town clients) for years. So, whether you would like to meet in person or over video-call we want to talk with you and review your financial plan and investments.

Section IV: Articles of Value, Recommended Reading

Third Quarter Review of 2020 "Sure Things" by Larry Swedroe, Principal and Director of Research for Buckingham Strategic Wealth

- In this article Larry Swedroe reviews his "top prediction" from a year ago. 5 out of 9 predictions came to fruition, but only as a result of chance and the result of the response to COVID-19. The takeaway here is simple: markets are complex vehicles, and the future is almost always an uncertainty in the short run. If you want to control your wealth over time, the "golden ticket" is typically by using a globally diversified portfolio built for the long-haul.

'Black Panther' star Chadwick Boseman didn't have a will – like many Americans by Alessandra Malito

- In recent news, the celebrity and actor Chadwick Boseman lost his life after a hard-fought battle with cancer at the age of 43. Nearly two months after his death, his wife, Taylor Simone Ledward, has filed documents in probate court to administer his estate. Unfortunately, this is a story that is heard far too often and leaves many families in a difficult and burdensome situation after they tragically lose a loved one. We cannot stress this enough, if you or your loved ones do not feel confident in your current estate plan or are not sure how to answer questions such as, "what would happen if I or my spouse were to pass away?" then please give us a call.

Your 5-Step Guide to Navigating a Scary Stock Market by Carl Richards

- There's no doubt about it: 2020 has been a year unlike any we have experienced before. From COVID-19 to political unrest to the fire's in California, this year has left many of us thinking to ourselves, "what else could *possibly* go wrong?" And in the midst of the calamity, I can think of no better author to turn to than Carl Richards – the financial planner who has made his career as a writer for the NY Times by "simplifying the complex" through sketches. This article is a great read for any of you thinking about your investments and if now is the right/wrong time to be in the marketplace. (PDF Link)

Sources:

1. Mills Wealth Advisors Q3 Market Review
2. Dimensional Fund Advisors, DFA Global Market Breakdown, Q3, 2020. (https://www.mydimensional.com/dfsmedia/f27f1cc5b9674653938eb84ff8006d8c/553-source/global-market-breakdown.pdf)
3. Figure 1: The Vanguard Group, Inc., 2020.
4. Figure 2: Dimensional Fund Advisors, September 20, 2020.