Q1 2021 Update: Hello Value, My Old Friend

Mike Mills
Managing Partner
CFP, CLU, CFS

In the update below, you will find the following links that will direct you to the topics and resources we have assembled for your benefit. I hope you find it informative and useful. If you have an extra second, read **Section III: Around the MWA Office** for a few attaboys. Please skim **Section II's Warning label** where I discuss today's high valuations, look at some charts and graphs, and issue a possible developing bubble warning along with some recommended portfolio moves we expect to take in the upcoming quarter. For those that are not adding substantial savings to their accounts over the next 5 years, now might be time to ring the register, pay some tax, and book some profits. We look forward to having these important discussions with you soon.
Best Wishes. – Mike

Section I: 1st Quarter Market Update

Ok, so I started off bragging on our staff in the opening paragraph, now I'm finally able to brag on our investment philosophy. Lord knows, waiting for Value to take off has not been an easy investment (from my standpoint, it has been downright painful), but I have never doubted that it would work, only how long would we need to wait to realize the results. Profiting from premiums requires patience and ***"sticktoitiveness."*** Nothing in the market is free, everything has a price. The price for owning the size, value, and high profit premiums is that the strategies returns will show up at different times than the large indexes that are mostly reported on TV. Diversifying globally will help smooth bumps in the ride and will generally increase long-term returns, but there will be periods of time, like the one we just invested through, that can test your resolve. The lesson I hope you will remember is that **premiums typically materialize very quickly and most of the gains occur within a few trading sessions**, which results in changes that impacts returns for a decade or so. I think you may be able to see this in some of the charts/graphs below. I wish we could just trade into an area as it starts going up/or move out right after it starts going down, but generally, there is not time to get in/out before the move is noticed. If you are not in/out of an asset class before it comes in/out of favor, much of the gain has already occurred. I hope you enjoy the words and graphs below in **Section II**.

In MWA's 1st Quarter 2021 Quarterly Market Review (link) ***slide deck:*** you will notice that many of your offensive positions, along with the rebalancing trades that were added during COVID lockdowns near market lows, have roared back making the 1st quarter another extremely profitable quarter for our investors - as you probably noticed by looking at your balances. In less than 6 months, many of our models have flipped from below targeted returns to above, partly because our tilt to US Small Cap Value which has been our largest trade relative to the index weighting. Over the last 12 months this is also true of emerging markets and our international positions, but not to the same magnitude as the US small asset class. I told everyone that "COVID would likely be the best buying opportunity of our lifetime," but when I said that I sure did not expect how fast prices would roar back.

It was difficult to foresee the degree that the developed world was willing to deficit spend to stimulate the economy, and to save the current system. Many have referred to this new world order as the "Fed Put" and while I think it has many undesired outcomes longer-term, I believe this lack of fiscal restraint has pushed future returns into today and has finally caused the shift we have been patiently waiting on for over 6 years (for dollars to spread out of Growth/Tech and into the less expensive areas of the world.)

If you glance through the ***MWA 1st Quarter 2021 Quarterly Market Review*** (link) slide deck, you will notice that small beat large, and value beat growth. Real Estate is an asset class that is underweighted in our public portfolio, and it has continued to lag stocks. Given the outlooks for office and the government rules regarding evictions, we continue to be somewhat leery of owning this in higher growth and more aggressive portfolios (because over time real estate is less risky than stocks when adjusted for leverage & it was one of the best performing areas of the last 20 years up to COVID), but we may be begin adding some real estate back into more conservative and balanced portfolios in an attempt to provide some inflation protection and additional diversification. Finally, the bulk of our bond exposure continues to be high quality with short to intermediate term duration. Because of the rise in rates our fixed income posted small losses, which is to be expected. We are not concerned by this because the yields will more than cover it over our investing time horizon. You may notice some tax loss selling here to capture these tax losses in the upcoming quarter if the dollar cost is worth the trade. We may also look to slightly increase our weighting in emerging market fixed income as we seek to add diversification to areas that can zig/zag as we begin to shift more toward a "let's play not to lose" as opposed to playing to win.

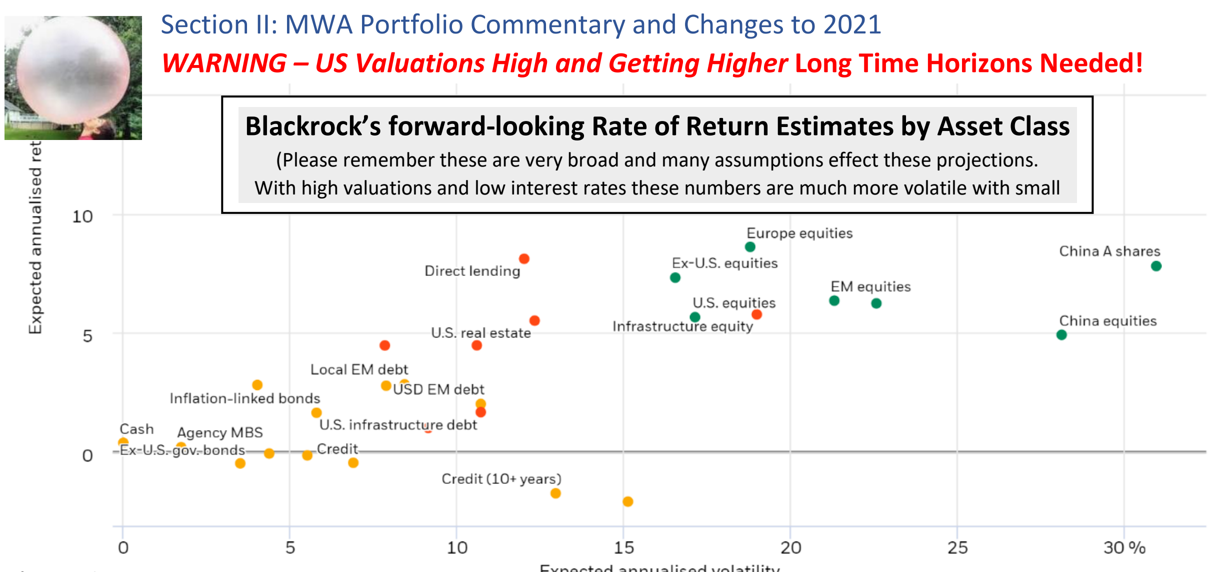


Figure 1

In the remaining portion of this commentary, I'm going to snip in pictures and graphs and try to use them to talk quickly about what we are seeing in the marketplace, so that you can make important decisions regarding your specific financial situation. As we have discussed before, investing is both an art and a science. Generating the desired returns in the long run is fairly certain in a diversified portfolio, however what to do as markets rise and fall above or below your specific financial goals is much more art than science. Remember rarely is the goal to beat the index. "**The goal is the goal" – (Millsism)** and when your investment returns increase to the point that your goals become overfunded in regard to the dollars it takes to pay for them, I think it is often prudent to reduce risk, especially when valuations are the most extreme in modern history (higher than both in 1929 and before the financial crisis).

I would like to pose a few important questions for you to chew on and discuss with our team:

Question #1: **Is now a good time to ring the proverbial cash register and book some gains, even if it involves paying some tax?**

Question #2: How long into the future am I willing to wait to make money in a negative investment climate? (This answer helps us determine how much risk we should take on and what strategies we may want to substitute)

Question #3: If we were to change the risk of your portfolio and markets kept roaring higher would you feel significant regret or FOMO (fear of missing out) **even if your goal were covered?**

Question #4: If we are in a bifurcated market where half is expensive and half is much cheaper, are you willing to overweight the cheaper assets that have much higher expected returns and larger cash flows, even if it results in a portfolio that is much different than what you will see on TV? (a portfolio that likely has a larger weighting of perceived safer assets/more defense and more assets not denominated in US Dollars)?

Are we in a Bubble?

I don't think we will know that answer until we look back at today in 20 years. However, it is a fact that US valuations are very high. Most of the faster growing companies in the United States that make up a larger portion of common indexes like the S&P500 or the NASDAQ100 are likely to have little to no returns for quite some time because future returns have been pulled forward in the past 6 months. In many possible scenarios, returns are low single digit returns if everything works out as projected, but what if they don't work out as expected? **I think investors must always ask yourself, if an investment ever gives you a classic bad bet scenario?** (A situation where you expect a relatively small upside, but where you are risking a much larger downside if something unexpected happens that spreads fear or uncertainty?)

After all what could happen? The current trend that is being priced into markets: Pent up demand is going to create some of the largest economic growth in the US in 30-40 years (estimates 5-6%/year in earnings growth up from 2 - 2.5%/year). **Is this growth already priced into today's stock prices?** (I think most of it probably is, that's why returns are up so much from a year ago.) **Do you believe in selling on the rumor, or on the fact, or some on both?**

It's possible these scenarios unfold: Could the vaccines stop working on a new variant that sends people back to hunkering down and spreading isolationist policies? Maybe the current tax plan passes through Washington which immediately cuts 8% of earnings estimates, or interest rates rise on inflation fears? Or the international community begins steps to remove the dollars as the base of the monetary system in favor of a blended basket of currencies?

Figure 2 is a picture of Professor Shiller's CAPE Ratio. Michael Finke, PhD, the Professor of Wealth Management at The American College of Financial Services and Texas Tech, put together the following chart projecting the returns of CAPE Index which is what many of the forward pricing models are based on and can be used to explain a good portion of future returns of the S&P500 returns, as represented by the blue dots. It shows actual returns vs. the expected over the next 10 years.

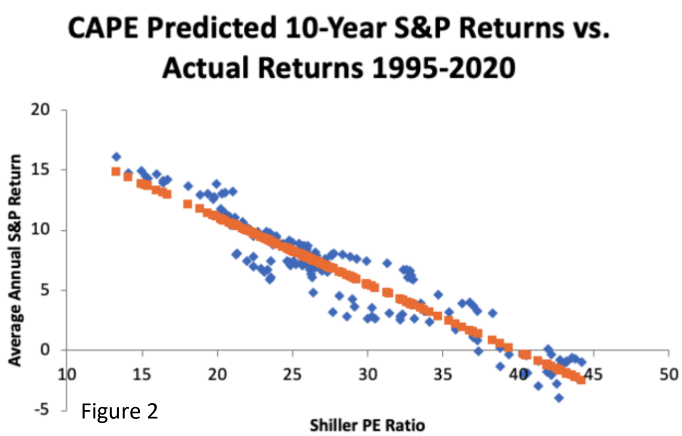


Figure 2

In a period where accounting rules changed and the 2008 global financial crisis decimated profits, CAPE explained 90% of the variation in 10-year returns. Here is what it looks like when he modeled 10-year nominal, annualized, geometric returns starting every month from January 1995 through June 2010 (185 blue dots) as a function of their CAPE value during this period:

Dr. Finke came up with a great analogy, "Let's assume two investors – one is a Vulcan and the other a behavioral human whose risk preferences depend on market sentiment. The Vulcan will simply look at current valuations and adjust asset allocations based on the expected return being offered by the market. If the CAPE is 34, the expected stock return is between 2% and 4% over the next 10 years. This paltry compensation for taking investment risk means that the Vulcan will select an optimal portfolio with a lower percentage of stocks. Conversely, the Vulcan will go all-in on stocks when CAPE ratios revert to the teens."[4]

Many target-date funds, and proponents of strategic allocation don't intend to ever change their allocations for fear of missing out of a larger move to the upside (which is usually a far bigger risk than a temporary market decline). In rare circumstances, possibly like today, the risk parameters get so lopsided that the downside for some investors is bigger than the small upside and for those situations advisors and clients should agree to err on the side of protecting capital and acting more like a Vulcan and not a human or robot.

2021 Trading Plans:

Selectively Trim and rebalance US Investments: Today we plan to rebalance and trim US Stock exposure in 2-3 increments. #1 Sell on the Rumor (and the old adage "Sell in May and Go away"): Because of the rapid rise in prices and the fact that markets have rebounded in Small Cap Value, CORE 2 and in High Profit in the US, we expect to sell or trim these positions, how much will depend on model, client situation and taxes, but we expect to shed about ½ of the position shortly and we will continue to watch the remainder of the position probably allowing it to run as long as it has momentum and legs, them when it rolls over and falls 8-10% we may exit the position and apply the funds elsewhere.

Figure 3, The top of the chart (Bull) shows when prices are attractive and when prices are unattractive.

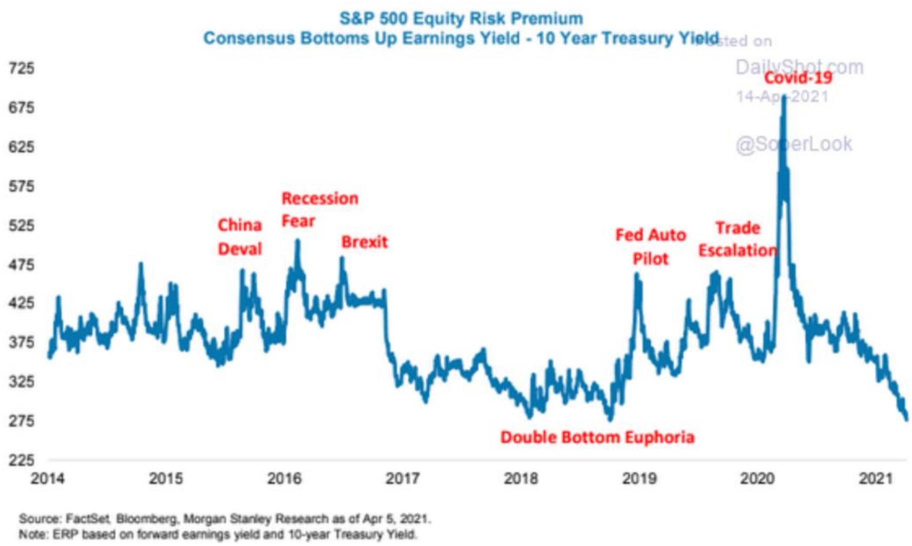


Figure 3

In Figure 4, below, we graphed DFA's Small Cap Value, its benchmark, and the S&P500 since the year 2000. As you can see, DFA's Small Cap Value fund outperformed both the Index and SP 500 since then.

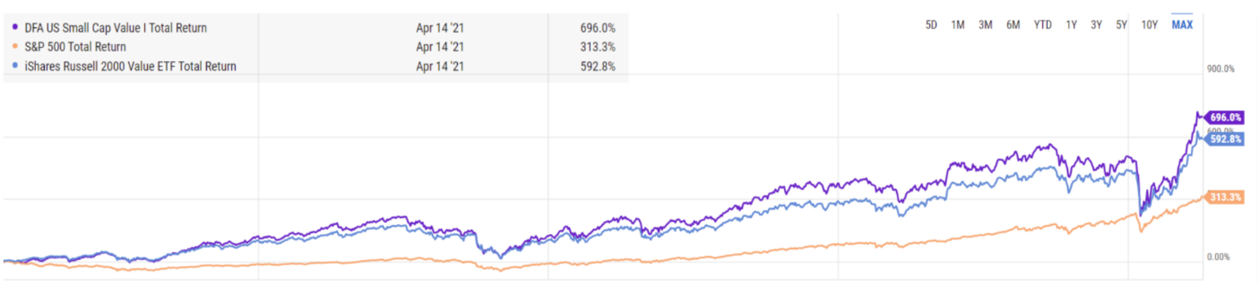
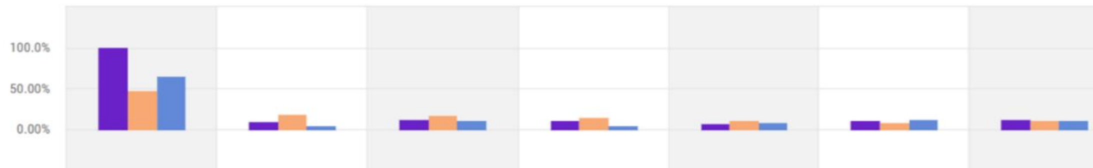


Figure 4

In Figure 5, below, we graphed Small Cap Value, Emerging Markets Small Companies, and the S&P500 and you can tell from the 10-year number compared to the 20-year number how much reversion to the mean is left. With US Small Cap Value, we think it is time to rebalance because the 10-year number is approaching its long-term return. With the S&P500 (the Red Circles) you can see how much above recent returns are above their long-term average returns, suggesting that with mean reversion future returns would likely be below these average returns, which is another reason to be cautious in the next few years.

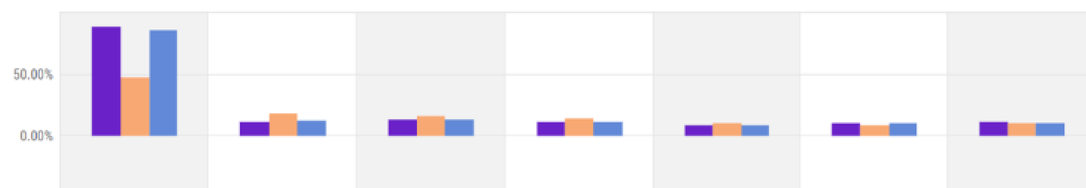


Name	1Y	3Y	5Y	10Y	15Y	20Y	AT
DFA US Small Cap Value I	100.8%	9.93%	12.06%	10.13%	7.42%	10.70%	11.56%
S&P 500 Total Return	47.37%	18.01%	16.90%	14.44%	10.33%	8.57%	10.45%
DFA Emerging Markets Small Cap I	65.38%	4.83%	10.40%	4.51%	7.70%	12.56%	11.10%

Figure 5

The 15-year return is the only long-term return that is still below the mean return at for SCV at 7.42%, which suggest there is likely a little upside left, from a reversion to the mean standpoint. Obviously, reversion to the mean is only 1 metric out of many, but you have heard me mention that reversion to the mean is one if not the strongest forces in finance. All in all, I think this picture shows that some profit taking is warranted, as we are overweight the normal market position by a large amount, esp. given the 120% increase in prices.

Now look at various small cap funds (which has growth value and profitability baked into it):



Name	1Y	3Y	5Y	10Y	15Y	20Y	AT
DFA US Micro Cap I	89.31%	11.56%	14.03%	11.79%	8.44%	11.00%	11.97%
S&P 500 Total Return	47.37%	18.01%	16.90%	14.44%	10.33%	8.57%	10.45%
DFA US Small Cap I	86.25%	12.47%	13.80%	11.70%	9.14%	10.53%	10.84%

Figure 6

Reversion to the mean has occurred across the board. It is time to trim this asset class (look at the 20-year numbers then look at the 3/5/10 year numbers). The high 1-year ROR has lifted the average returns of 3/5/10 all the way back to average returns. The only returns that are still a little below average are the 15-year returns, and it may keep running and lift those back to normal too, since it has the momentum right now, but given the run and our weights, I think it is time to make a decent reduction, we will still keep some exposure and as it finishes reverting, we will trim it more.

Now in Figure 7, below, let's examine the overseas markets via the funds we currently use through the lens of mean reversion:

Emerging Markets Core, Emerging Small Cap, Emerging Value, VWO: As you can see from the chart above Emerging, unlike SCV, has not fully mean reverted and still has room left to go. Because it has underperformed its long-term average and the growth prospects are much higher as we intend to continue to hold a similar weighting as we have in the past. For investors that have flows in or out we will use the cash flows to help minimize transaction cost over time.

Figure 7

Name	1Y	3Y	5Y	10Y	15Y	20Y	AT
DFA Emerging Markets Small Cap I	65.38%	4.83%	10.40%	4.51%	7.70%	12.56%	11.10%
MSCI ACWI Ex USA Net Total Return	45.78%	6.90%	9.91%	5.07%	4.59%	6.13%	5.46%
DFA Emerging Markets Value I	51.51%	1.95%	9.36%	1.21%	5.24%	11.36%	9.59%
DFA Emerging Markets Core Equity I	56.92%	5.52%	10.94%	3.45%	6.47%	--	8.25%
Vanguard FTSE Emerging Markets ETF	49.45%	6.75%	11.00%	3.22%	5.45%	--	7.27%

In Figure 8 below, I thought this was an interesting picture as it shows the loss of purchasing power since 1913. With the rollouts of the COVID-19 vaccines, economic activity is accelerating on the back of extremely low short-term interest rates by the Fed, pent up demand, record government deficit stimulus/spending (infrastructure plan), and money printing to boot. As you would expect all of this has and cut rat quickly pushed up the cost of commodities like lumber, copper, gold, oil, etc. This combined with low supply of housing, a lack of travel, and record deficit spending is causing shortages of products, rapidly rising prices, and an expected boom in growth for 2021.

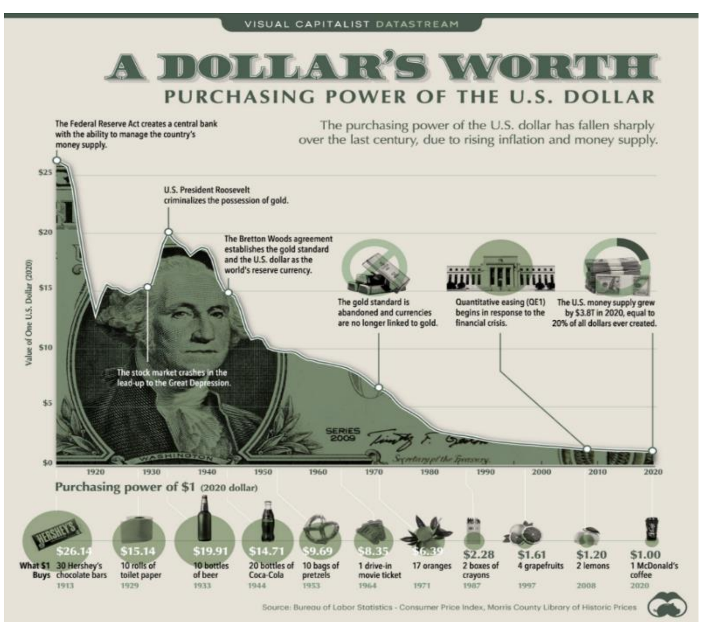


Figure 8

The $64,000 Question: Who is left to buy? Where will the incremental buyer that marginally drives the US market higher and where do they come from?

Take a look at Figure 9 Below, this chart shows how the major groups of investors have evolved and grown over the past 55 years. The biggest group of new owners over time has been foreigners. One question we must ask, "**If valuations in the investors home country gets cheap enough will these investors take a portion of their money back to their home countries?"** When you think about all the new investors unemployed or underemployed, millennials are using information found on platforms like WallStreeBets to gamble, not invest, with their stimulus checks from their parent's basements. Many are day-trading SPACs, Crypto, Non-Fungible tokens with no income royalty rights, and are trying to cause short squeezes on hedge funds. I don't know if you remember what the end of the tech boom felt like but let me assure you it was eerily similar to what we are experiencing today. I'm no stock market timer, but I'll bet my career that we are closer to the later innings than the early innings. Furthermore, I won't pretend to know where the top is, but I feel like if we are there, we are either close or we are somewhere on the plateau.

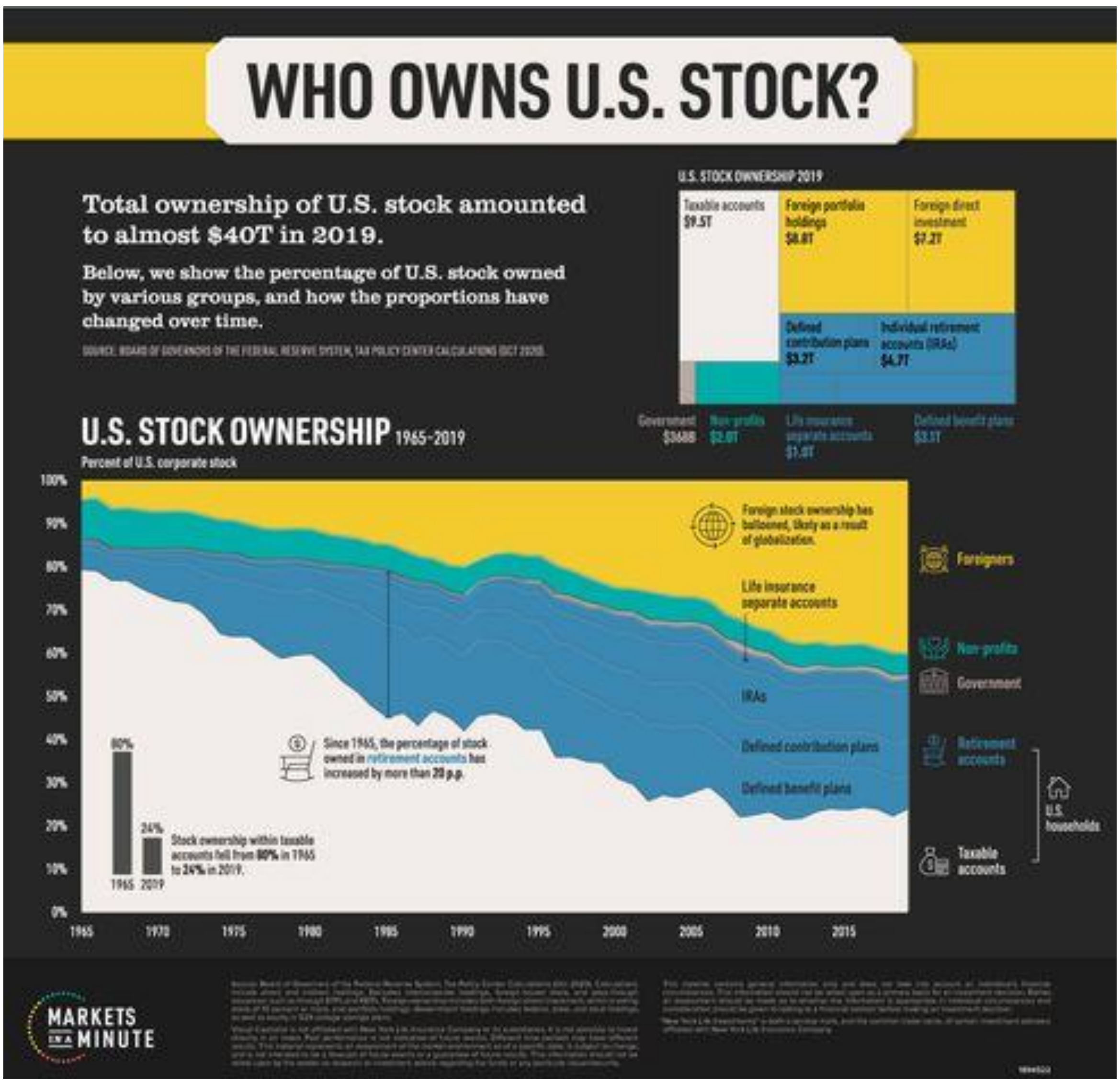


Figure 9

Who is the incremental buyer that pushes prices higher? I'm beginning to the think the US market is a poor bet. Could it be that 50-60% equity decline isn't worth an upside of 10-20% over the next few years? In this type of trade off I think lower risk investors and those that are a head and can handle paying taxes or who can place trades in IRAs or tax deferred accounts are better off taking some risk off the table. If you do this and markets rise for a few years you can't let FOMO (fear of missing out) bother you and to help counter this, we think you should complete a new investment profile and IPS and really get comfortable with the tradeoffs. Generally, there is more risk being out of the market than being in it because markets tend to rise much more than they fall.

Section II-A: Bitcoin 101 Should you own it?

We think so at the right price, but likely not at $60,000. We are long bitcoin, but in the short term we aren't sure if there is going to be a down before the up. It is a beginning to be viewed as a legitimate asset by many individuals and major players in the industry. There are more and more Bitcoin ETFs being applied for, there have already been seven including Fidelity, Van Eck, Skybridge, and most likely Grayscale soon (they have been hiring ETF specialists recently).

Section III: Around the MWA Office

For the better part of 5 years, I have used this quarterly letter to reaffirm many of the lessons we tried to teach in the financial planning meetings and client reviews. Common items have been a few tax nuggets, timely strategies, a refresher on our investment philosophy, links to content etc. But today I want to do something that I don't do very often, **I want to brag a little bit**.

First, I want to brag on the dedicated team of professionals that we have attracted to help you reach your goals, sooner and safer. Crystal, Matt, Stephen, & Jim are doing an amazing job taking care of our family of clients, and even though I don't tell them enough (mostly because I don't want it to go to their heads), many of you have passed on consistent positive feedback of the great work they are doing with many specific examples of them going above and beyond what is required. I want you to know how proud I am of their work and how privileged it is to be able to come to work each day and teach a little but learn a lot from these amazing professionals.

Over the last 3 years, their hard work and strengths have allowed me to step back a little and focus on building the business infrastructure with the plan to grow and evolve from a small practice into a multi-advisor company with a deeper bench of experience, strengths, interest, and talents than existed when it was just me and a helper or two. In any business, growth is the lifeblood of the business, and because of your help, we just wanted to say thank you for blessing us with the introductions and referrals to those people you care about that needed some help combined with the additional resources you bestowed on us.

In an effort to keep improving on our service standards, please know we are continuing to invest in both people and technology. We expect to hire 2-3 more staff members over the next 6 - 18 months that will give us additional resources to continue to deliver personalized financial planning, investment on the quality and relationship we have promised you and your family.

Section IV: Videos, Podcast, & Recommended Reading

We Study Billionaires Podcast – this is an amazing series of interviews There are so many great podcasts listen to it weekly, but if you just want to listen to 1 hour on Bitcoin, I think this episode is the best.
https://www.theinvestorspodcast.com/we-study-billionaires/
https://www.theinvestorspodcast.com/bitcoin-fundamentals/btc003-bitcoin-a-deflationary-world-w-jeff-booth/

Jeremy Grantham, GMO - Are we in a bubble?
https://www.advisorperspectives.com/commentaries/2021/01/05/waiting-for-the-last-dance

Podcast The Bullish Case on Bitcoin: https://www.defiance.news/podcast/the-bullish-case-for-bitcoin
https://www.advisorperspectives.com/commentaries/2021/01/13/bitcoin-magic-internet-money
Commentary of the negative case for bitcoin

Jeff Booth 2 Podcast - On possibility of deflation and why he likes Bitcoin.
Bitcoin Fundamentals: Episode 3 https://www.youtube.com/watch?v=XQDYMr-PMKg
We Study Billionaires: Episode 294 https://www.youtube.com/watch?v=bZ5udTPyLak

Super Investors with Special Guest John Hussman:

Episode 39 - Navigating One Of The Most Overextended Stock Markets Of All Time:
https://podcasts.apple.com/us/podcast/39-john-hussman-on-navigating-one-most-overextended/id1242377947?i=1000506805756

Sources:

1. https://www.advisorperspectives.com/articles/2021/01/04/the-95-year-history-stock-and-bond-returns-in-four-pictures
2. https://www.advisorperspectives.com/commentaries/2021/01/13/bitcoin-magic-internet-money
3. https://www.coindesk.com/big-reasons-bitcoin-belongs-portfolio
4. https://podcasts.apple.com/gb/podcast/ep-4-becoming-a-vulcan-investor/id1533084522?i=1000492245982