December 2019

December saw 3 of the 4 major US indexes make all time highs, with small caps as represented by the Russell 2000 being the exception. From Bespoke:

Full Year 2019, Q4, and December Asset Class Total Returns

Thu, Jan 2, 2020

Asset Class Performance Full Yr, Q4, and Dec. - Total Return (%)

US Related

ETF	Description	Dec.	Q4	Full Yr
SPY	S&P 500	2.90	8.99	31.22
DIA	Dow 30	1.79	6.50	25.01
QQQ	Nasdaq 100	3.89	12.85	38.96
IJH	S&P Midcap 400	2.81	6.99	26.10
IJR	S&P Smallcap 600	3.00	8.26	22.82
IWB	Russell 1000	2.80	8.95	31.06
IWM	Russell 2000	2.78	9.87	25.39
IWV	Russell 3000	2.80	8.99	30.66
IVW	S&P 500 Growth	2.89	8.23	30.77
IJK	Midcap 400 Growth	2.46	6.71	25.96
IJT	Smallcap 600 Growth	3.03	8.67	20.99
IVE	S&P 500 Value	3.00	9.82	31.63
IJJ	Midcap 400 Value	3.08	7.31	25.67
IJS	Smallcap 600 Value	2.84	7.74	24.12
DVY	DJ Dividend	2.72	4.52	22.62
RSP	S&P 500 Equalweight	2.70	7.50	28.91
FXB	British Pound	2.42	7.70	3.87
FXE	Euro	1.71	2.65	-2.90
FXY	Yen	0.67	-0.59	0.37
XLY	Cons Disc	2.76	4.25	28.39
XLP	Cons Stap	2.41	3.37	27.43
XLE	Energy	6.03	5.47	11.74
XLF	Financials	2.61	10.49	31.88
XLV	Health Care	3.48	14.22	20.44
XLI	Industrials	-0.20	5.47	29.09
XLB	Materials	2.86	6.11	24.13
XLK	Technology	4.32	14.20	49.86
XLC	Comm Services	2.26	8.53	31.05
XLU	Utilities	3.29	0.59	25.92

Global

ETF	Description	Dec.	Q4	Full Yr
EWA	Australia	1.15	3.79	22.41
EWZ	Brazil	13.38	14.29	27.65
EWC	Canada	2.22	4.81	27.56
ASHR	China	8.54	10.50	36.51
EWQ	France	3.54	8.76	26.67
EWG	Germany	1.59	9.25	19.15
EWH	Hong Kong	4.25	8.11	10.71
PIN	India	1.72	4.45	4.85
EWI	Italy	2.82	7.75	26.97
EWJ	Japan	0.86	5.65	19.33
EWW	Mexico	4.45	6.41	12.64
EWP	Spain	4.33	6.32	11.91
RSX	Russia	8.82	15.73	40.79
EWU	UK	5.37	10.39	21.25
EFA	EAFE	2.98	7.67	22.03
EEM	Emerging Mkts	7.71	12.11	18.20
IOO	Global 100	3.90	9.97	30.00
EEB	BRIC	8.14	15.27	25.86
DBC	Commodities	5.85	7.75	11.84
USO	Oil	10.24	12.96	32.61
UNG	Nat. Gas	-5.44	-15.40	-31.77
GLD	Gold	3.66	2.90	17.86
SLV	Silver	4.77	4.77	14.88
SHY	1-3 Yr Treasuries	0.15	0.42	3.38
IEF	7-10 Yr Treasuries	-0.93	-1.42	8.03
TLT	20+ Yr Treasuries	-3.20	-4.66	14.12
AGG	Aggregate Bond	-0.05	0.13	8.46
BND	Total Bond Market	-0.07	0.20	8.84
TIP	T.I.P.S.	0.35	0.61	8.35

Above are the final total return performance numbers for key ETFs across asset classes in 2019. For each ETF, we also include its performance in Q4 and December.

The S&P 500 rallied 2.9% in December and 8.99% in Q4 to finish the full year up 31.22%. The Tech-heavy Nasdaq 100 (QQQ) was by far the best performing US index ETF in 2019 with a gain of 38.96%, and it was the third best ETF in the entire matrix. The title of best performing ETF in 2019 goes to the S&P 500 Technology sector ETF (XLK), which rallied 49.86%. Remember, **40% of XLK** is made up of just Apple (AAPL) and Microsoft (MSFT), which gained 89% and 58% in 2019, respectively. The Russia stock market ETF (RSX) was the second biggest winner in the matrix with a 2019 total return of 40.79%.

Everywhere you look across the equity landscape, there were big winners in 2019, but the weakest area of the market was the Energy sector ETF (XLE). Even still, XLE managed to put up double-digit percentage gains on the year at +11.74%.

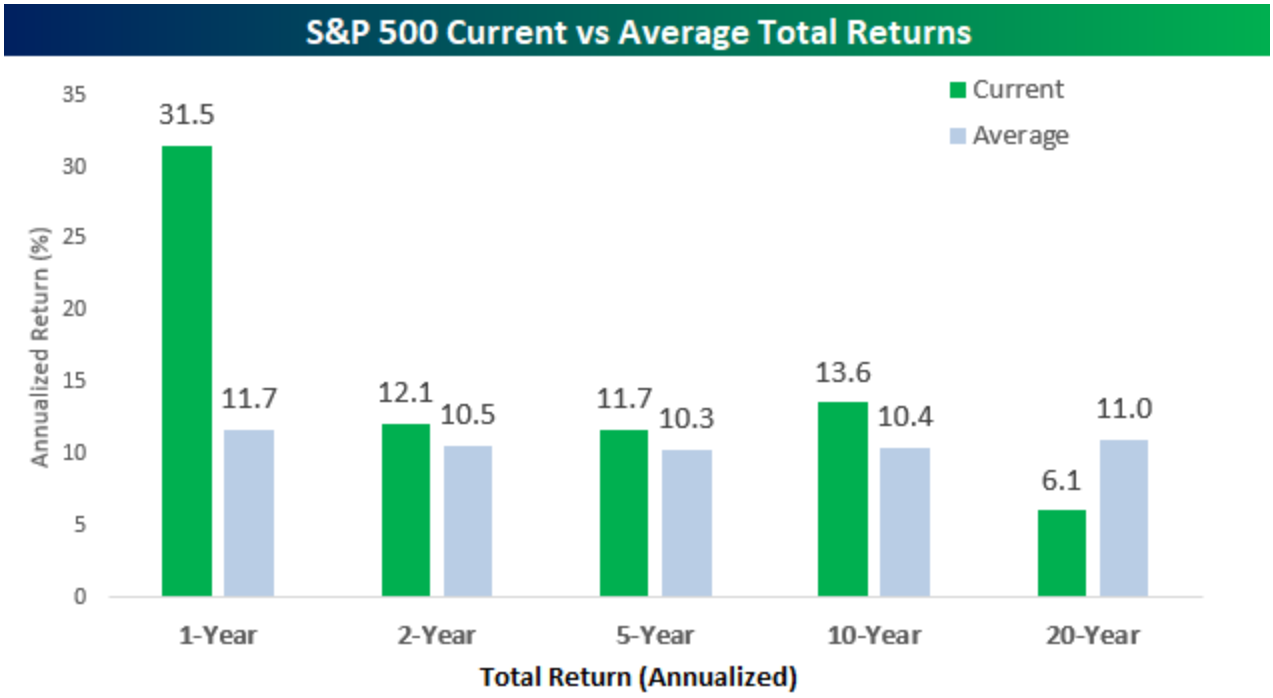
In the commodities space, we saw oil gain 32.61% in 2019, which actually bested the gain for the S&P 500. Gold (GLD) and silver (SLV) both put in solid gains in the mid-teens, while the perpetually losing natural gas ETF (UNG) was the only ticker in the matrix that fell across all three time frames (December, Q4, and full year).

Looking at fixed income, the aggregate bond market ETFs (AGG and BND) posted total returns of 8%+, while the 20+ Year Treasury ETF (TLT) gained 14% on the year. Q4 and December were tough for fixed income, however, as rates moved higher.

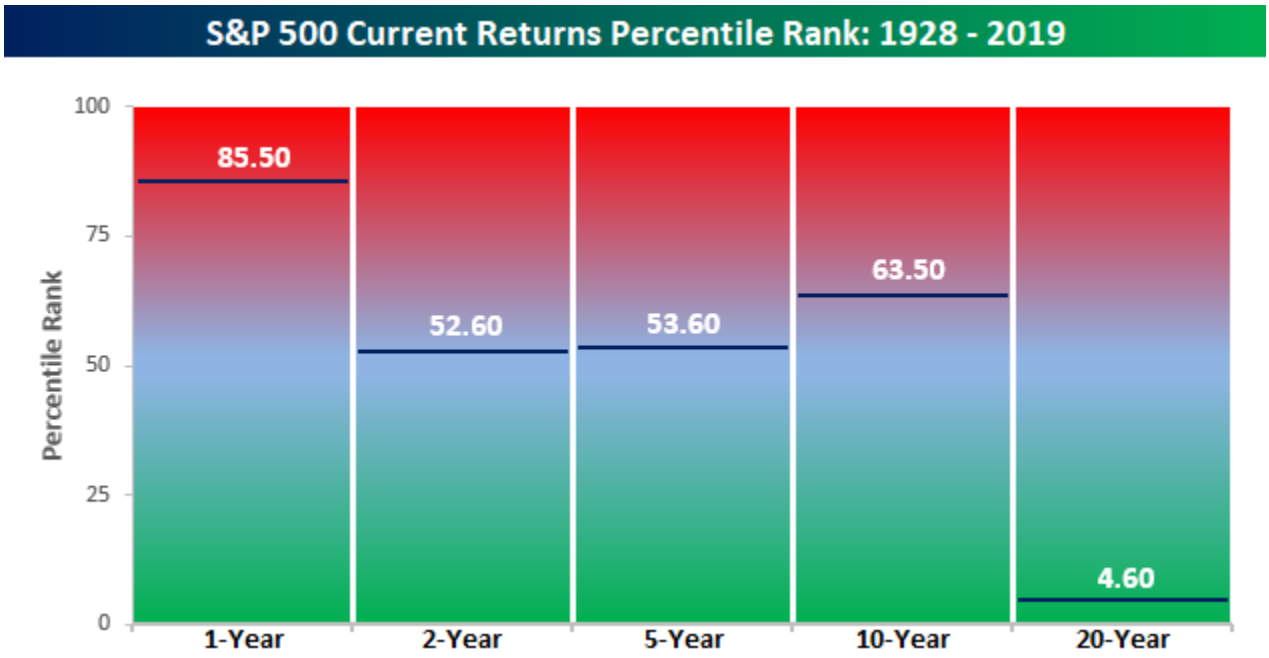
A Banner Year for US Equities

Thu, Jan 2, 2020

2019 was surely a banner year for US equities. With a total return of 31.5%, the S&P 500's gain in 2019 was nearly three times the historical average 12-month return of 11.7%. That's strong! In the chart below we compare the S&P 500's annualized returns over the last one, two, five, ten, and twenty years to its *average* annualized returns over those same time frames since 1928. While the one-year return sticks out like a sore thumb, we would note that the S&P 500's annualized returns over the last two, three, and ten years are also above average. Almost as notable as the fact that the one year return has been so much stronger than average is that the S&P 500's two-year return is less than two percentage points above its historical average. That just shows how bad 2018 was! Looking further out, the only time frame where returns are below average is over the last twenty years where the 6.1% annualized gain is almost five percentage points below the historical average. Over a full twenty years, that's a difference of tripling your investment versus making eight times your investment!

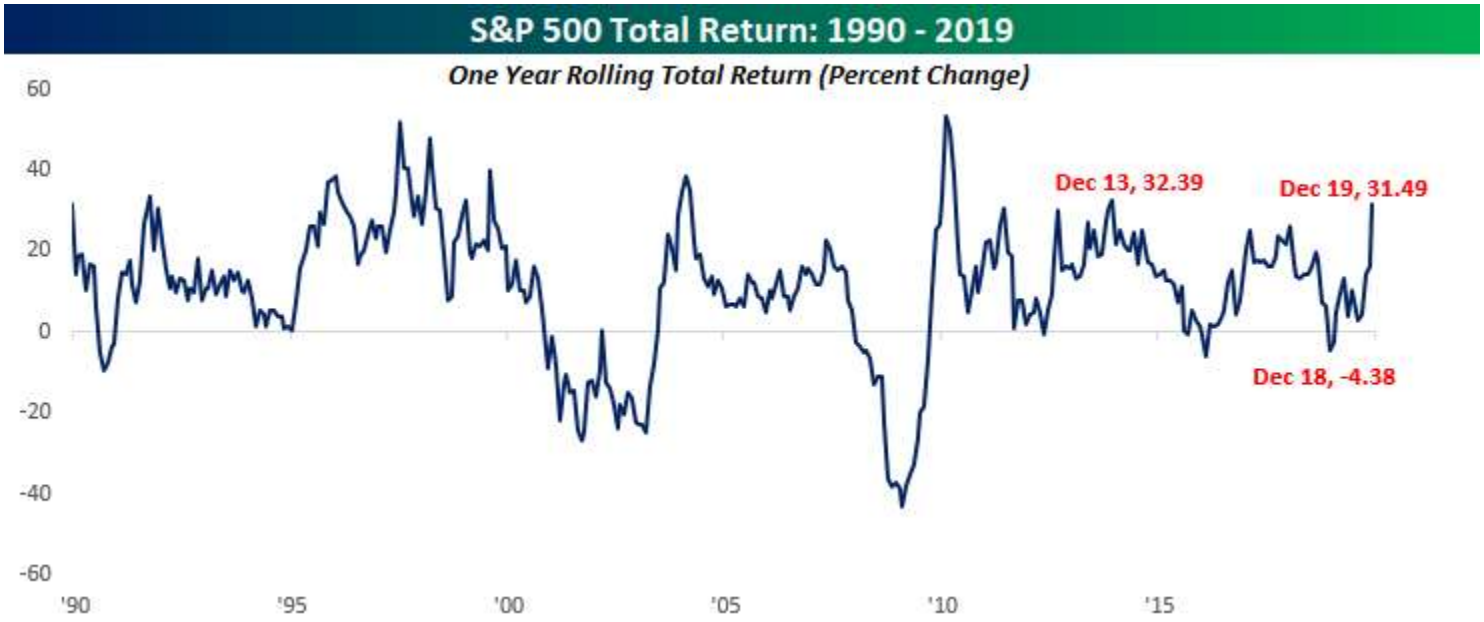


The chart below compares how current returns during the above time frames rank on a percentile basis relative to all other periods. The S&P 500's one-year return ranks in the 85th percentile which is pretty extreme. For the two, five, and ten year periods, though, current returns are much more middle of the road. Conversely, as stretched as extreme to the upside that the one-year return is relative to all other periods, the twenty-year return is even more depressed to the downside. At just 4.6, more than 95% of all other 20-year periods have been better than the last 20.



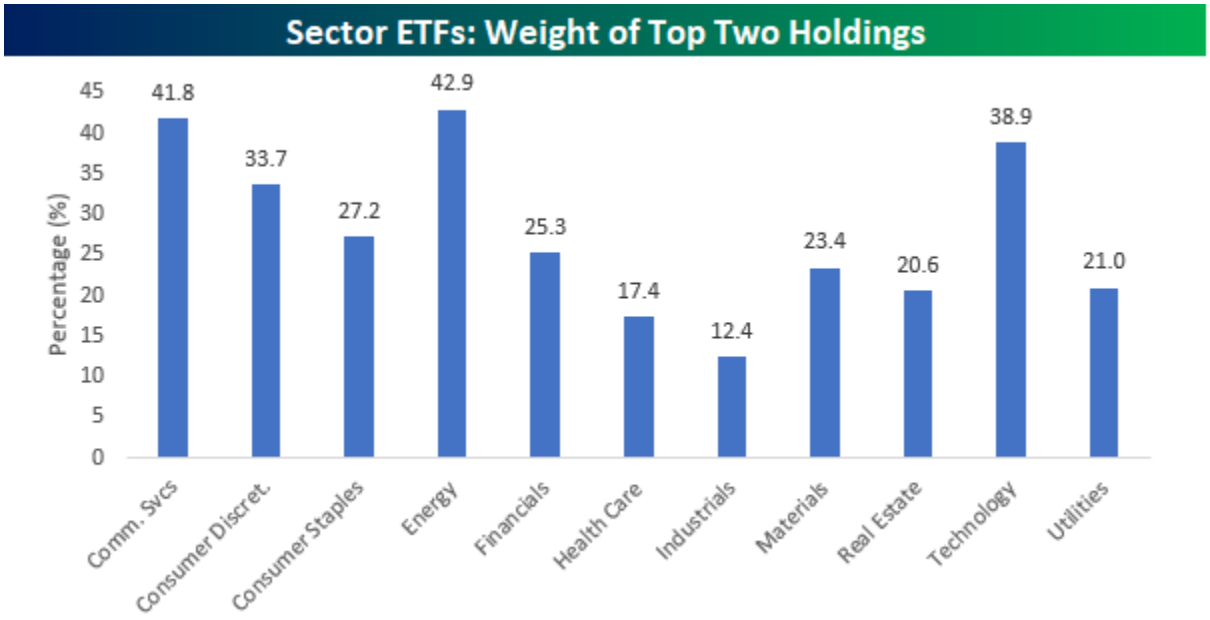
Finally, as mentioned above the last year has certainly been a strong one, and it follows a year where returns had been abnormally poor. The chart below shows the rolling 12-month total return for the S&P 500 going back to 1990. The gain of 31.49% over the last year was the strongest for the S&P 500 in six years coming up

just shy of the 32.39% gain in 2013. Last year at this time, though, the S&P 500 was down over 4% on a total return basis in the prior 12 months.



Am I Diversified?

Mon, Dec 30, 2019



One of the primary drivers of the boom in ETFs over the last decade is that they provide efficient diversification to the market and various sectors/groups. While that's the theory, the reality is that a number of the biggest sector ETF's aren't all that diversified at all. The chart above shows the weight of the top two holdings in each of the 11 S&P 500 sector ETFs. Would you believe that the two largest holdings in two ETFs account for more

than 40% of the entire ETF, while in the ETFs for another two sectors the largest two components account for more than a third of the entire ETF? That's right, in the Energy sector, the top two holdings (Exxon and Chevron) account for just under 43% of the entire ETF, while Alphabet (GOOGL) and Facebook (FB) account for 41.8% of the new Communications Services sector ETF (XLC). In the Tech sector, Apple (AAPL) and Microsoft (MSFT) account for just under 40% of the XLK ETF.

The table below lists each of the eleven sector ETFs along with their top two holdings. As noted, in the case of companies with dual-listed share classes in the ETF, we include both share classes as one. In the case of three sectors (Communication Services, Consumer Discretionary, and Energy), the top holding accounts for over 20% of the entire ETF. Normally, when you think about diversification, you would picture spreading out your bets across a variety of different companies so that you aren't too exposed to any one name. However, when one out of every five dollars invested goes to one stock, we aren't sure how diversified that really is. Now, the purpose of highlighting these top-heavy ETFs is in no way meant to imply that these ETFs are faulty in their construction. In fact, these ETFs do a very good job of tracking the sectors they are intended to track. Instead, it is an illustration of just how top-heavy the major indices have become. Investing in "the market" or a specific sector is increasingly becoming a concentrated bet on a number of large names.

S&P 500 Sector ETFs: Top Two Holdings*

Sector	Ticker	Largest Holding	2nd Largest Holding
Communication Svcs	XLC	Alphabet (GOOGL): 22.37%	Facebook (FB): 19.42%
Consumer Discret.	XLY	Amazon.com (AMZN): 23.77%	Home Depot (HD): 9.90%
Consumer Staples	XLP	Procter & Gamble (PG): 16.22%	Coca-Cola (KO): 11.01%
Energy	XLE	Exxon Mobil (XOM): 22.47%	Chevron (CVX): 20.38%
Financials	XLF	Berkshire Hath (BRK/b): 12.73%	JP Morgan Chase (JPM): 12.56%
Health Care	XLV	J&J (JNJ): 10.05%	UnitedHealth (UNH): 7.35%
Industrials	XLI	Boeing (BA): 7.24%	Honeywell (HON): 5.17%
Materials	XLB	Linde (LIN): 16.10%	Air Products (APD): 7.33%
Real Estate	XLRE	American Tower (AMT): 13.02%	Crown Castle (CCI): 7.53%
Technology	XLK	Microsoft (MSFT): 19.45%	Apple (AAPL): 19.42%
Utilities	XLU	NextEra Energy (NEE): 13.38%	Dominion Energy (D): 7.62%

**Stocks with dual classes are included as one.*

From Verdad's Nick Schmitz on Dec. 16th:

A Strange Divergence

We have seen a massive divergence this year between the performance of US small-cap value stocks and US large growth stocks.

This year, stocks that were larger and more expensive performed better than stocks that were smaller and cheaper. This is a sharp divergence from the performance record of the last 30 years. Over the long term, betting on smaller, cheaper stocks has generated very attractive relative returns. This strange divergence in 2019 appears to have been true globally—in the US, Japan, and Europe. In Figure 1 below, we show the US market divided into quintiles by size and then by valuation.

Figure 1: Returns by Size and Valuation (Price-to-Book) in 2019 and over the Last 30 Years

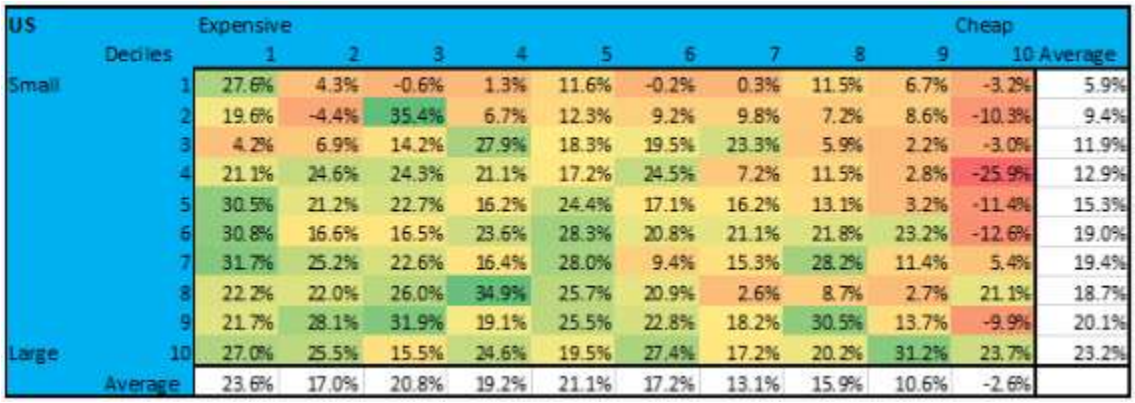
2019 YTD							
US		Expensive				Cheap	
	Quintiles	1	2	3	4	5	Average
Small	1	13.7%	7.4%	6.3%	7.4%	0.7%	7.1%
	2	15.1%	22.2%	19.8%	12.5%	-3.0%	13.3%
	3	25.4%	19.5%	23.9%	17.8%	6.4%	18.6%
	4	25.6%	24.4%	21.3%	15.0%	10.9%	19.4%
Large	5	25.3%	23.0%	23.6%	19.7%	14.0%	21.1%
	Average	21.0%	19.3%	19.0%	14.5%	5.8%	

Last 30 Years							
US		Expensive				Cheap	
	Quintiles	1	2	3	4	5	Average
Small	1	5.0%	12.1%	14.1%	16.9%	19.4%	13.5%
	2	7.1%	12.3%	14.7%	14.5%	14.2%	12.5%
	3	8.2%	13.0%	12.9%	14.8%	15.7%	12.9%
	4	10.3%	11.1%	12.1%	13.8%	13.2%	12.1%
Large	5	9.5%	11.0%	11.7%	10.8%	12.4%	11.1%
	Average	8.0%	11.9%	13.1%	14.2%	15.0%	

Source: Ken French. These are the Ken French equal-weighted portfolios.

The cheapest and smallest quintile in 2019 returned less than 1%, while the largest and most expensive returned over 25%. This divergence is even more extreme when we look beyond the cheapest and smallest 20% of the market. If we look at the cheapest and smallest 10%, we see what's driving the divergence.

Figure 2: Returns by Size and Valuation in 2019



US		Expensive									Cheap	
	Deciles	1	2	3	4	5	6	7	8	9	10	Average
Small	1	27.6%	4.3%	-0.6%	1.3%	11.6%	-0.2%	0.3%	11.5%	6.7%	-3.2%	5.9%
	2	19.6%	-4.4%	35.4%	6.7%	12.3%	9.2%	9.8%	7.2%	8.6%	-10.3%	9.4%
	3	4.2%	6.9%	14.2%	27.9%	18.3%	19.5%	23.3%	5.9%	2.2%	-3.0%	11.9%
	4	21.1%	24.6%	24.3%	21.1%	17.2%	24.5%	7.2%	11.5%	2.8%	-25.9%	12.9%
	5	30.5%	21.2%	22.7%	16.2%	24.4%	17.1%	16.2%	13.1%	3.2%	-11.4%	15.3%
	6	30.8%	16.6%	16.5%	23.6%	28.3%	20.8%	21.1%	21.8%	23.2%	-12.6%	19.0%
	7	31.7%	25.2%	22.6%	16.4%	28.0%	9.4%	15.3%	28.2%	11.4%	5.4%	19.4%
	8	22.2%	22.0%	26.0%	34.9%	25.7%	20.9%	2.6%	8.7%	2.7%	21.1%	18.7%
	9	21.7%	28.1%	31.9%	19.1%	25.5%	22.8%	18.2%	30.5%	13.7%	-9.9%	20.1%
Large	10	27.0%	25.5%	15.5%	24.6%	19.5%	27.4%	17.2%	20.2%	31.2%	23.7%	23.2%
	Average	23.6%	17.0%	20.8%	19.2%	21.1%	17.2%	13.1%	15.9%	10.6%	-2.6%	

Source: Ken French. These are the Ken French equal-weighted portfolios

Deep-value portfolios of any size in 2019 were about 26% behind the most expensive decile of the market, with the smaller half of deep value performing even worse. We're convinced that a proverbial monkey throwing darts in deep-value would have probably had a negative YTD return, while a monkey throwing darts at large growth stocks would have likely returned north of 20% YTD.

But most interestingly, a "market-cap-weighted" dart-throwing monkey would have done much better than an "equal-weighted" dart-throwing monkey. As we've seen, most index funds are cap-weighted by design, and most actively managed funds are cap-weighted by necessity. The Russell 2000 Index, for example, has 80% of capital invested in the fifth, sixth, and seventh size deciles and less than 20% in the smallest deciles of the market.

Based on our research, the only times worse than 2019 for US small-cap value on a relative basis were right before the Great Depression in 1929 and at the height of the tech bubble in 1999. In Figure 3 below, we show the ten worst 10-month periods for US small-cap value relative to large-cap growth over the past 100 years. On average, when small-cap value stocks have lagged by around 30%, the one- and three-year forward returns have been very attractive on an absolute and relative basis.

Figure 3: The 10 Worst Periods for Small-Cap Value Relative Performance

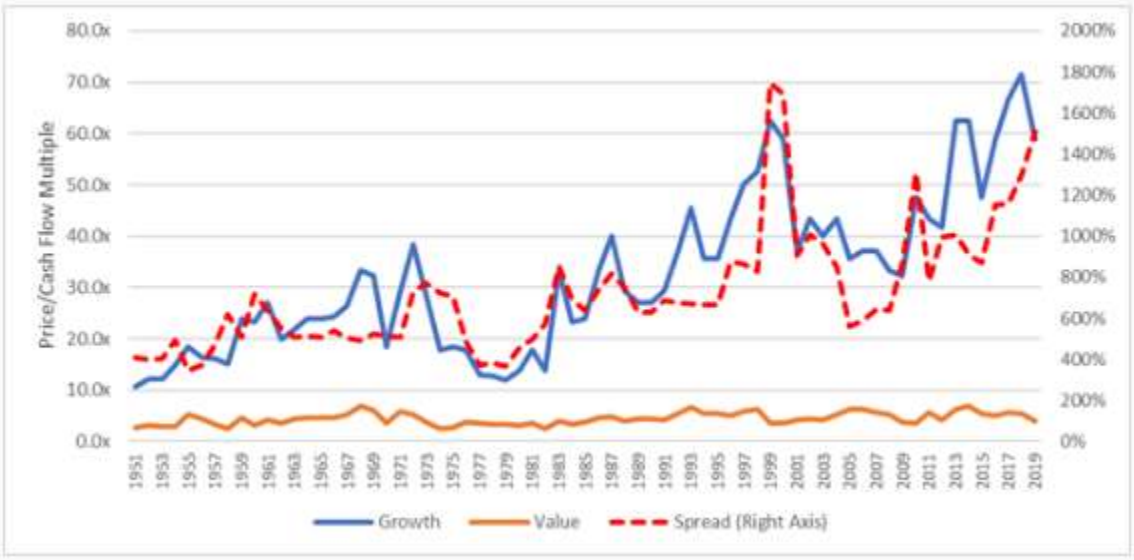
Rank	Trailing 10 Months	Date	Relative Return 1 Yr Fwd	Relative Return 3 Yr Fwd	Absolute Return 1 Yr Fwd	Absolute Return 3 Yr Fwd
1	-48%	Aug-1929	-8%	37%	-43%	-34%
2	-44%	Sep-1929	-8%	32%	-49%	-37%
3	-40%	Mar-1999	41%	116%	68%	107%
4	-36%	Dec-1998	11%	96%	36%	91%
5	-35%	Aug-2019				
6	-35%	Nov-1938	25%	49%	27%	36%
7	-35%	Dec-1990	17%	214%	61%	267%
8	-34%	Aug-1938	-19%	62%	-20%	64%
9	-34%	Sep-1938	58%	61%	69%	62%
10	-33%	Feb-1935	183%	88%	231%	114%

Source: Ken French. The returns are based on the equal-weighted quintiles of size and value. Latest data is October 2019 for the US.

While this may help demystify why different strategies have performed the way they have in 2019, what does this mean for investors going forward? How should we think about these extreme movements?

In Figure 4 below, we show the price-to-cash-flow multiples for the whole US market going back as far as we have data (to 1951). We include the two most extreme valuation deciles of the market (growth and value). We show the absolute trading multiples of each extreme as well as the ratio of the prices of the two ("spreads") over time.

Figure 4: Price/Cash Flow Multiples and Spreads

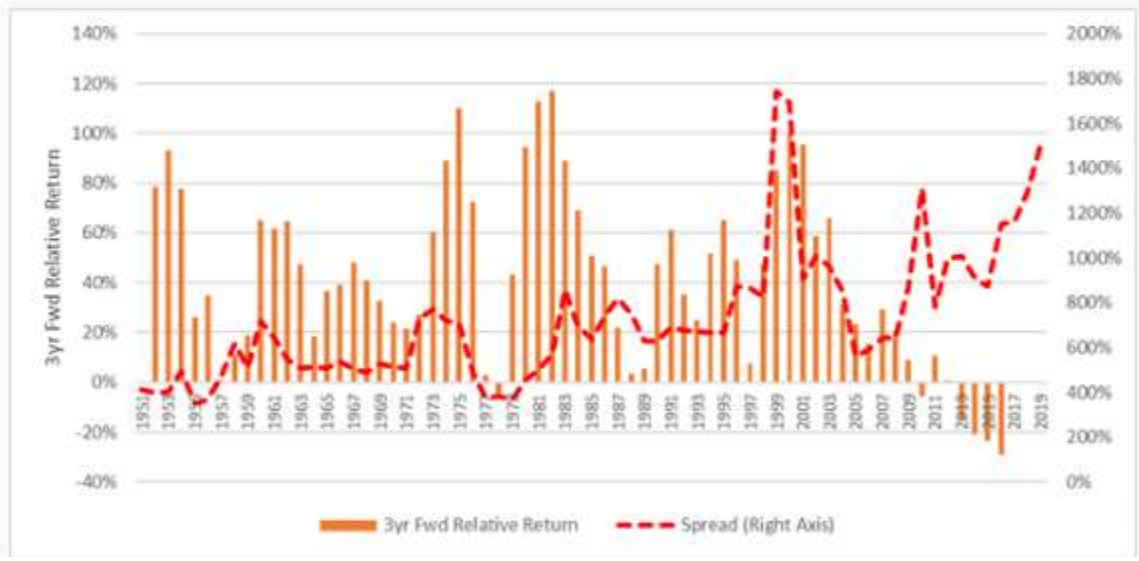


Source: Ken French. Multiples shown above are the extreme value and growth decile breakpoints at the 10th and 90th percentiles of the market.

The "extremely extreme" divergence in the most extreme deciles of growth and value stocks we see in the trailing returns above appears to have caused a jump in spreads for deep value that is only rivaled by the tech bubble.

And these relative growth expectations matter, as we have shown. Pairing the historical price-to-cash-flow spreads above with the three-year forward relative returns to deep-value, we can see that when spreads rise, it's usually a good time to get out of growth and into value.

Figure 5: Price/Cash Flow Spreads and Forward Returns



Source: Ken French. These are the equal-weighted deep value returns relative to extreme growth.

Moments like these are extremely rare in market history. However, looking at every 10-month period during the last ~100 years when small value has underperformed large growth by more than the YTD figures in 2019 (about 50 different times), you would have done quite well in the long haul to shift over to small value. You would have outperformed large growth 63.4% of the time over one year and 87.8% of the time over the next three years, earning a premium of 70% over three years relative to large growth. On an absolute basis, you would have made money in small value 65.9% of the time over the next year and 85.4% of the time over three years.

From a trailing returns and relative valuations perspective, the extreme movements of deep-value small caps we've seen in the last year look an awful lot like the tech bubble. The base rates above suggest investors would be wise to reduce their exposure to large-cap growth stocks over the next decade and (if possible) increase exposure to equal-weighted small value. Investors in cap-weighted products or indexes, such as Vanguard's or the Russell 2000 small-cap index, should be aware that the large size-factor tilt (that has done so well recently) is probably baked into future results more than the title of the product might imply.

Positions

USCR - Dropped 18.7% on 5.9 times normal volume after releasing earnings, which were a 3.8% Negative Earnings Surprise, on 11/8. Analysts lowered Earnings Estimates for both 4Q & 1Q, with 1 increasing their recommendation to a Buy, while another lowered theirs to a Hold; 1 held their Target Price, while 8 lowered theirs. On 12/19 we sold for 6 clients @ 43.02.