Patience

In our last Worth Sharing, titled **"Momo Is a No-Go" Really?**, we highlighted our favorite Fund for the Momentum Factor, MTUM, which HCM has been successfully using for clients for years. I subsequently learned that one of the DIYers that receives these decided to add MTUM to their portfolio. While I normally don't talk to our DIYers, I'm assuming this one bought on Monday, April 23rd, saw MTUM close down 1.8% the next day, and decided to call. Even though as of Friday, May 4th MTUM closed higher than it did on April 23rd, that is not the reason for the title of this Worth Sharing. First, I need to note that HCM has no idea whether any fund mentioned in these posts would be appropriate for a non-clients' portfolio. Such a determination requires a Risk Profile and then the construction of an appropriate Factor-based portfolio. As we have previously shared, the Momentum Factor has a synergistic effect on a portfolio when combined with the Value Factor. This results from Momentum's -.23 correlation with Value. If a Momentum Fund were merely added to most of the portfolios that I am asked to analyze for potential clients, it may increase returns, but it would definitely increase risk.

The title of this Worth Sharing comes from the WSJ's Jason Zweig column shared below. As the Apr. 27th issue of the Global Investment Strategy points out: "Value stocks have massively underperformed growth stocks for the past 11 years (Chart 20). Today, value trades at a greater-than-normal discount to growth. Earnings revisions are moving in favor of value names. Just like at the turn of the millennium, it may be value's turn to shine."

Or, it may not be. While Patience is a virtue, it is an absolute Necessity in order to be a successful investor, and, if history is your guide, it will be rewarded.

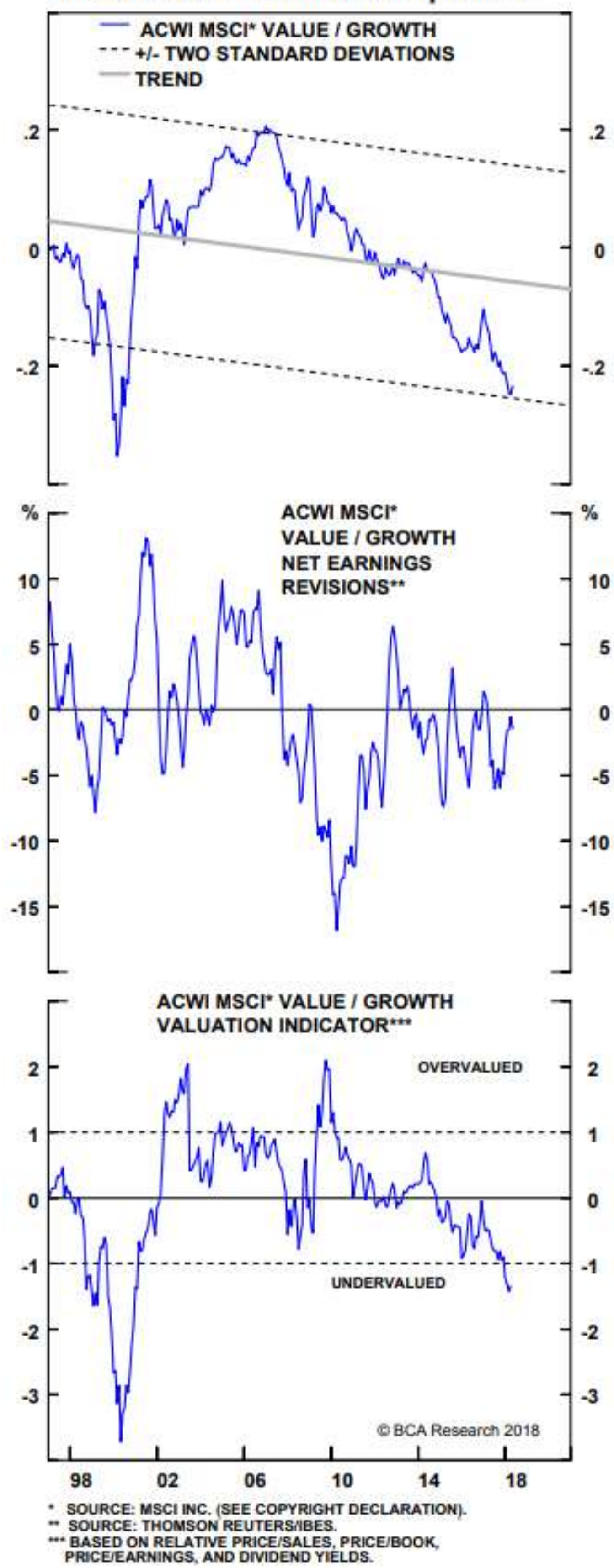


CHART 20
Value Stocks: An Attractive Proposition

THE INTELLIGENT INVESTOR

Patience Is a Virtue (Necessity) For the Value (Every) Investor

By Jason Zweig Apr 27, 2018

Value investors haven't been wandering in the wilderness for 40 years, but it's starting to feel that way.

Over the past 10 years, the S&P 500 Value Index of companies selling at low prices relative to their earnings, revenues and net worth has returned an average of 7.1% annually. The S&P 500 Growth Index — stocks selling at high prices — has gained an average of 10.7%.

The longer-term picture is brighter for value-hunters: Over the course of many decades, cheap stocks have tended to do better, as you would expect from investments bought as bargains: From 1926 through the end of last year, value out-earned growth stocks by an average of 3.1 percentage points annually.

With interest rates rising and stocks volatile, the market appears to be at a crossroads. Could this be the moment that value reasserts itself and catches up to the rest of the market? Maybe, but you would be foolhardy to believe anyone who claims to be able to predict precisely when it will happen.

Many try.

The yield on the 10-year Treasury has risen about half a percentage point over the past year. Since 1962, on average, value stocks have outperformed growth stocks by 6.1 percentage points over the 12 months following an increase in yield on 10-year Treasurys, according to César Orosco, a quantitative analyst at AJO, an investment firm in Philadelphia that manages $25 billion.

However, Mr. Orosco warns, that average conceals almost as much as it reveals. In 1999, value stocks fell badly behind growth stocks even as interest rates rose; they also sporadically lagged in 1979, 1980, 1990, 1994 and other periods of rising rates. The signal is full of noise.

Overall, "there is little relationship between interest-rate movements and a value premium," or excess return on cheap stocks, says Andrew Ang, head of factor-based strategies at BlackRock, which manages about $190 billion using such techniques.

"Value performs best during economic recovery from the worst periods of recessions," he says.

For example, from 2009 through 2011, as the economy recovered from the financial crisis, value stocks earned an average of 18.6% annually, including dividends, while growth stocks gained 6.6%, according to Dartmouth College finance professor Kenneth French's online data library.

That sort of bounceback is highly unlikely nowadays, with the economy already performing well by most measures.

What if inflation heats up? "We have not found the inflation rate to have a strong relationship to the value premium either," says Marlena Lee, co-head of research at Dimensional Fund Advisors in Austin, Texas, which manages $586 billion.

Another factor that could try investors' patience: Although value stocks are less pricey than growth stocks by definition, they aren't particularly cheap in the light of long-term history.

As of the end of 2017, according to data from Dimensional, growth stocks were about 72% above their average valuation since 1970; value stocks were roughly 39% more expensive than their historical average. That analysis defines growth stocks as the most expensive, and value stocks as the cheapest, relative to their corporate net worth (essentially what the companies own minus what they owe).

"We would love to be able to have an answer for you," says Ms. Lee of Dimensional. "In the end, we have not found any reliable ways to predict that. It's very difficult to say, 'Under these conditions, it's safe to expect value to outperform growth.' You can look back and assign some sort of story for each historical period when that happened, but then you need a new story for the next period."

Over the long run, "the value factor is not very correlated to macro stuff but works on average," says Cliff Asness, co-founder of AQR Capital Management in Greenwich, Conn., which manages approximately $225 billion. But there's a lot of variation in that average, and the long run can be longer than many investors imagine. Along the way, the returns to value investing look "fairly random and unconnected to other things," says Mr. Asness.

Ultimately, then, the higher long-run return from investing in cheaper stocks is a righteous form of payback for the pain of sitting around for years watching all those growth stocks with piddling profits go straight up. If you don't have a vast reservoir of patience and you can't ignore the better short-term fortune of other investors, you won't be able to stomach value investing long enough to benefit from it.

Assuming you do possess the necessary patience and composure, you should tilt your money toward value-oriented investments with low annual expenses that can capture the extra return the strategy is likely to achieve — eventually. What you shouldn't do is believe anyone who claims to be able to predict exactly when value investing is about to pay off.

One of the debates we have previously shared among academic practitioners of Factor-based investing is whether investors should attempt to time Factor exposures. Rob Arnott, Research Affiliates Chairman, favors adjusting Factor exposures based on relative valuation. One of our all time favorite quotes comes from Vanguard's Jack Bogle referring to Arnott: **"I wish I was as sure of anything as he is of everything."** While HCM may tilt a portfolio's composition, we tend to side with AQR's Cliff Asness, who is cited above, and favors maintaining diversification among proven factors. In other words, we have and will continue to maintain exposure to both the Value and Momentum Factors in client portfolios, along with Size and Quality, and, depending on the client's Risk Profile, Low Volatility.

Many Bubbles, Few Troubles

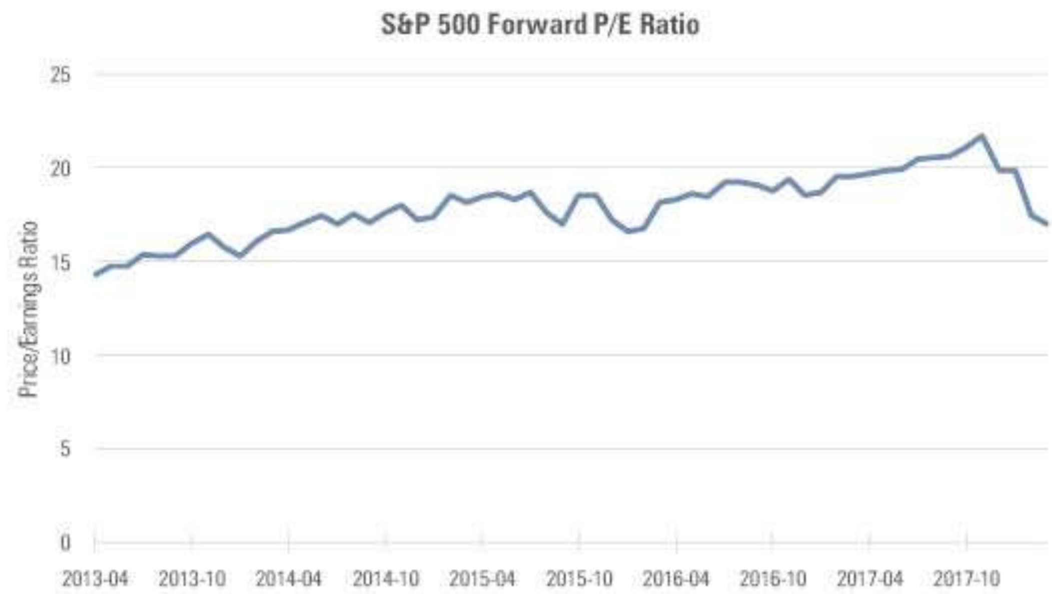
John Rekenthaler 27 Apr 2018

Testing the Claim
On my desk is "Yes, It's a Bubble. So What?," by Research Affiliates. ...

Consider the Research Affiliates paper's opening: "U.S. stock market valuations now exceed all historical valuation levels, except for those hit at the peak of the dot-com craze. This raises an obvious question for investors: Today, in early 2018, and has been the case over the last year, is the U.S. stock market in another bubble?" The authors' immediate answer is "Yes."

The paper does not attempt to support that assertion, presumably because the authors view it as self-evident. No matter what reasonable measure of U.S. stock-market valuation that one selects, it will show prices to be high. Let's test that. One common valuation measure is forward-looking price/earnings ratio.
Morningstar calculates that figure, dividing 1) share price by 2) forecast earnings for the current fiscal year. These results can then be rolled up to give a stock market's aggregate figure.

Below is a graph for the S&P 500's forward price/earnings ratio, as computed by Morningstar over the trailing five years.



Source: Morningstar Direct

Hmm. The S&P 500's figure is currently 17. In spring 2017, it was just below 20. Three years back it was 18, and five years ago it was 14. Rather than describing a bubble, the forward P/E ratio appears to indicate "market as usual."

The Longer View
Perhaps Research Affiliates is directionally correct, but the timing is exaggerated. The paper implies that the bubble is 12 months old ("the case over the last year"), but it may extend somewhat longer, back to 2015 or so. If so, that wouldn't weaken the paper's case, because bubbles don't immediately pop. Sometimes they linger for several years. Justice does not always come swiftly.

However, these forward P/E levels are not new. From the 2008 stock-market crash through 2015, forward P/E ratios were consistently lower than today's, but not that much lower, averaging about 14. Surely the difference between 17 and 14 does not constitute a bubble. What's more, the S&P 500's forward P/E ratio was 18 in 2003, and nobody calls that year a bubble, given that stocks were recovering from losses.

This isn't to say Research Associates couldn't defend its assertion. Forward P/E ratios are one way to judge stock prices. Other approaches could yield different conclusions. (For example, the market's relative trailing P/E ratios make it look more expensive than the forward view.) By selecting the measures that support their case--

as I did myself when choosing forward P/E ratios--the authors could raise concerns about current stock prices. But they would be hard-pressed to demonstrate a bubble.

The Real Target

As it turns out, that is not their intention. The paper's actual target is not the overall U.S. stock market, but instead global technology companies. The authors point out that the world's seven most-valuable firms, as determined by market cap, are all technology businesses. Five reside in the United States, two in China. The authors expect "at least six" of those seven stocks to underperform over the next decade.

That discussion is a good read, and the headline's apparently flippant "So what?" is intended seriously. At the paper's conclusion, the authors provide several investment recommendations for those who share their belief that the major global technology stocks are severely overpriced. Thus, in addition to the somewhat abstract exploration of whether technology valuations can be justified, the authors offer direct, useful suggestions. ...

I don't see a bubble--certainly not with the overall U.S. stock market. With a forward earnings yield of 6% (earnings yield being the inverse of a P/E ratio: earnings divided by price), at a time when 10-year Treasuries pay 3% and annual inflation hovers around 1%-3%, stocks are not dear when compared with the alternatives. At some point, of course, the economy will turn; those P/E ratios will spike because earnings collapse; and stocks will get shellacked. But the same could have been written in 2012, and 2013, and so forth. Without further evidence, why believe this year is different?

With global technology stocks, the authors are on firmer ground. It is indeed true that the leading companies must grow their businesses dramatically to justify their stock prices. Sometimes, such minor miracles occur. For 15 years, skeptics have argued that Apple's (AAPL) (According to Bespoke on 5/4, "Warren Buffett told CNBC that he purchased an additional 75 million shares of the stock during the first quarter.) and Amazon's (AMZN) share prices have assumed unrealistically strong business fundamentals. So far, so wrong. Often, though, a glamorous company's business fundamentals don't match the expectations. Perhaps now is that moment for the giant tech leaders.

Unsure Things

But the thing is, real bubbles aren't modified by the word "perhaps." In my 30 years at Morningstar, I have encountered only two true bubbles in the stock and bond markets: speculation that led to what I regarded as obviously inflated security prices, accompanied by what appeared to outsiders as a mob mentality among buyers. One was Japanese stocks in the 1980s; the other, U.S. tech firms in the late 1990s. Even at the time, I felt that doom was inevitable.

Not so with today's leading tech companies. They are expensive, certainly. That said, those companies have real, dominant businesses. It is possible, if not necessarily probable, that their business growth will match the sky-high expectations and they will continue to outperform other stocks. Even if that doesn't happen, there is a good chance that their returns will be positive.

Many bubbles are proclaimed, but few arrive. The word is not useful; rather than signal something extraordinary, it has come to mean "securities I don't like because they strike me as being too expensive."

John Rekenthaler has been researching the fund industry since 1988. He is now a columnist for Morningstar.com and a member of Morningstar's investment research department. John is quick to point out that while Morningstar typically agrees with the views of the Rekenthaler Report, his views are his own.

According to Barry Ritholtz, **"Being patient as an investor, is much, much harder than it sounds."** We agree, and Value isn't the only segment of the Market where we believe patience will be rewarded. Again, from the WSJ:

HEARD ON THE STREET

Real Estate Stocks Are on Sale but No One Is Buying

Listed property companies are trading at discounts to their assets, yet investors are pouring cash into private funds

By Ken Brown April 27, 2018

Investors hate real estate, and investors love real estate. Both statements are true right now, creating one of the oddest dichotomies in markets.

More specifically, investors hate real estate investment trusts, which have lagged behind the S&P 500 by more than 15 percentage points over the past 12 months. REITs on average are trading a 16.4% discount to the assets they own, one of the widest gaps that has ever occurred outside of a recession, according to Green Street Advisors.

Property on Sale

REITs are trading at some of biggest nonrecession discounts to their assets.

Note: Through April 10
Source: Green Street Advisors

But investors love private real estate funds, which don't trade on the market and so never are valued at a discount to their assets. Institutions and rich investors poured $71 billion in equity capital into private real estate funds that closed last year, according to Preqin. Private-equity firms held $1.2 trillion in real estate assets at the end of 2016, according to consultants PwC.

“There’s a big pile of private capital that wants to own real estate and a big pile of real estate trading at a discount,” said Jonathan Litt, the chief investment officer of Land & Buildings, which invests in REITs and has pressured some companies to take steps to eliminate the discounts.

The love-hate situation is driven by two main factors. Investors have sold REITs because of rising interest rates, which have left their yields less attractive. Meanwhile, investors also have been pouring cash into private equity, hedge funds and other alternative investments on the belief they will outperform public markets.

Yet REITs historically have outperformed similar private funds (and "the broader equity market", as shared on our website), according to Green Street. And when REITs are trading at big discounts, as they are today, they outperform by a lot.

The question is why investors would choose to invest in private funds when publicly traded REITs are on sale. The likely explanation is that investors believe private funds are less risky because their values don’t bounce around like stock prices do. Risk, though, isn’t volatility but rather the chance of a permanent loss of capital. (Which is why we use Maximum Drawdown as our preferred measurement of risk.)

Veteran real estate investors know that the better reason for avoiding REITs is that entrenched managements often do little to close the gap such as selling properties. ...

But the best strategy for most investors is to grab the REITs at current discounts and wait for them to shrink, as they always have. With so much private cash primed to invest in real estate, that could happen pretty quickly.