January 2023

On 5/22/22 we shared "**Why we finally bought**":

"Our repeated warnings about inflation, and speculative excesses, has been accompanied by cash building in most of the accounts we manage. ... As stocks were capitulating on Wednesday, we added to domestic funds, resulting in all of our clients now being fully invested.

While pessimism has reached an extreme (see our SentimenTrader update), and we believe that stocks are near enough to a bottom, that doesn't mean they won't continue to slide."

As can be seen in the chart below, the S&P 500 didn't reach its closing low until 10/12:

From Bloomberg on Saturday:

The US job market just won't quit. While that's a sign of underlying strength for the economy and great news for American workers, it's also a possible pitfall if wage gains don't continue to ease. Hiring surged in January and the jobless rate fell to a landmark 53-year low (of 3.4%), potentially bolstering the Federal Reserve's argument that more interest-rate hikes are needed to finish off inflation. (As expected, the Fed Fund Rate was increased by .25% on Wednesday.) Fed Chair Jerome Powell echoed a growing number of economic experts when he expressed optimism that policymakers can pull off a soft landing, avoiding a downturn by quelling price rises without pushing millions out of work. That seems to be the sentiment elsewhere, too. Along with the Fed, the European Central Bank hiked rates this week in its quest to pull inflation back to its 2% target. But there's a wild card when it comes to global inflation: China. The abrupt reopening of the world's second-largest economy from Covid lockdowns is set to provide a boost to global growth, albeit at a catastrophic cost in Chinese lives lost. And the sudden rise in consumer demand could trigger price jumps on commodities like oil and gas, putting upward pressure on inflation again.

A look at ETF performance from Bespoke on Feb 1 shows that Small and Mid Caps (IJR, IJH vs. SPY), Value (IVE, IJJ, IJS vs. IVW, IJK, IJT), and Foreign Developed Markets (EFA vs. SPY) continued to outperform through last month:

ETF Total Returns (%) Across Asset Classes: Last Year, Last Six Months, and YTD 2023

US Related

ETF	Description	YTD 2023	Last 6 Mths	Last 12 Mths
SPY	S&P 500	6.29	-0.47	-8.18
DIA	Dow 30	2.95	4.78	-1.00
QQQ	Nasdaq 100	10.64	-6.21	-18.25
IJH	S&P Midcap 400	9.26	6.43	2.38
IJR	S&P Smallcap 600	9.51	2.98	-1.08
IWB	Russell 1000	6.64	-0.21	-8.68
IWM	Russell 2000	9.82	3.27	-3.47
IWV	Russell 3000	6.79	-0.07	-8.41
IVW	S&P 500 Growth	5.61	-8.81	-18.74
IJK	Midcap 400 Growth	7.16	2.52	-3.18
IJT	Smallcap 600 Growth	7.34	-0.87	-5.93
IVE	S&P 500 Value	6.97	7.95	2.90
IJJ	Midcap 400 Value	11.36	10.31	7.83
IJS	Smallcap 600 Value	11.95	6.74	3.84
DVY	DJ Dividend	4.20	4.92	4.83
RSP	S&P 500 Equalweight	7.42	4.94	-0.73
FXB	British Pound	2.19	1.78	-7.93
FXE	Euro	1.58	6.28	-3.85
FXY	Yen	0.79	2.12	-12.01
XLY	Cons Disc	15.13	-8.23	-18.90
XLP	Cons Stap	-1.09	0.35	-0.44
XLE	Energy	2.81	17.12	42.11
XLF	Financials	6.90	9.70	-4.46
XLV	Health Care	-1.83	1.55	3.19
XLI	Industrials	3.71	7.51	2.85
XLB	Materials	8.97	9.66	2.53
XLRE	Real Estate	9.91	-6.56	-11.28
XLK	Technology	9.26	-5.22	-15.24
XLC	Comm Services	14.77	-1.84	-24.80
XLU	Utilities	-2.00	-5.17	2.73

Past performance is no guarantee of future results.

Global

ETF	Description	YTD 2023	Last 6 Mths	Last 12 Mths
EWA	Australia	11.83	11.36	14.45
EWZ	Brazil	8.47	12.52	8.19
EWC	Canada	9.47	2.95	-4.10
ASHR	China	11.38	0.76	-13.40
EWQ	France	11.59	16.03	0.78
EWG	Germany	13.38	18.95	-9.66
EWH	Hong Kong	4.95	5.12	-4.35
PIN	India	-0.05	-2.35	-8.79
EWI	Italy	12.36	24.70	-2.35
EWJ	Japan	7.77	4.72	-7.34
EWW	Mexico	16.58	25.71	23.03
EWP	Spain	11.29	19.09	5.11
EIS	Israel	4.29	-8.33	-19.78
EWU	UK	6.23	6.95	-0.67
EFA	EAFE	9.00	9.30	-3.12
EEM	Emerging Mkts	9.13	5.07	-13.29
IOO	Global 100	6.10	-0.98	-8.81
BKF	BRIC	8.23	6.13	-15.45
CWI	All World ex US	8.60	8.04	-5.77
DBC	Commodities	0.89	-4.17	11.60
DBA	Agric. Commod.	0.40	0.69	0.69
USO	Oil	-1.13	-11.19	10.95
UNG	Nat. Gas	-33.90	-67.44	-45.21
GLD	Gold	5.76	9.33	6.73
SLV	Silver	-0.86	16.74	4.95
SHY	1-3 Yr Treasuries	0.78	-0.55	-2.46
IEF	7-10 Yr Treasuries	3.58	-4.57	-10.22
TLT	20+ Yr Treasuries	7.64	-7.50	-22.97
AGG	Aggregate Bond	3.33	-2.44	-8.30
BND	Total Bond Market	3.31	-2.20	-8.34
TIP	T.I.P.S.	2.08	-5.59	-8.54

From Friday's Global Investment Strategy:

After Goldilocks

The Fed Buoys the Markets

Jay Powell sent some reassuring signals to investors this week, noting during his press conference that the risk of a wage price spiral has become "less salient" as inflation has fallen. He downplayed the recent easing in financial conditions and said that the Fed intends to hike rates only a "couple more" times before pausing.

When asked why, in contrast to market expectations, the Fed dot plot foresees no rate cuts this year, Powell answered that investors think that inflation will fall faster than the Fed believes. He then nudged open the door to the possibility of preemptive rate cuts, saying that "if we do see inflation coming down much more quickly, that will play into our policy setting, of course."

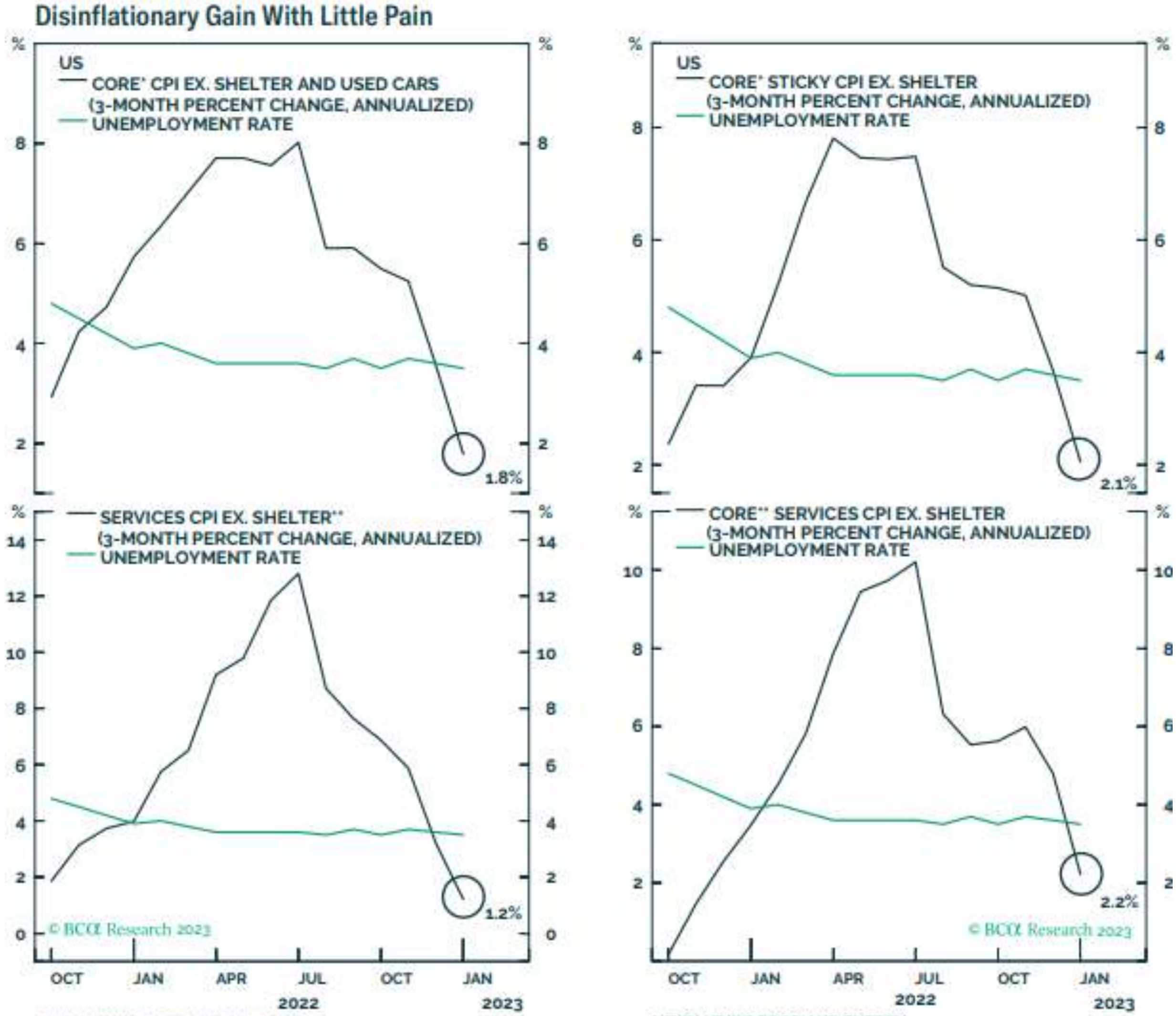
It is worth noting that relative goods prices are still quite high by historic standards. If Powell's assertion, made during the press conference, that goods inflation will quickly return to trend turns out to be wrong, then inflation could indeed surprise on the downside this year relative to the Fed's projections.

For their part, the ECB and the Bank of England signaled their intentions to wind down their tightening campaigns in favor of a wait-and-see approach. This follows the Bank of Canada's decision to effectively pause raising rates.

Ultimately, what central bankers expect is a lot less important than what actually happens to growth and inflation. For example, if one had known in 2021 that US inflation would reach 9% in 2022, one could have easily

CHART 4

Disinflationary Gain With Little Pain



* EXCLUDING FOOD AND ENERGY.
** RENT OF SHELTER.

* EXCLUDING FOOD AND ENERGY.
SOURCE: FEDERAL RESERVE BANK OF ATLANTA.
** EXCLUDING ENERGY SERVICES.

surmised that the Fed would jack up rates to previously unthinkable levels ....

When unemployment is high, rising labor demand does little to lift inflation. In contrast, when unemployment is low, rising labor demand can boost inflation significantly. ...

Chart 4 shows that core inflation first soared and is now receding, all without much change in the unemployment rate.

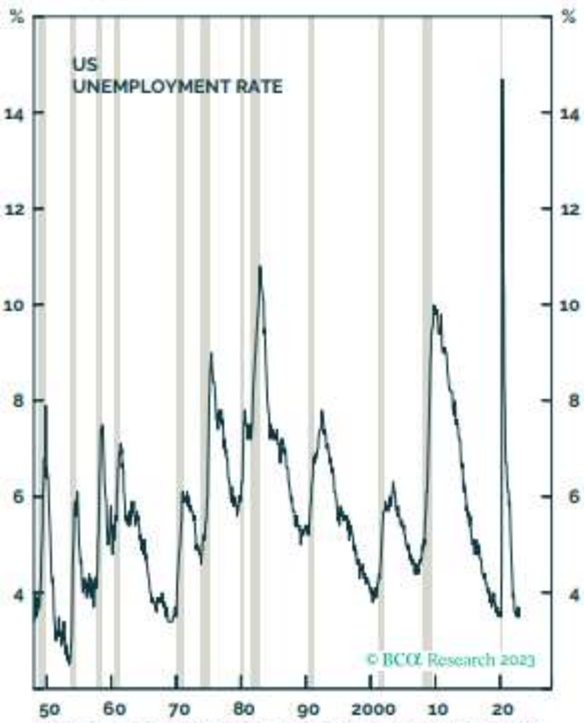
Low Odds of a Soft Landing

Of the three possibilities listed above (10% Soft Landing, 70% Mild Recession, 20% Second Inflation Wave), we regard a soft landing as the least likely. As we pointed out two weeks ago, this is because the combination of low unemployment and low inflation is inherently unstable. Any positive shock to aggregate demand will push up inflation, whereas any negative shock will push up unemployment. ...

The difficulty of achieving soft landings can be appreciated by simply looking at a chart of the unemployment rate (**Chart 5**). Historically, the unemployment rate is usually rising or falling. When the unemployment rate drops to such a low level that it has nowhere to go but up, a recession becomes all but inevitable. This helps explain why subsequent equity returns typically have been low when the unemployment rate is depressed (**Chart 6**).

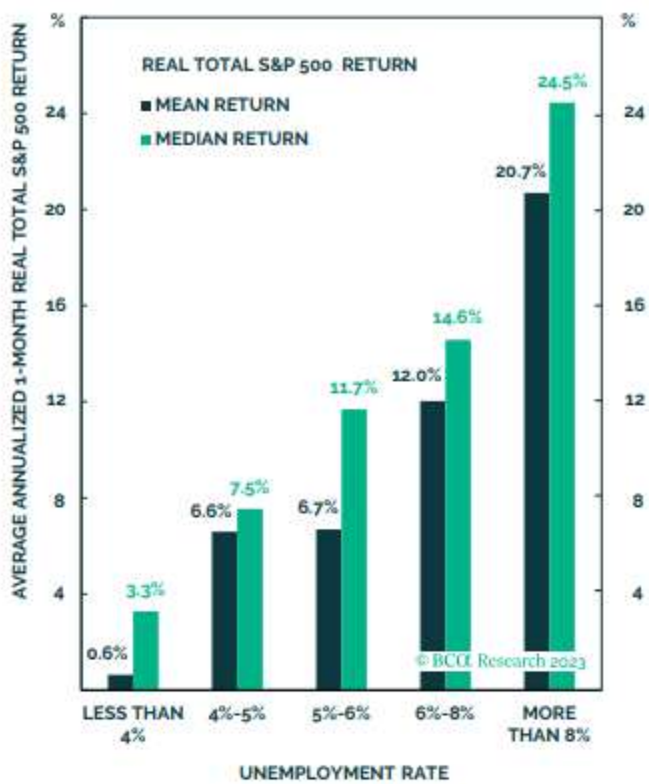
During the past five cycles, including (coincidentally) the pandemic, the unemployment rate has trended sideways for 21-to-23 months before beginning its ascent (**Table 1**). The unemployment rate fell to 3.6% in

CHART 5
Keeping The Unemployment Rate Flat For Extended Periods Of Time Has Proven To Be Difficult



NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

CHART 6
Stocks Do Best When Unemployment Is High, Not Low



NOTE: CALCULATIONS BASED ON UNEMPLOYMENT RATE FROM JANUARY 1950 TO DECEMBER 2022.

TABLE 1

The Unemployment Rate Will Remain Flat In 2023 If It Follows The Pattern From Previous Business Cycles

US UNEMPLOYMENT RATE PRIOR TO RECESSIONS				
	MINIMUM (%)	MAXIMUM (%)	DIFFERENCE (%)	DURATION (MONTHS)
APR 1978 TO DEC 1979	5.6%	6.2%	0.6%	21
SEP 1988 TO JUN 1990	5.0%	5.4%	0.4%	22
MAR 1999 TO JAN 2001	3.8%	4.3%	0.5%	23
JAN 2006 TO NOV 2007	4.4%	4.8%	0.4%	23
MAY 2018 TO FEB 2020	3.5%	4.0%	0.5%	22
SINCE MARCH 2022	3.5%	3.7%	0.2%	10

March 2022 and has been broadly stable since then. Based on this historic pattern, it should start rising again late this year or in early 2024.

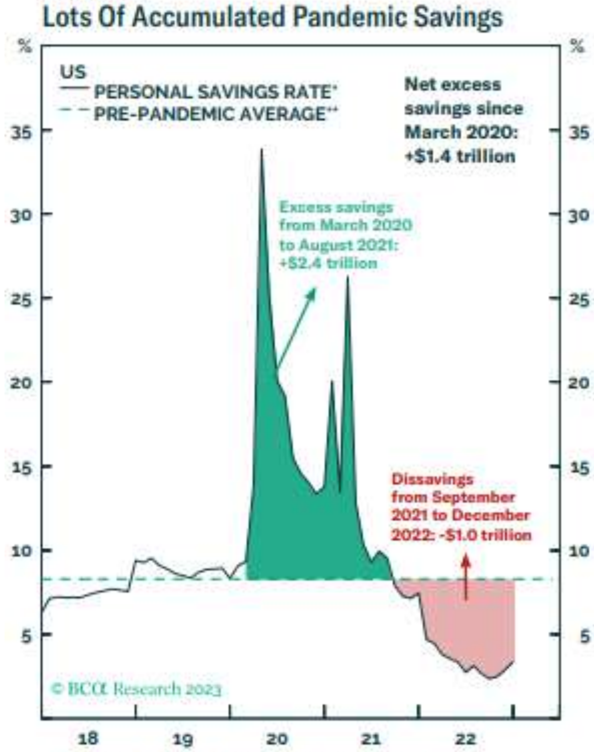
Still a Lot of Insulation Around the US Economy

Our guess is that it may take somewhat longer for unemployment to increase than in the past. There are still 1.9 job openings per unemployed worker, with almost all industries reporting higher-than-normal vacancies. For the next few quarters at least, most workers who lose their jobs will have little difficulty in finding new ones.

In addition, American households are holding onto $1.4 trillion in pandemic savings (**Chart 8**). Based on the current savings rate, it will take another 15 months to fully deplete those savings.

CHART 8

Lots Of Accumulated Pandemic Savings



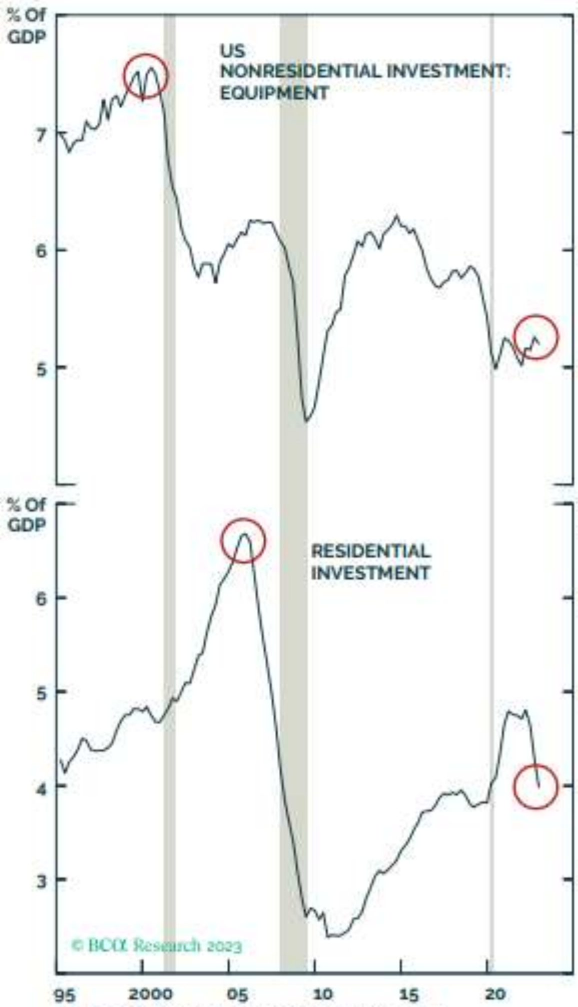
* SHOWN AS A PERCENT OF DISPOSABLE INCOME.
** AVERAGE SAVINGS RATE FROM THE BEGINNING OF 2018 UNTIL THE START OF THE PANDEMIC.
NOTE: THE CALCULATION OF EXCESS SAVINGS ASSUMES A PRE-PANDEMIC BASELINE WITH 4% DISPOSABLE INCOME GROWTH AND 8.3% SAVINGS RATE.

Our best bet is that the next recession will start in mid-2024, as the lagged effects of the tightening cycle continue to accumulate. This is about a year later than when the current consensus expects. ...

Long-term inflation expectations are well anchored, and with realized inflation set to fall towards the Fed's 2% target by early 2024, the Fed will be in a position to cut rates when unemployment starts rising. Moreover, unlike in 2001, when the economy was suffering a hangover from the dotcom capex boom, or in 2007, when the economy was suffering a hangover from the housing bubble, the interest-rate sensitive sectors are

CHART 9

No Overhang In Equipment And Residential Investment



SOURCE: BUREAU OF ECONOMIC ANALYSIS (BEA).
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

CHART 10

Financial Conditions Have Been Easing

* SOURCE: GOLDMAN SACHS VIA BLOOMBERG FINANCE L.P.

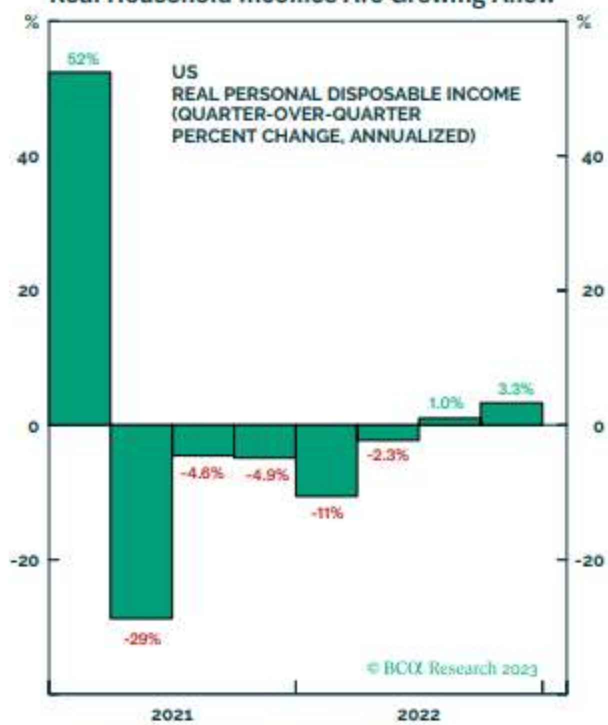
fairly lean today (**Chart 9**). As such, they will react positively to easier monetary policy.

The Risk of a Second Wave of Inflation

... While not our base case, the risk of a 2023 second wave has increased over the past few months, as financial conditions have eased and real income growth has recovered (**Chart 10**).

CHART 11

Real Household Incomes Are Growing Anew

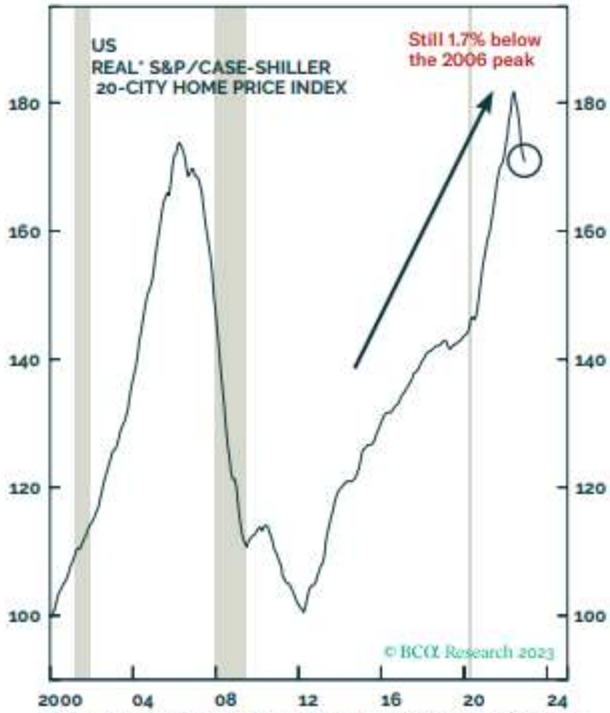


SOURCE: BUREAU OF ECONOMIC ANALYSIS (BEA).

Aggregate real personal disposable income contracted for five straight quarters beginning in Q2 of 2021, first as pandemic-related transfer payments were wound down and then as inflation galloped higher (**Chart 11**). Rising real incomes could generate more spending, and eventually, higher inflation. In this way, falling inflation could sow the seeds of its own demise.

Watch Housing

CHART 12
House Prices Have Receded From Record Highs



* DEFLATED BY HEADLINE CPI. SHOWN REBASED TO JAN. 2000 = 100.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

Whether rising real incomes offset the impact of higher interest rates may hinge on how housing – the most interest-rate sensitive sector of the economy – fares during the next few quarters. Nationwide home prices are still very high and will likely grind lower over the next few years (**Chart 12**).

Housing activity, however, could bottom much sooner. Both mortgage applications and pending home sales already appear to have troughed, reflecting the roughly one percentage-point drop in mortgage rates since November. Homebuilder confidence, single-family housing starts, and the share of consumers planning to buy a home within the next six months all increased in the latest readings (**Chart 13**).

CHART 13
Some Rays Of Light For The US Housing Sector

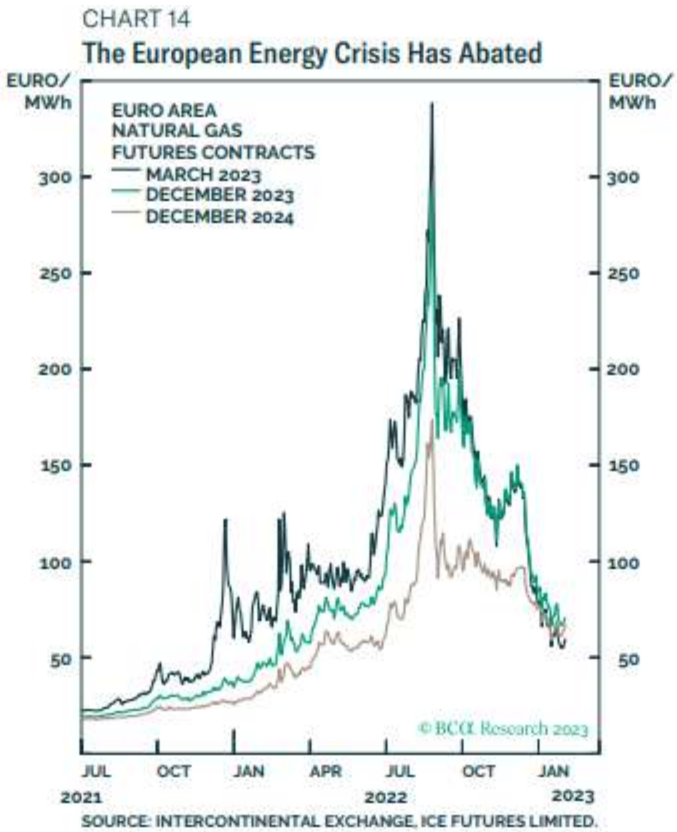
* SHOWN AS 4-WEEK MOVING AVERAGE.
SOURCE: MORTGAGE BANKERS ASSOCIATION.
** VOLUME INDEX (2001 = 100).
SOURCE: NATIONAL ASSOCIATION OF REALTORS.
*** NATIONAL ASSOCIATION OF HOME BUILDERS.
**** SHOWN AS A 3-MONTH MOVING AVERAGE.
SOURCE: THE CONFERENCE BOARD.

A Brighter Economic Outlook Abroad

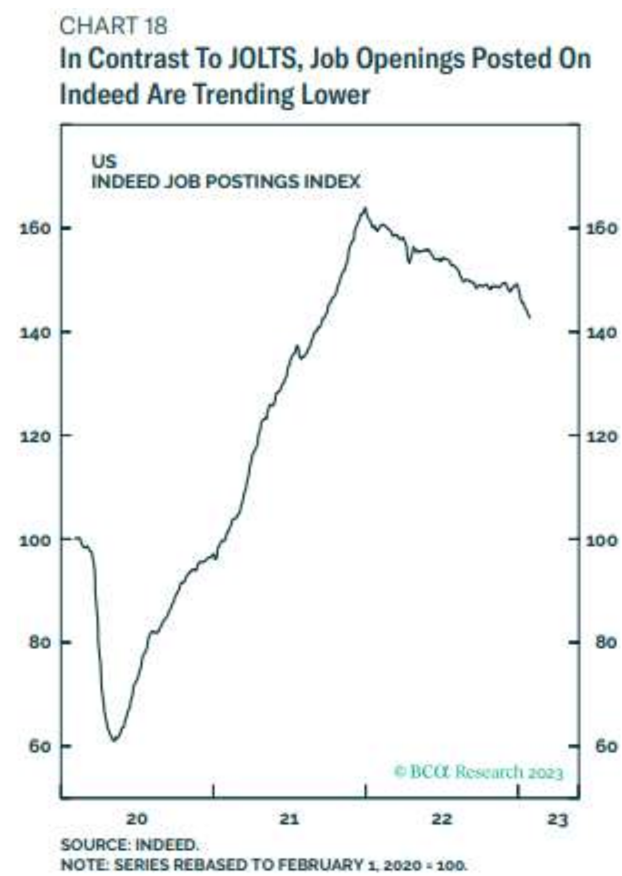
Stronger growth abroad could also raise the risk of a second wave of US inflation. The drop in natural gas prices has stoked hopes of a European growth rebound (**Chart 14**).

Bellwether confidence measures such as the ZEW, Sentix, and Ifo have all hooked higher. The forward-looking manufacturing PMI new orders-to-inventory ratio has jumped in both the euro area and the UK.

Chinese growth is also on the upswing, spurred on by the post-pandemic reopening of the economy and increased government support for the country’s beleaguered property sector.



Reflecting the brighter external growth outlook, the real broad trade-weighted US dollar has weakened by 6.7% from its October highs (**Chart 17**). The Federal Reserve's FRB/US model suggests that, all things equal, such a depreciation will boost aggregate demand by about 0.5 percentage points over the next two years. While not a huge effect ... it could still mean the difference between falling inflation and rising inflation.



Investment Implications

For now, we are in ... the Goldilocks, benign disinflationary phase. In this stage, the natural tendency of stocks will be to rise.

Our favorite measure of where we are in this stage is the job openings series from Indeed, a more timely and less volatile series than the official one from JOLTS. It shows that job openings are slowly falling (**Chart 18**). At the current pace of decline, they are unlikely to reach a level that would precipitate a recession until 2024.

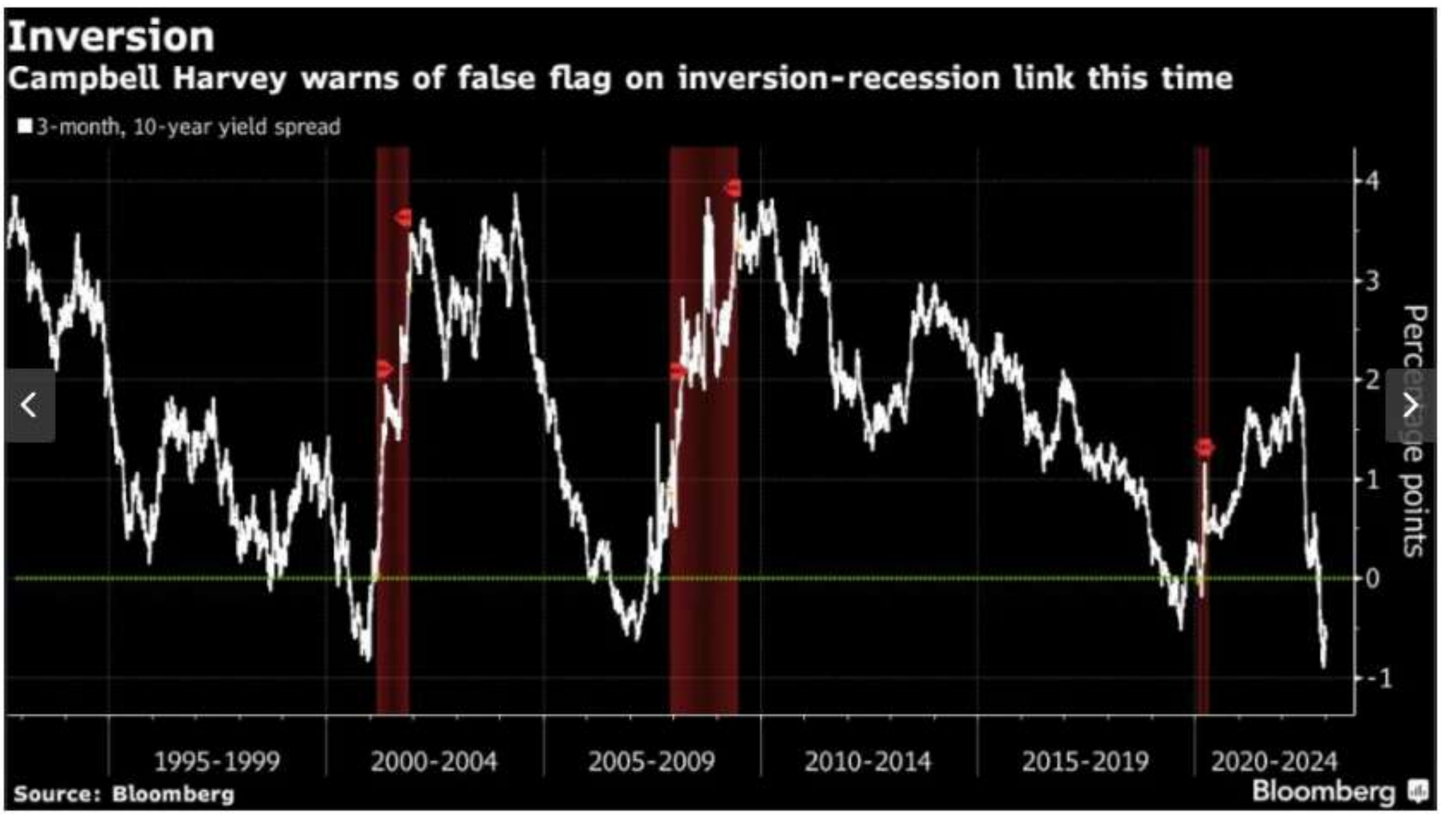
Still, given the storm clouds gathering on the horizon, we are wary about overstaying our welcome in the bullish equity camp. We will trim our tactically long equity recommendation to neutral if the S&P 500 rallies to 4,300, with the intention of turning outright bearish later this year. In the meantime, we continue to prefer non-US stocks over their US peers, and US and European small caps over large caps. ...

For now, we do not have a strong near-term view on the direction of bond yields. On the one hand, falling inflation ... is likely to put downward pressure on yields. On the other hand, the absence of a recession this year will probably keep the Fed from cutting rates, which could put some upward pressure on yields.

Where bond yields end up in 2024 will depend on which of the three scenarios in Stage 3 materializes. In a soft landing scenario, the 10-year Treasury yield will probably stay at around 3.5%; in the more likely mild recession scenario, the yield will drop to about 2.75%; in a second inflation wave scenario, the yield could temporarily rise to 4.5%, as the Fed is forced to bring short-term rates to 6%, before collapsing once a deep recession ensues.

Economist Says His Indicator That Predicted Eight US Recessions Is Wrong This Year

Liz Capo McCormick
January 4, 2023



(Bloomberg) -- Economist Campbell Harvey has had a winning track record since he showed in his dissertation at the University of Chicago decades ago that the shape of the bond yield curve was linked to the path of US economic activity.

US recessions have been preceded by an inverted yield curve — when short-term rates exceed those of longer tenors — since the late 1960s. Fast forward to 2023, that’s exactly what’s been happening with the Treasury yield curve in the past month and half. Yet, Harvey is saying this time the US economy will manage to avoid a real slump even though it will keep slowing down for a bit longer.

“My yield-curve indicator has gone code red, and it’s 8 for 8 in forecasting recessions since 1968 — with no false alarms,” Harvey, now a professor at Duke University’s Fuqua School of Business, said in a interview Tuesday. “I have reasons to believe, however, that it is flashing a false signal.”

The spread between three-month rates and 10-year yields dropped to nearly minus one percentage point last month from as high as 234 basis points in May 2022. The spread, which Harvey’s work is based on, has been consistently inverted since mid November and hovered Wednesday at around minus 82 basis points.

Despite the curve being inverted for the ninth time since 1968, Harvey said it’s probably not a harbinger for a recession.

One of the reasons is the fact the yield curve-growth relation has become so well known and widely covered in popular media that now it impacts behavior, he said. The awareness induces companies and consumers to take risk-mitigating actions, such as increasing savings and avoiding major investment projects — which bode well for the economy.

Another boost to the economy is coming from the job markets, where the current excess demand for labor means laid-off workers will likely find new positions more quickly than usual. In addition, he said, given the largest job cuts so far have been in the tech sector, those highly skilled recently fired workers are also not apt to be unemployed for very long.

‘Dodge the Bullet’

Harvey’s model was linked to inflation-adjusted yields and he said the fact inflation expectations are inverted — meaning traders see price pressures easing through time — also eases odds for a recession ahead.

“When you put all this together it suggests we could dodge the bullet,” Harvey said. “Avoiding the hard-landing — recession — and realizing slow growth or minor negative growth. If a recession arrives, it will be mild.”

The level of real yields also casts doubt on the recession signal. US 10-year yields adjusted for inflation are likely well above corresponding three-month ones. While there are no three-month break-even rates, cross-referencing the latest annual CPI reading with one-year break-evens would return a negative real rate for the tenor, compared with 10-year real yields above 1.5%.

Harvey’s view is not the consensus. Many Wall Street firms are calling for a recession some time this year or early 2024 in the aftermath of the Federal Reserve’s most aggressive hiking campaign in decades to rein on inflation.

Former Fed Chair Alan Greenspan said Tuesday a US recession is the “most likely outcome,” a view also shared by former New York Fed President William Dudley.

If the US economy manages to avoid recession, for Harvey, that won’t mean mean his model is now debunked.

“In science we use models all the time, and they’re simplifications of reality,” he said. “And part of the skill of the scientist is to know when to deploy the model and when not to or, in other words, to know the limitations of the model. And maybe I’m in a good position of knowing the limitations, given that it’s my model.”

One wildcard, he said, is if it the Fed after being late to raise rates last year proves to push them too high.

Fed officials last month raised interest rates by half a percentage point, bringing their benchmark to a target range of 4.25% to 4.5%. Quarterly forecasts also released showed rates ending next year at 5.1%, according to their median forecast, with no rate cuts before 2024.

Fed policy makers in their gathering last month also affirmed their resolve to bring down inflation, according to minutes of the their Dec. 13-14 meeting released Wednesday.

“I believe the time to end the tightening is now,” Harvey said.

From Verdad on Jan 30:

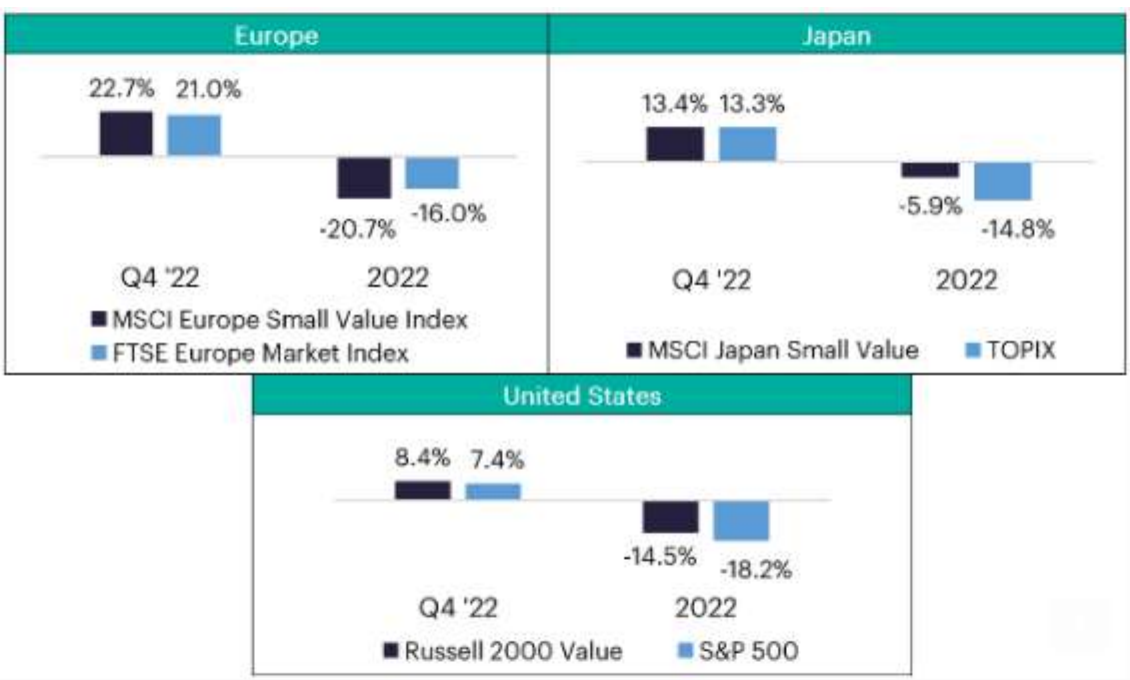
After the Darkest Hour Comes the Dawn

As economic activity in Europe begins to stabilize, we believe the rotation toward small value is just getting started.

By: Brian Chingono

In the fourth quarter of 2022, global markets rallied from their September 30 lows, led by international firms and small value stocks in particular. This rebound was driven by a recovery in cheap companies that had been oversold during the pessimism of the first nine months of 2022. According to MSCI and FTSE Russell, small value indices returned 23% in Europe, 13% in Japan, and 8% in the US during Q4—ahead of the market indexes in all three cases. But Europe was the only developed market where small value lagged the market for 2022 as a whole.

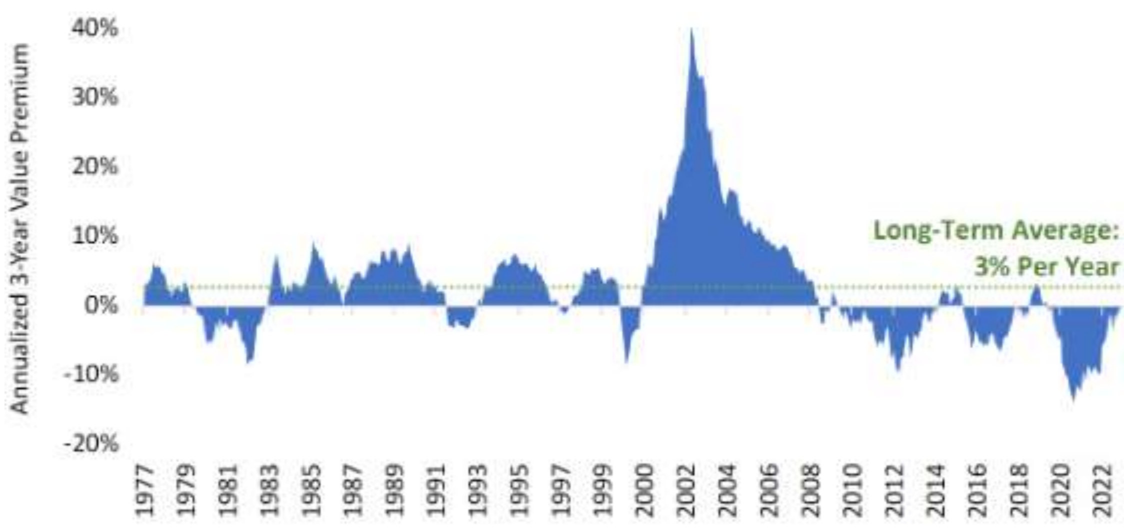
Figure 1: Small Value vs Market Returns in 2022



What explains the more extreme outcomes for small value in Europe during 2022 relative to other developed markets? Quite simply: fear and reaction to news. Small value stocks often sell off on fear and rally on results. The past year was no exception: Europe's small value stocks bore the brunt of pessimism in 2022 and appear to be benefiting the most from news that economic fundamentals in Europe are turning out better than anticipated. In the summer of 2022, there were widespread fears of natural gas rationing across Europe during the winter. Instead, Europe entered the winter with full gas storage (albeit procured at higher cost), and now that winter is here, there are no signs of serious concern over gas rationing. In fact, natural gas prices have declined by 50% since the summer highs, with February gas futures trading at the same level as a year ago, before Russia's invasion of Ukraine. Consequently, fears of a deep recession in Europe appear to be receding, with the ECB President Christine Lagarde reiterating in December that "the recession we feared is likely to be short-lived and shallow," as she cited projections of 0.5% GDP growth in 2023 and 1.8% and 1.9% growth for 2024 and 2025 respectively. While every forecast should be taken with a grain of salt, we believe it's important to note that the ECB's base case appears to align with today's moderate level of the credit market's "fear gauge" since European high yield spreads ended the year at 5.0%, almost exactly in line with their long-term median level of 4.9%.

The signs of resilience in the underlying economy suggest that central banks may stay the course in keeping interest rates at higher levels to tame inflation. And we believe that would spell good news for value stocks that distribute cash to shareholders today, as opposed to growth stocks that offer payouts in the distant future. After a decade of record-low interest rates that were cited as a reason for paying almost any price for growth stocks (and stretching valuation spreads to near the 100th percentile of recorded history in 2021), today's higher cost of capital means that expensive valuations are much harder to justify. And we believe value stocks, which trade at bargain multiples, should become more attractive to investors on a relative basis. We can see evidence of this dynamic in the chart below, which shows the rolling three-year difference in returns of value stocks versus growth stocks.

Figure 2: Rolling 3-Year Value Premium in Europe (1975 – 2022)



Source: Ken French data library

Based on the longest data sample we have available since the mid-1970s, we can see that up until the decade of near-zero interest rates began in 2008, bouts of underperformance in value relative to growth were followed by relatively long periods of outperformance in value. And after the bursting of the previous tech bubble in 2000, value's outperformance was the strongest. So now that we appear to be returning to an interest rate regime where capital actually costs something, and there are clear signs of a contraction in the tech sector, we believe that value stocks could be on the cusp of a winning stretch similar to the 1980s, 1990s, or the 2000s.

Global valuation spreads have already begun to narrow from 2021's record-setting levels to the 94th percentile at the end of 2022. As evidenced by the value-led rally in Q4, even a small amount of mean-reversion from extreme levels can move the needle in big way for value returns. We believe the recent recovery for small value is just the tip of the iceberg, and there is still a lot of room for value to run in the years ahead, from today's extreme level of valuation spreads. Historically, wide divergences between the valuations of cheap stocks relative to expensive stocks have preceded significant outperformance for value over the subsequent decade, as shown in the figure below.

Figure 3: European Valuation Spreads (1975 – 2022)

Source: Ken French data library

Today, deep value companies in Europe can be purchased at around 5x EV/EBITDA (one of our 3 preferred valuation metrics) and 0.8x Price/Book, based on data from S&P Capital IQ. If firms in that category prove to be more resilient than the pessimistic expectations embedded in their prices would imply, they could significantly benefit from multiple expansion over time and still avoid looking expensive. And while waiting for the fruits of mean reversion, we believe investors in European deep value companies can benefit from cash distributions in the form of dividend yields around 4%, share buybacks, and deleveraging.

Follow-ups

From Morningstar:

What to Know About Small-Value Funds

Should investors just index?

John Rekenthaler
Jan 19, 2023

Small Value's Victory

Last week's column, "All-Weather Stock Funds Do Exist," discussed five U.S. equity funds that have combined downside protection with high overall returns. Each fund fell less than 70% as far as Vanguard Total Market Stock Index VGTSX during the three down years of 2002, 2008, and 2022, while also outgaining Vanguard Total Market Stock Index for the 21 years from 2002 through 2022. Nice work if you can get it.

As all five of the all-weather winners hold small-value stocks, one might wonder how much of their accomplishment has owed to managerial insight, as opposed to being in the right place. ... Perhaps owning a small-value index fund would have sufficed.

Indeed, it would have. On average, small-value index funds gained half a percentage point more per year than did the overall stock market. What's more, although their bear-market performances were not quite as spectacular as those of the all-weather funds, small-value index funds also fared much better than the mainstream index funds when the bears arrived.

Exhibit 1: Index Funds: Small Value Versus Vanguard Total Stock Market
(Annualized Total Return %, 2002–22)

	Overall	2002	2008	2022
Small Value Advantage	0.46	10.05	7.06	7.91

Source: Morningstar Direct, author's calculations.

Two Caveats

While heartening for small-value devotees, this outcome does require two caveats.

First, the selected period could be accused of favoring small-value stocks. After all, they thrashed blue chips both in 2002 and 2022. While correct in spirit—cherry-picking time periods is an unscrupulous analyst's best ally—the argument is dubious, because small-value stocks also excelled before the study began, in 2000 and 2001. Also, the stock market's after inflation return over those 21 years resembled its long-term average. In that sense, the period was representative.

The other objection is stronger. Over the full period, small-value index funds were more volatile than their blue-chip rivals. That argument is not entirely convincing, because small-value index funds better protected shareholders during the worst of times, but the math cannot be disputed. According to customary financial theory, small-value index funds provided no free lunch because they paid for their higher returns with extra volatility.

Nevertheless, by any reasonable standard, small-value index funds thrived. Even as growth stocks sparkled—along with the late '90s, the five-year period from 2017 through 2021 was the strongest growth-stock climate of the past half century—small-value index funds persevered. Small-value stocks entered this century with the best track record among U.S. equities. Quietly, they continued their success. In this instance, at least, past performance was indeed indicative of future results.

Considering Active Funds

For investors, however, the performance of active funds is what matters. Even today, index funds claim only about half of small-value assets. In 2002, they accounted for almost none. Thus, most of the gains enjoyed by small-value index funds exist only on paper. Shareholder profits have depended on the fortunes of the group's actively managed funds.

The following table evaluates three groups of actively run small-value funds. The first basket contains all funds that existed from 2002 until 2022; the second holds only lower-cost funds, defined as those that carried expense ratios of 1.00% or less throughout the period; and the third consists of the five all-weather funds that were identified in last week's column.

The format resembles that of the previous table. The results are relative. Positive figures indicate that the active-fund average bested the index-fund average, with negative outcome depicting the reverse. The table also displays the difference in expense ratios. Predictably, the index funds hold a comfortable advantage.

Exhibit 2: Small-Value Funds: Active Versus Index
(Annualized Total Return %, 2002–22)

	Overall	2002	2008	2022	Expense Ratio
All Active Funds Advantage	-0.24	1.01	-2.08	1.70	-0.92
Cheap Active Funds Advantage	0.23	2.96	0.65	2.02	-0.46
All-Weather Funds Advantage	0.29	2.82	9.74	10.2	-0.86

Source: Source: Morningstar Direct, author's calculations.. Data as of May 29, 2020.

In aggregate, actively run small-value funds kept pace with their indexed rivals. However, they did so with a significant dropout rate. Forty percent of the active funds that existed in 2002 have since disappeared. In addition, of those funds that persisted, one fourth returned less than the worst index fund. In other words, only half of the active funds managed the simultaneous feat of surviving the 21-year period and outgaining the last-place index fund.

Thus, although the summary figures for the active funds look equal, investors should likely have indexed. Unless they had selected the sole index fund that folded its tent (which almost no investors did, as that fund was tiny), doing so would have brought them an annualized return of at least 7.77%. Half the active funds failed to achieve that outcome.

The second basket of cheap active funds, on the other hand, were a plausible alternative. Eleven of the 15 funds survived, with overall results that closely matched the index funds', along with modestly better bear-market performances. As Jack Bogle often said, low-cost index funds succeed not because they index but because they are low-cost. With small-value stocks, actively managed funds are competitive when they are offered at the right price.

The all-weather funds, of course, were easily the best of the three investment baskets. Unfortunately, it would have been challenging to identify those funds in advance. Only three of the five funds had existed for even five years before 2002, and none of them boasted particularly impressive track records. Investors would therefore have needed to anticipate that those funds would shine, although their past performances offered no such clues. That would be a tricky assignment.

Last week's column was largely theoretical. It demonstrated that true all-weather funds do exist, but it left open the difficult question of how to find such funds before the fact. Today's article, in contrast, aims to be practical. It shows that, despite unfavorable publicity, small-value U.S. stock funds have continued to deliver attractive investment performance by posting competitive gains that are accompanied by bear-market resistance. Investors who wish to participate can do so either by indexing or by buying an established, low-cost actively run fund (HCM does both.).

From the Financial Times:

Venture capital's reckoning looms closer

Valuations on holdings will have to converge sooner rather than later with listed tech sector

Hating Cathie Wood's Ark and loving venture capital seems intellectually inconsistent. The underlying companies are similar.

Daniel Rasmussen JANUARY 2 2023

The writer is founder and chief investment officer of Verdad Advisers

After about a decade of significant outperformance culminating in a Covid boom, technology investors faced a sharp reversal this year. By the end of June, Nasdaq was down 29.5 per cent and the Goldman Sachs Unprofitable Tech index was down 52 per cent.

Yet one corner of the tech market was strangely unaffected. The US Venture Capital index compiled by Cambridge Associates was down only 12.5 per cent through the end of June (the last available data).

This gap between private markets and public markets is the largest since the bursting of the dotcom bubble more than two decades ago.

Few would argue that these venture capital marks are accurate in aggregate in any meaningful way — though probably most venture capitalists believe their own portfolio valuations to be right. They reflect an accountant's appraisal of value, rather than the market's capricious judgment — and thus tend to be significantly less volatile.

Academics have found that venture capital returns tend to lag behind public markets; the venture capital index looks roughly like an average of the last five quarters of the public market benchmark.

There aren't many investors in VC funds complaining. Both they and the fund managers seem quite happy with the smoothed marks. It's the volatility of public markets that seems outlandish and excessive, not the smoothness of the VC valuations. Yet perhaps this is not the costless ploy that it appears on the surface.

Consider an institutional investor looking to add growth/tech exposure at the start of 2020. They could choose between allocating to Cathie Wood's Ark Innovation exchange traded fund or to a VC fund. The ETF was on a great run, beating both the Nasdaq and VC indices by about 15 per cent annually over the previous three years.

But, other than the State of Wisconsin Investment Board, endowments, foundations and pensions do not appear on the list of top 100 investors in the ETF, according to Capital IQ. In fact, scepticism about Ark was so widespread that Tuttle Capital launched an ETF (SARK) explicitly designed for investors who wanted to short Ark.

But despite the doubts about Ark, which had handily outperformed the venture index during the bull market, institutional investors dumped money into VC funds. In 2021 and 2022, investors allocated an unprecedented $270bn to US VC, according to Preqin. Back in 2014-17 there was only $30bn-40bn of VC capital raised per year.

Hating Ark and loving venture capital seems intellectually inconsistent. The underlying companies are similar.

The valuations of innovative companies should be comparable across both the private and public markets. And Ark was dramatically outperforming venture in the good years. But it presented a problem that venture does not: true mark-to-market volatility on small and unprofitable companies' equity.

While most institutional VC managers acknowledge the smoothing effect and make internal adjustments, we think the reported marks are what truly drives decision making.

Just think: if an institution told you they had 15 per cent of their portfolio in Ark, you might question the degree of the bet. But many institutions have well over that allocation to venture capital.

The average buyout and VC allocations for a university with a $1bn endowment were 16.6 per cent and 13.4 per cent, respectively, at the end of June last year, according to data from the US National Association of College and University Business Officers. Some investment consultants recommend that clients should take private allocations (which also include private real estate and other private assets) higher than 40 per cent, arguing that institutions with higher allocations to privates do better in market downturns.

Institutions have fallen in love with private markets, lured by promises of higher returns and lower volatility. Allocations to VC have soared along with allocations to private equity, private real estate and private credit.

But perhaps these investors have been lulled into complacency, paying an illiquidity premium for the "phoney happiness" of private marks. By doing so — instead of receiving a premium as economic theory suggests — there is bound to be a drag on returns.

As research from Harvard economist Andrei Shleifer has shown, there are three ingredients to a financial crisis: consensus optimism, leverage and illiquidity. And private markets exhibit all three characteristics. Illiquidity may be fine on the way up, but, as investors in the Blackstone Real Estate Income Trust are discovering, it's not ideal when market conditions change. Blackstone limited withdrawals from its $125bn real estate investment fund last month following a surge in redemptions.

And after the dotcom bubble bursting, it took all the way until the end of 2014 for the VC index to regain the high water mark it set in early 2000. If the current listed equity market downturn persists, marks will eventually converge nearer to reality, leaving institutions nursing very real and illiquid losses.

Positions

OBIOX - At the beginning of each year we analyze our existing Foreign Funds list, and also screen for new ones that are rated 5* by Morningstar. Our clients' base exposure comes from ISCF, a low-cost multi-factor ETF, which has a Ratio of average historical Max. Drawdowns to S&P 500 declines greater than 10% since 2007 of 1.2. We expect any additional client funds to outperform ISCF, especially those with the same, or a higher Risk Ratio. As can be seen below, that was no longer the case for OBIOX, which has a Risk Ratio of 1.4. On 1/12 we sold OBIOX for the 2 clients that still had positions.

From Morningstar:

Veteran leadership deftly steers this risky strategy.

Summary |by Stephen Welch, Senior Analyst Sep 9, 2022

Oberweis International Opportunities' proven team plies a consistent and well-codified approach. Its institutional shares receive a Morningstar Analyst Rating of Bronze, while the no-load shares come in at Neutral.

This strategy is in good hands. Ralf Scherschmidt has over 20 years of investment experience and launched this strategy in 2007 shortly after joining Oberweis. He draws on assistant manager Jeff Papp, who joined the firm in 2004 and started working with Scherschmidt part-time when the strategy launched. Papp then joined the team full-time in 2013. Three senior analysts with over 20 years of average industry experience round out the team.

The team attempts to find what it views as the cheapest small- and mid-cap non-U.S. stocks by taking advantage of the post-earnings announcement drift phenomenon. The team believes investors tend to underreact to positive news because of anchoring and behavioral biases; as a result, the managers say share prices often take six to 12 months to fully reflect new information. The team runs daily screens for significant earnings surprises or earnings revisions and runs through a 17-step process to make sure each opportunity fits its criteria. Stocks that check all of the boxes with the widest valuation gaps between its internal estimates and Wall Street consensus are favored, and the team will hold until the gap converges, or a better opportunity arises.

Long-term investors have benefited here. Since the strategy’s February 2007 inception, the no-load shares' 7.1% annualized gain through August 2022 trounced the MSCI World ex USA Small Growth Index's 3.7% and landed near the top of all foreign small/mid-growth Morningstar Category peers.

The fund hasn't been without risks, though. Its six- to 12-month investment horizon has often led to portfolio turnover 3 times the category norm, averaging 133% over the past five years. It's also been volatile. The fund's five-year standard deviation though August 2022, ranked the most volatile of the category and has been roughly 20% more volatile than its benchmark during Scherschmidt's tenure.

TPVG - On 12/13 our primary BDC analyst sold his position at the open for $12.70. "... there was an 8-K SEC filing discussing TPVG's investments in Medly Health, which has been placed on non-accrual for the reasons discussed last month. ... I will make repurchases of TPVG once credit quality improves." High Dividend Opportunities maintained its position, and currently rates TPVG a Top Buy under 16.

Of the 3 brokerage firms that have updated since 12/12, the 1st cut its Target Price to 11.5 from 13, while maintaining their neutral recommendation on 12/12. The 2nd firm lowered its TP to 13.5 from 14.5, and lowered their rating to neutral from overweight on 12/13, and then lowered their TP again to 12 on 12/16. The 3rd firm, which had maintained both it's recommendation, and TP on 12/12, lowered its TP to 10 from 13, and lowered their rating to underperform from market perform on 12/19.

While we didn't get our clients out at the open on 12/13, we did wait for the typical bounce, selling for all 5 clients at 11.7016 on 1/12.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