QUARTER 1 • 2018

Investing INSIGHTS

from Evanston Advisors

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April 2018

It's been a weird start to the year, in more ways than one. The market's been crazy, and politics? Don't get me started. Even the weather has us all confused. Here in Chicago, we had three days above 60 earlier this year… in February, no less! And then this past Monday, it snowed, it's supposed to be in the 70s by Friday, and they say it may snow again on Sunday. Well, you know what they say about the weather in Chicago, "if you don't like it, wait three minutes, it'll change!"

Volatility and corrections

Lately it seems like the market might be taking its cues from Mother Nature. We began 2018 in what appeared to be a continuation of 2017's unstoppable bull market. In fact, the S&P 500 hit 14 new all-time highs in January, the last which occurred on January 26th. By that date, the S&P 500 was up 7.45% for the year.

Like last year, the FAANG stocks accounted for a large portion of that January run up. Note that FAANG has an extra letter "A" in it compared to my previous discussions. Lately commentators have added Apple to the FANG group making it Facebook, Apple, Amazon Netflix, Google. Through January 26th, the FAANG group accounted for 17% of the market's returns in 2018. From that point forward the market began to slide, and within nine trading days had hit a full 10% correction from the 26th high and was now negative for the year. The FAANG group represented about 1/10 of that 10% correction, and as a group was back to flat for the year.

The correction was sparked in part by revelation of personal data mismanagement by a Facebook customer. That initial downturn was exacerbated by concerns of a potential trade war with China and the effect that could have on the global economy. For the next several weeks (and continuing even now) the market experienced dramatic swings from day-to-day and even from high to low intraday.

> *"Lately it seems like the market might be taking its cues from Mother Nature."*

In the candlestick chart on the next page, the red bars represent days that the market closed lower than it opened, and the green bars represent days that closed higher. On those days where the candle is red the top of the "candle's" body is where the market opened that day and the bottom of its body is where it closed. If the candle is green, it's the opposite. The tips of the lines or the "wicks" are the highs and lows of each

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S&P 500, First Quarter 2018

trading day. As you can see there were a number of days with dramatic differences between the high and low of the day.

Investors look at the long term

> *"As I discussed in the past, we are at heart value investors. We are looking to buy and own quality companies, not just buy stocks."*

As I discussed in the past, we are at heart value investors. We are looking to buy and own quality companies, not just buy stocks. The rationale behind value investing is in stark contrast to investing in growth stocks. Growth investing tends to be a bit more speculative, as its proponents are buying based on what they hope the company may one day earn, vs. investing in a more developed and stable stream of earnings. Over the course of the business cycle, the value orientation typically provides better returns, but at various points within the cycle either growth or value may outperform.

Our Senior Portfolio Manager, Matt Terrien, was recently analyzing the relationship of the returns of our portfolio, the S&P 500 Value Index, the S&P 500 Growth Index, and the S&P 500 Composite Index. As would be expected, our portfolio is highly correlated with the S&P 500 Value Index. What you might not expect however, is that over time it is also highly correlated with the S&P 500 Growth Index.

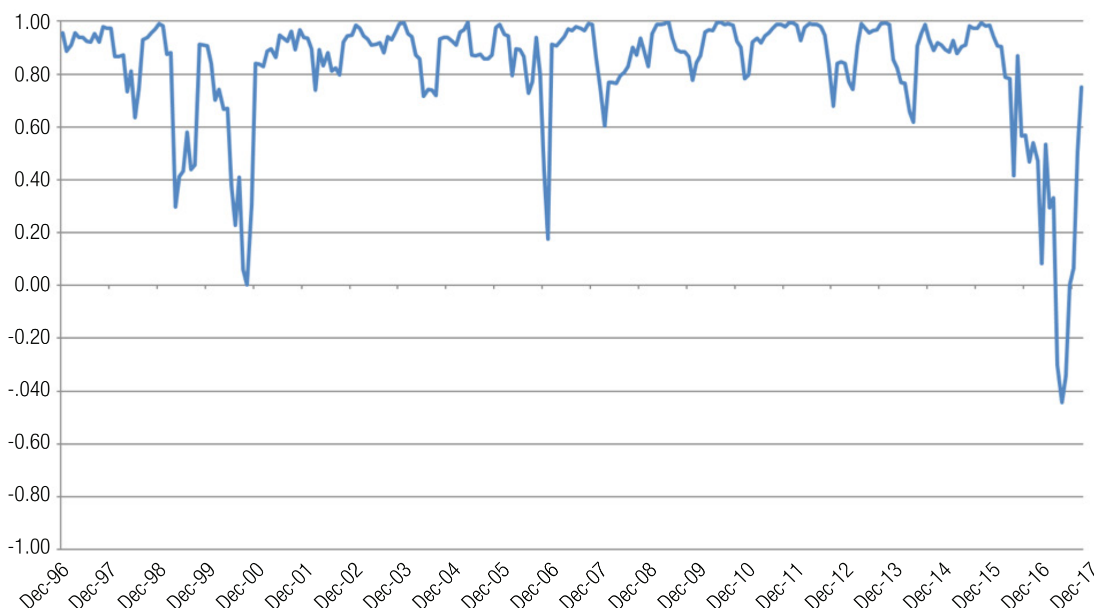
The reality is that the growth orientation and the value orientation are typically highly positively correlated, meaning that they tend to move in the same direction. Usually if value is up, growth is also up, but not necessarily to the same magnitude. The correlation between the two is relatively consistent and rather strong, and they tend to swap leadership back and forth during any given period. As such, the fact that the value orientation has been underperforming the market for the past 15 months or so has been particularly perplexing for us. It's resulted in what appears, at first glance, to be the subpar performance for our portfolio.

However, the performance has been anything but subpar. What has happened is that we've experienced a divergence from the historical correlation between value and growth. While divergences from the historical range of correlations are not unheard of, they are relatively rare, relatively minor, and typically relatively short lived. As can be seen in the chart on the next page, the correlation actually went negative last year. In the past 25 years this is the only time it has gone negative. The only other time it was even close was in the dot-com era (which is also the last time that investors began to believe that earnings don't matter). I believe we all know how that ended.

Measuring performance

Which leads me to our next topic of discussion:

6-Month Rolling Correlation Coefficients



S&P 500 Value TR USD and S&P 500 Growth TR USD

performance reporting. In the past we have always compared our Core Equity portfolio's performance to the S&P 500 Composite. So long as the correlation is within normal ranges, whether we measure performance against the Composite or the S&P 500 Value Index we have a meaningful backdrop against which to understand portfolio results. The choice of comparison index becomes more critical when correlations deviate from the norm. The last time that our portfolio seemingly underperformed so dramatically was, you may have guessed, in the dot-com era.

Finding the right benchmark

We have spent a considerable amount of time investigating and debating whether the S&P 500 Composite is the appropriate benchmark against which to compare our equity portfolio.

The arguments for continuing to use the S&P 500 Composite included:

- It's an index that's readily available to clients, as its typically reported on the evening news.
- It's what we've always done, and everyone is used to it.
- Most of the time it doesn't matter.

In the corner of "we should be using the S&P 500 Value Index":

- By definition about half of the constituents of the S&P 500 Composite would not be considered for inclusion in our portfolio, so why are we measuring our portfolio against them? It's like measuring a domestic portfolio against the European markets.
- Our stock selection model is designed to ferret out value, and the Value Index is the best way to measure what our portfolio management is bringing to the table.
- We're value investors… our strategy is in the name!

We have decided that the S&P 500 Value Index is the most appropriate way to help clients understand how their portfolio is doing. Yes, most of the time it won't matter, as correlations are typically high. But when Value is trouncing Growth, and therefore by default we outperform the market, how can we be sure it is our stock selection bringing value to the table, and not merely the fact that Growth is underperforming for a season, and vice versa? The S&P 500 Value Index is a truer representation of the type of companies we want to own, and as such we are replacing the S&P 500 Composite with the S&P 500 Value Index in all blended benchmarks, effective with the first quarter of 2018. This will not change any performance measures for dates prior to 2018, it is simply effective on a go-forward basis.

> *"Our stock selection model is designed to ferret out value, and the Value Index is the best way to measure what our portfolio management is bringing to the table."*

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"Volatility induced by geopolitical and trade-war saber-rattling aside, there are a lot of positives in the economy to point to."

What's on the horizon?

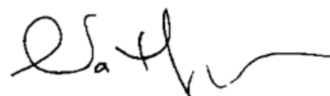
And finally, we come to the part where I get to say, "I told you so". Only I guess I told you so too early. I've been calling for a correction for quite some time, as the market had run for a very long time without one, and valuations were rather overheated. I expected we'd see it at some point last year, but it never materialized. Well, my prediction was a bit early, but it did happen, and we're still flirting with correction territory off and on as this market remains volatile.

So where do we go from here? It may take a bit for us to pull firmly out of this correction, as we spent very little time actually in a textbook definition correction. We entered the correction on February 8th, and came back out of correction territory the very next day, only to float along about 3%-5% outside of correction territory for most of March. In the final days of the first quarter we bounced off the 10% correction level several times. The less time we spend at correction levels, the greater the likelihood that we will revisit those levels at some point later in the year.

Volatility induced by geopolitical and trade-war saber-rattling aside, there are a lot of positives in the economy to point to. The tax cuts have resulted in increased take-home pay for most employees, and a number of companies have given bonuses or raises as a result of the reduced tax rates on corporations. In addition, repatriation of overseas profits should result in a large influx of cash coming back into the United States. More money in consumers' pockets and more cash in circulation both bode well for the economy and the stock market. Unemployment is now at 4.1%, the lowest level since 2000. Average weekly hours worked have been slowly increasing, as has average pay. So far, inflation is remaining relatively benign.

I reiterate my earlier contention that in the absence of any economic or geopolitical crisis, the Fed will continue to raise rates this year in an effort to stay ahead of inflation. I expect at least two more rate increases this year. This obviously could change as the effects of the tax law changes and economic growth play out in the coming months and quarters.

If you have any questions, please feel free to contact us.



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Confidence for your future.

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