KEATSCONNELLY
ENRICHING YOUR CROSS-BORDER LIFESTYLE

December 31, 2015

REVIEW OF THE FOURTH QUARTER

Value Stocks and Portfolio Performance

Happy New Year! We hope this year brings you much joy and gratitude!

As we move into 2016 we want to take some time to talk about overall portfolio performance. Stock markets around the world started off 2016 with significant losses. This leads naturally to doubts about future returns.

At KeatsConnelly we construct portfolios with allocations to cash, bonds, stocks and other assets. So losses in stock markets around the world do not have a dollar-for-dollar impact on losses in portfolios. But there are losses when stocks go down and we want to explain how the factor investing approach we use helps to minimize losses in your portfolio.

There are many different ways to categorize the stocks that make up stock markets around the world. They can be categorized by geographic region, industry, size, and style, just to name a few.

And just as there are many ways to categorize stocks, there are investment strategies based around these different categorizations. For example, you can invest in large company stocks or small company stocks. Or you can invest in funds that target a specific industry, like health care or technology.

Although it is true that there are many ways to invest, most investment strategies don't hold up to the test of time. If an investment strategy makes money in a specific time period, in order for it to be a valid investment strategy, the strategy also needs to hold up when tested in different time periods. For example, an investment strategy of rotating industries based on different economic environments may work in some periods but may not hold up to scrutiny when tested in other times.

One investment strategy that has shown to be persistent over many different economic environments is style investing. Specifically, an index that tracks value stocks has generally had higher performance. Source: Ken French's website from Dartmouth's Tuck School of Business[(1)].

What does it mean to have a value style instead of a growth style? All companies that make up the stock market can be thought of as having more value characteristics or more growth characteristics.

Value companies are more likely to be in older sectors like industrials, financials, and energy. Growth companies are more likely to be in relatively younger sectors like technology and health care. Value companies are also more likely to pay dividends. Growth companies are more likely to reinvest earnings into future growth instead of paying it out as dividends.

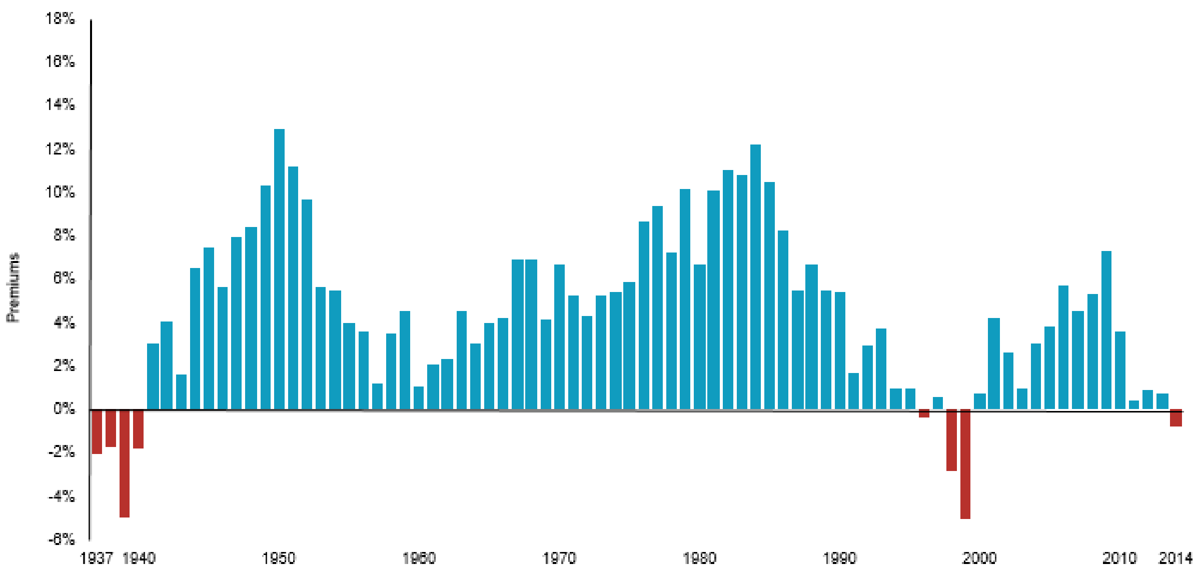
When you look at these statements, you may be tempted to think that you might find better investment success with growth companies than with value companies. This, however, has not been the case over history.

Good data on stock market returns go back to into the 1920s. Value stocks have outperformed growth stocks in more than half the years based on this data. And when we look at the data over longer time periods, value stocks are the clear winner [1].

However, in the years after the economic downturn, 2009 – 2014, growth stocks have outperformed value companies. In 2015 growth again outperformed value but by a smaller margin[1]. We have to look back into the late 1990s to find a time when growth companies outperformed value over any rolling ten-year period. The chart below shows that for rolling ten-year periods since 1937 there were only a few periods where growth outperformed value.

Historical Observations of 10-Year Premiums

Value minus growth: US markets
1937–2014



Information provided by Dimensional Fund Advisors LP.
The 10-year rolling relative price premium is computed as the 10-year annualized compound return on the Fama/French US Value Index minus the 10-year annualized compound return on the Fama/French US Growth Index. Fama/French indices provided by Ken French. Index descriptions available upon request. Eugene Fama and Ken French are members of the Board of Directors for and provide consulting services to Dimensional Fund Advisors LP.
Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results.

So what happened in 2000-2001 that caused such a significant reversal to put value on top again? Remarkably, during a five-month period from November 2000 to March 2001, value outperformed growth by 35%! The "tech bubble" burst and prices for growth stocks were down from lofty (and what turned out to be unsustainable) valuations of the late 1990s. See link for a more complete discussion: https://blogs.cfainstitute.org/investor/2015/12/08/o-value-where-art-thou/.

Portfolios managed by KeatsConnelly have a higher allocation to value stocks relative to growth stocks. This is one of the reasons that returns relative to a general stock market index have been lower over the past few years.

Why should we continue to allocate to value stocks if they have underperformed growth stocks over the past few years? Value stocks are bought at lower prices relative to their earnings. Because they are purchased at lower prices, they should have higher returns. Value stocks should outperform the growth stocks over any given time period; each day, month, year or decade.

Although there is no guarantee that value stocks will provide outperformance relative to growth stocks in the future, this factor is one that has shown to be persistent in and out of sample over long time periods and has academic justification for the effect. In the late 1990s there was a long period where growth outperformed value. This led many people to question if value stocks were still going to be better in the future. Then in the early 2000s, value stocks had significant outperformance, which caused the value effect to be stronger for many years.

We can never be sure that any given investment theme will continue to work in the future, but academic studies continue to support the value effect as a persistent factor in achieving long-term investment success. It has faltered for time periods in the past, but has come back to reward investors that stayed the course.

Investment Committee Review

We are adding a new section into our quarterly letter to report on issues that were discussed in KeatsConnelly investment committee meetings over the past quarter. This will include topical discussions, decisions made (to make changes or not make changes), and other areas that affect our clients' portfolios.

In the fourth quarter of 2015 our investment committee discussed the following topics:

- Currency - the stronger USD and weaker CAD and their impact on portfolio returns.
- Rebalancing bands – we review portfolios to look for rebalancing opportunities when asset classes drift between 3%-6% away from target allocation.
- 3Q15 Performance and fund review – We reviewed the performance of specific funds and total portfolios during 3Q15. This included the time period when markets dropped more than 5% on a single day in late August.
- Loss harvesting at end of year – We discussed the process of realizing losses in portfolios prior to year-end. We decided to realize any losses that were above thresholds in client accounts unless there were specific client circumstances where harvesting losses would not benefit the client.

If you have any questions about any of the topics that were discussed in the Investment Committee during the fourth quarter of 2015 please let us know.

(1) Source: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html

Sincerely yours,

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