Financial Advisory Service, Inc.
Expertise & Objectivity®
Leawood, Kansas
(913) 239-2300
www.faskc.com
Second Quarter 2018

A Strong Case for Value

As we close out the first half of 2018 we are reminded again that volatility is back and is showing no signs of fading over the near term. Headlines from Washington continue to bring strong reactions from investors as trade tensions and political news have been the main catalysts for major swings in the markets. However, despite the increased volatility we have seen since the start of the year, the CBOE Volatility Index (VIX) still remains below its long-term average of around 20. The Dow Jones Industrial Average returned a modest 0.70% return in the second quarter and is actually down 1.81% for the year with high-priced constituents in the financials and consumer defensive sectors dragging the index lower. The S&P 500 was up 2.93% in Q2 and is up 1.67% for the year. The NASDAQ continues to outperform driven by technology stocks. The index returned 6.33% in Q2 and is up 8.79% for the year.

After falling in value relative to other currencies in the first quarter of 2018, the US dollar strengthened last quarter which hampered returns in international equities. The MSCI EAFE fell 2.34% and is down 4.49% for the year.

Macro factors have favored US small cap stocks this year as they tend to be more sheltered from trade disputes with most of their sales generated domestically. The Russell 2000 was up 7.43% in Q2 and is up 7% for the year.

The Fed raised rates in the second quarter for the second time in 2018. The 10-year treasury yield rose over 30 basis points (i.e. 0.30%) last quarter before retreating back down and finishing the quarter 11 basis points higher from the start of the quarter. The Barclays US Bond Aggregate was down 0.16% last quarter and is down 1.62% for the year.

Looking back at the first half of the year and comparing equity returns to years past it is important to take notice of the divergence between growth stocks and value stocks. The Russell 1000 Growth is up 7.88% in the first half of the year while the Russell 1000 Value is down 1.66%. Additionally, the Russell 1000 Growth returned over 30% last year while the Russell 1000 Value returned 13.7%. The difference between growth and value stocks can be described as low book-to-market stocks (i.e. book value of a company relative to its market value) and high book-to-market stocks, respectively. The book value of a company is the value of its assets less the liabilities of the company and the market value is the price of the stock. Growth stocks tend to have higher prices relative to their book value which means they have a *low* book-to-market ratio whereas value stocks will have lower prices relative to their book value and a *high* book-to-market ratio. The best way to think about it is that value stocks are cheap relative to their price and growth stocks are expensive relative to their price. Due to the relative cheapness of value stocks compared to growth stocks they tend to be less volatile over time. The difference between the average return of value stocks and growth stocks is referred to as the value premium.

From 2007 through 2017 the value premium has been negative in seven of those ten years, meaning that value has underperformed relative to growth over the last decade. With individual investors in value funds growing increasingly impatient – iShares Russell 1000 Value ETF has experienced over $4.2B in outflows this year vs. $682M of outflows from iShares Russell 1000 Growth ETF according to Morningstar – it's important to assess the landscape of value investing as we move into the tenth year of the current expansion and the economy becomes more susceptible to external factors that could end the current market cycle.

The average post WWII bull market has returned 161% over 1,821 days while the current bull market (S&P 500) has returned 302% over just more than 3,400 days and is the

(Continued from page 1)

second longest in post WWII history. As we have discussed in the past, it has also been one of the slowest expansions in history, primarily due to the maturity of the US economy and our transition from a manufacturing-based economy to a service-based economy. Due to several factors during this expansion including sub-3% GDP growth, zero interest rate policy from the Fed coupled with quantitative easing and slower recovery in global markets, investors have not only been searching for higher yields but for more growth as well.

The largest demographic in the US - Baby Boomers - have been unable to afford a high allocation to bonds with low interest rates and have turned towards equities that pay a higher dividend. Couple that with the low cost, passive investing strategy that has swept through the investing universe and you have the arbitrary buying of large, high growth companies with excess debt. This effect is compounded with increasing inflows into passively managed funds that allocate based on market capitalization. Of the 987 holdings in the iShares Russell 1000 ETF, just five growth stocks comprise almost 14% of the fund. What happens when the catalyst comes that could potentially derail the current economic expansion and corresponding bull market? The growth stocks that make up a large portion of these passive investments could lose significant value in a short period of time and negatively affect the overall value of that ETF or mutual fund. When – not if – that day comes, whether it be two months or two years from now, it may be a good idea to be invested in stocks of companies with strong balance sheets, low leverage (debt), and relatively higher book-to-market rations (low price-to-book ratios); value stocks which should hold up better versus growth stocks in this scenario. This is not a debate about passive vs. active investing but rather growth vs. value. There is a place for both in a well-diversified portfolio.

In the decade from 1990 to 1999, the value premium was negative 3% according to a white paper from Dimensional Fund Advisors (DFA). In 1998 value stocks had underperformed growth stocks over the trailing 1, 3, 5, 10, 15 and 20 years. In 1999 the Russell 1000 Growth outperformed the Russell 1000 Value by over 25%. From April to November 2000, value stocks *outperformed* growth stocks by such a dramatic amount that by the end of November 2000 value stocks had outperformed growth stocks over the trailing 1, 3, 5, 10, 15, and 20 year timeframes. It took one year for the entire tide to shift. In the same white paper from DFA they illustrated data looking back at 10-year periods ending in 1937 – 2017 (i.e. 1928-1937, 1929-1938… 2008-2017) and out of 81 ten-year periods the value premium was negative in 13 of them, 2008 – 2017 being one of them.

The key to successful investing is to buy low and sell high. Now is not the time, in our opinion, to "sell low" on value investing, because if, and when, the tides turn and this market cycle comes to an end, the quality of the value stocks you hold should mitigate the decline one would experience. The last decade has been favorable to investors. And we are by no means saying that this market cycle's end is imminent. However a day will come when it does end and we want our clients to be prepared when that day comes.

ANNOUNCEMENT

We are pleased to announce that for the third consecutive year Financial Advisory Service, Inc. has been named on the *Financial Times* list of Top 300 Registered Investment Advisers in the country. We want to thank each and every one of our clients without whom none of this would have been possible.

2018 Performance Figures

	2nd Qtr	2018
DJIA (Dow)	0.70%	(1.81%)
S&P 500	2.93%	1.67%
NASDAQ COMP	6.33%	8.79%
MSCI EAFE	(2.43%)	(4.49%)
Russell 2000 Small Cap	7.43%	7.00%
Barclays US Aggregate Bond Index	(0.16%)	(1.62%)
MSCI World All Cap	1.09%	(0.67%)