Things That Matter for Investors II

By: Robert Klosterman, CEO & Chief Investment Officer

Earlier this year investors had many concerns about the economy, investment markets, US politics and global geo-political environments. Oil prices plunging were a significant concern with what the plunging prices might mean for the economy as a whole. What has changed since the beginning of the year? While the specific things we might point to have changed over the past few months there are still issues we need to be aware of as conscientious, thoughtful investors.

The fact that we are in one of the longest economic expansions in modern history legitimately gives investors concern. In general, equities face some daily significant headwinds during recessionary times. While bonds have historically done well, with historically low interest rates and the FED continuing to make noise about raising rates, skepticism about meaningful upside potential is well earned.

Of course, the old saying "markets climb a wall of worry" points out that our worries about markets are always with us and the surest sign of trouble is when investors feel we have a smooth road ahead for investing. One of my favorite quotes by William G.T. Shedd, in his book, "Salt from my Attic" - 'A ship in harbor is safe, but that is not what ships are built for' reminds us of the investor hoarding cash waiting for the possibility of the perfect time to invest. Of course, what usually happens is markets rise so then it "feels safe" and then investment are made at or near the top. Periodic investing at or near the top tends to not lead to happy investors and reinforces bad behavior when it comes to investing. It's not hard to imagine why. The emotions of "making a bad timing decision" only encourage the notion that timing is the most important part of an investment decision. The evidence simply does not support the idea that timing works. Quite the contrary, evidence supports that timing does not work and should be avoided at all costs.

So…what does work? White Oaks believes there are four key things that matter for investors success over the long term. Successful investing requires understanding what matters, and at the same time, recognizing what an investor can control. The intersection of these two concepts are the important distinctions to be made when making portfolio decisions. For example, the ability to control what the economy does or doesn't do, whether the various market places for investments will be positive or negative, what inflation will be and what new geopolitical events may pop into our world are impossible to know with a degree of precision, yet we can't get enough of those opining on their view of these same topics. If they clearly knew they would most likely keep their opinions private in order to capitalize on the knowledge or "secret sauce'.

While the previous paragraph might possibly lead one to conclude that this information is useless, it is not. It is helpful in constructing a portfolio based on things we can, in fact, control. These four controllable factors can increase the effectiveness of a portfolio and its overall probability of success. These controllable factors are:

- Valuations
- Costs
- Volatility
- Tax Effectiveness

Valuations: Despite whether we are buying a private residence, business or other type of investment, common sense tells us that buying an asset at an expensive price will likely lead to a less than favorable outcome. At the same, time buying assets at a reasonable or possibly undervalued price will most likely lead to favorable outcomes. Of course, investing in assets with reasonable or even undervalued values is not a guarantee of what results will likely be but does provide wind at the back for investors rather than a strong head wind. Does this mean that the S&P 500 at current valuations should be totally avoided? No, but it does suggest that overweighting this singular asset type may not be helpful in constructing a high probability portfolio. Other asset classes may provide better risk return characteristics and would likely deserve a higher relative weighting from your base allocation model. More on this later.

Costs: Of course, costs are a drag on portfolio performance and reasonable care should be taken to make sure the costs incurred are not only reasonable but deliver value. If traditional core equities will deliver mid single digit returns active managers must deliver a significant "excess return" to deliver value over a passive index fund or ETF. If the lower return scenario is accurate, then the excess returns an active manager must deliver to compensate for their higher fees, is a higher percentage of the gross return than they previously need to deliver. For example, one percent off a ten percent gross return is 10% of the return. Likewise a one percent fee on a 5% gross return is twenty percent of the return. The burden of proof is on the active manager but the hill to climb for them has become much steeper in the likely low return environment for long-only equity strategies.

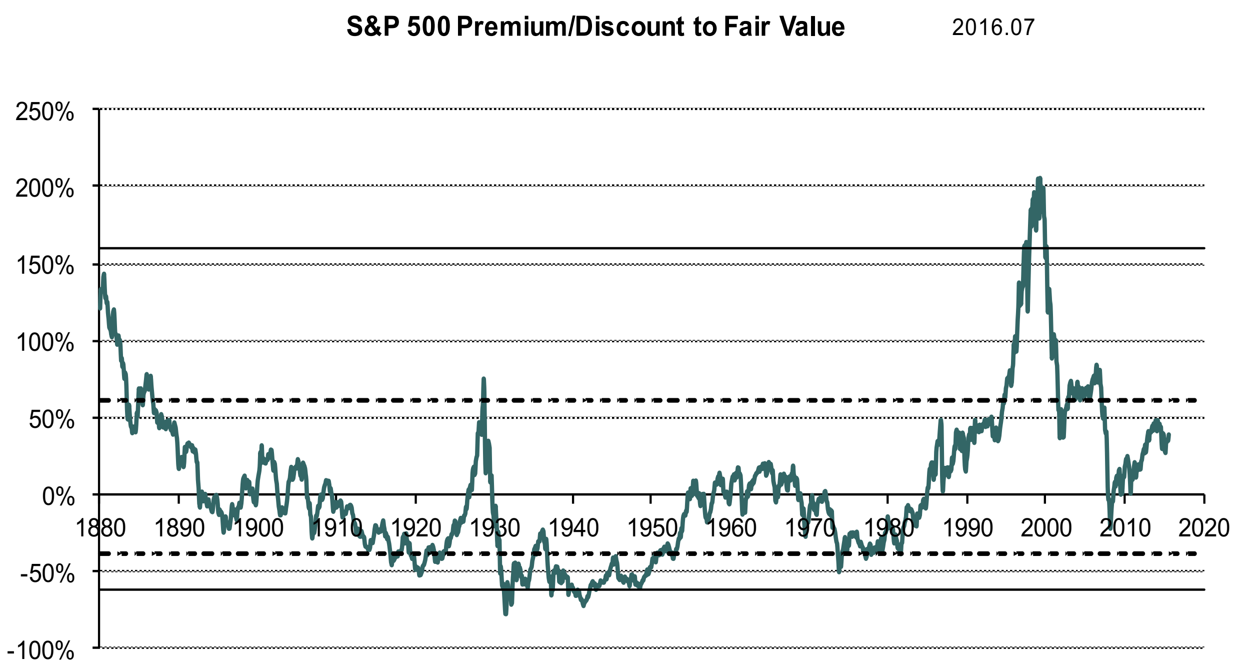
An observation that White Oaks has made is that the more liquid the asset class (i.e. Large Stocks) the harder it is for an active manager to add value. Active managers have an easier time adding value in inefficient markets. Further, asset classes we considered less liquid 15-20 years ago, such as Developed International, Emerging Markets and Small Caps, have been and are continuing to be more followed by analysts and therefore efficient. Driving down costs in the current low return, more correlated and efficient markets is an imperative to today's times.

Volatility: A reader may quickly come to the opinion that "I have no control of stock market volatility" and from that perspective they are correct. Long-only equity strategies are volatile, there is never a good time for down drafts in the market and drawdowns come usually at the worst time. As if there was ever a good time! Investing is not necessarily restricted to long-only stocks, bonds and cash fortunately. Well-selected non-traditional strategies can reduce fluctuation in the portfolio dramatically and preserve capital during stressful times. Strategies such as market neutral, long-short, and managed futures add value by muting the impact of portfolio volatility. Absolute return strategies including private lending, real estate and private equity provide additional characteristics and engines of return to add to the effectiveness of your portfolio.

It is important to consider that not all "non-traditional or alternative investments" are truly inefficient. Some are trading strategies that attempt to time the markets. As mentioned above these strategies face strong headwinds and with high fees and an efficient market environment many will struggle, as they have for the past few years. That being said there are interesting opportunities in private debt, well selected Real Estate and Energy opportunities that fit in nicely with the four things that matter to investors.

Tax Effectiveness: No one likes to pay taxes but I prefer to use "tax effectiveness" over the term "tax efficiency". Tax efficiency implies reducing taxes to the absolute lowest level they can be. Unfortunately this too often leads to good short term but lousy long term decisions when it comes to taxes. For example, tax loss harvesting each year can lead to lowering the overall cost basis of the portfolio. While deferral can be good, one of the items we likely will not have control over is the level of taxation in the future. The lowered tax basis in the portfolio also reduces investment flexibility in the future by having less "taxed" capital available to meet current needs or to reallocate portfolio positions. "Tax effectiveness" focuses instead on realizing an attractive "after tax" return on capital while preserving the maximum flexibility longer term.

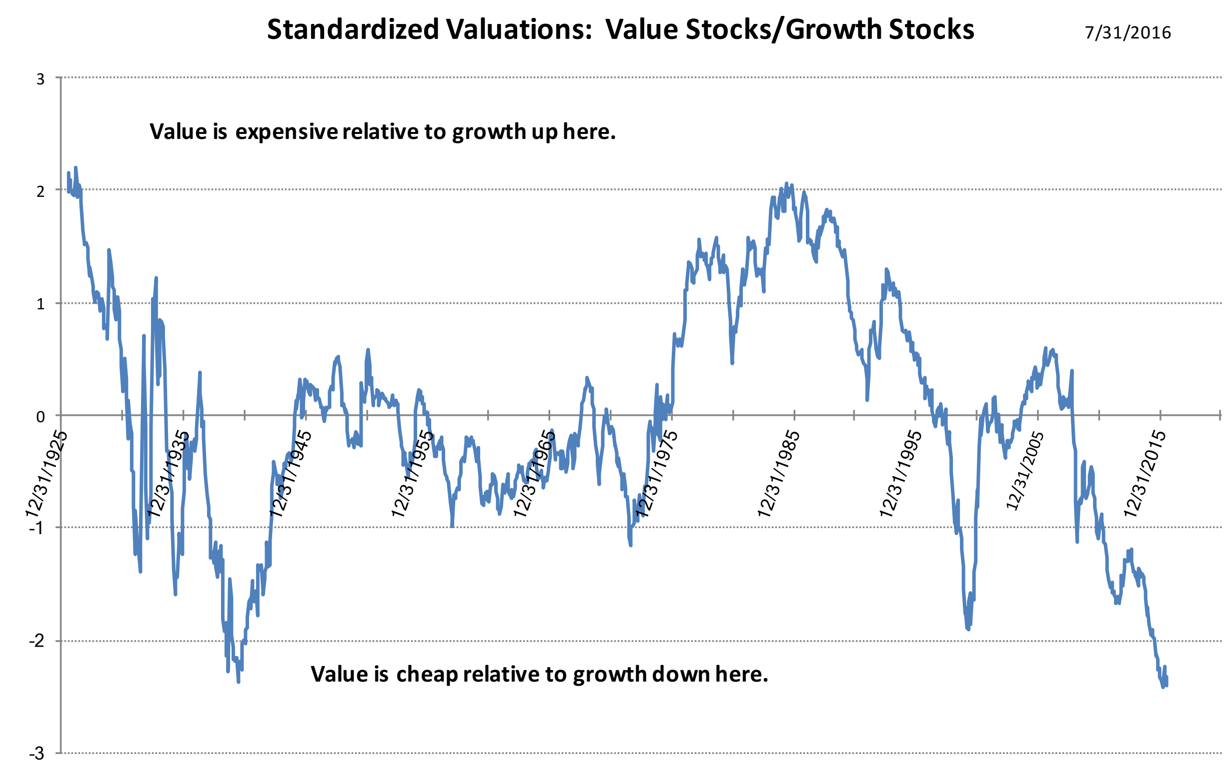
More on Valuations: As mentioned above this paper would provide more information on valuations. White Oaks uses a number of external sources as well as creating our own internal valuation models to assist in developing overall asset allocation models. At the present time we are noticing some interesting factors that we believe investors should pay attention to.



Data Sources: Robert Shiller, Standard & Poor's, Yahoo Finance, and Morningstar
LN (S&P 500 TR) is regressed on time variable to form a log-linear trend line that is considered fair value. Plus and minus one and two standard deviation bands are shown in this chart.

Note in the chart above the relative valuations over time (starting in 1880) of the S&P 500; the zero (0) line representing fair value. This chart indicates the S&P 500 is roughly 30-40% above fair value. Of course, this is not new to investors who read and study the markets. This does not mean that the markets are doomed to crash soon. It may indicate, however, that the S&P 500 may face some headwinds absent strong earnings growth.

The chart below looks at the difference of growth stocks versus value stocks. It is interesting to us at White Oaks how undervalued the value stocks are as compared to growth. This relative under-valuation has not been beyond two standard deviations since the 30's. It is also important to be aware that the methodology of determining value is NOT based on Price/Earnings (P/E) ratios that often lead to so called "value traps" but instead is based on Price to Book Value. If valuations matter, and the evidence suggests that they do, then leaning a portfolio more to true value metrics should help.

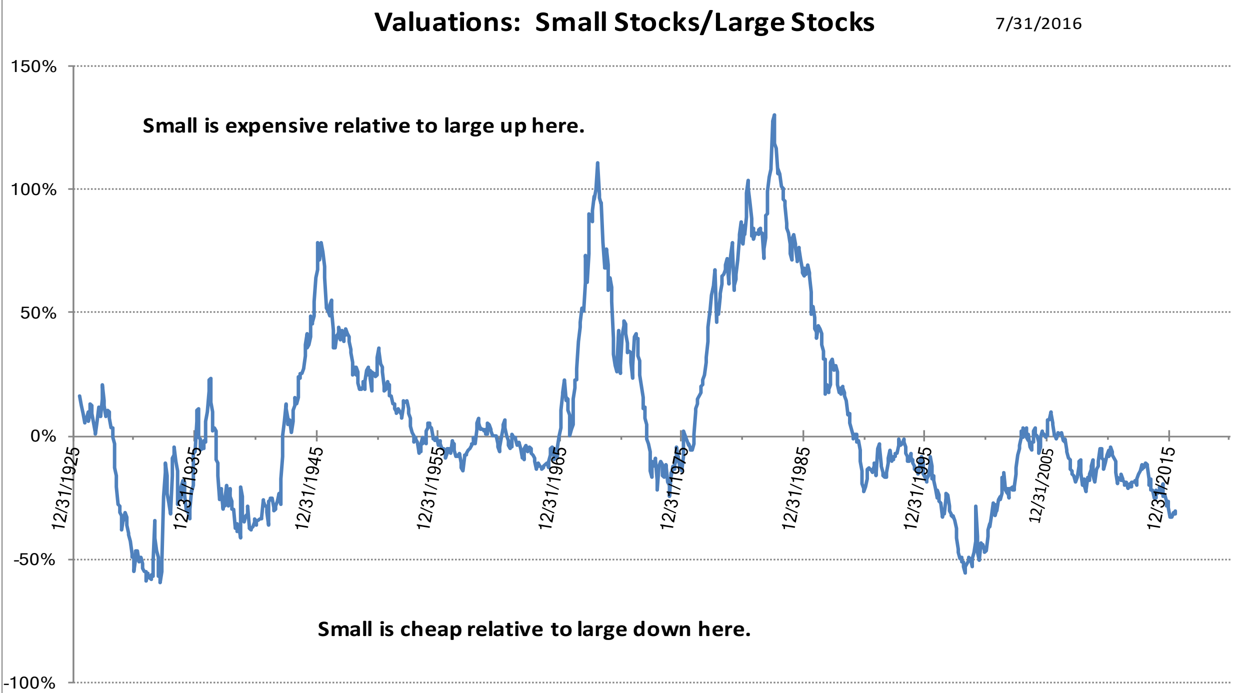


Data Source: Eugene Fama and Kenneth French

The Hi 30 Index (value stocks) is the 30% of US stocks in the database that have the highest book equity to market equity ratios. The Lo 30 Index (growth stocks) is the 30% of US stocks in the database that have the lowest book equity to market equity ratios. The relative TR index represents the total return index of the Hi 30 divided by the total return index of the Lo 30. The valuation shown is the relative valuation between Hi 30 and Lo 30 and is expressed in terms of standard deviations from the mean. A total return index divided by its log-linear trend line is used as the valuation methodology. The trend line is calculated by regressing LN (Hi 30/Lo 30) on time.

Now let's look at the relationship of valuation on Large Caps to Small Caps. In the chart below the advantage would strongly suggest a leaning in allocation towards allocating assets with a Small Cap bias since they are relatively under-valued compared to Large Caps.

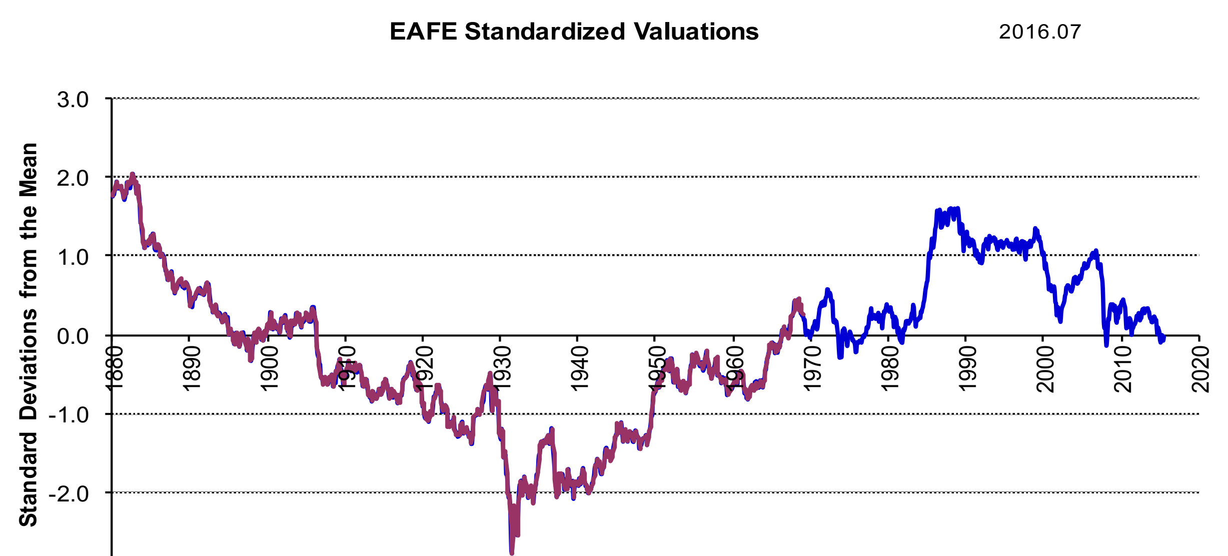
It is not lost on me that for the past 4-5 years investing in Value and/or Small Caps have not been the winning formula. That being said, the strong evidence, over time, indicates that value and small caps provide the best returns. It never has been "all the time" and never will be. Yet, in this environment it may be an excellent time.



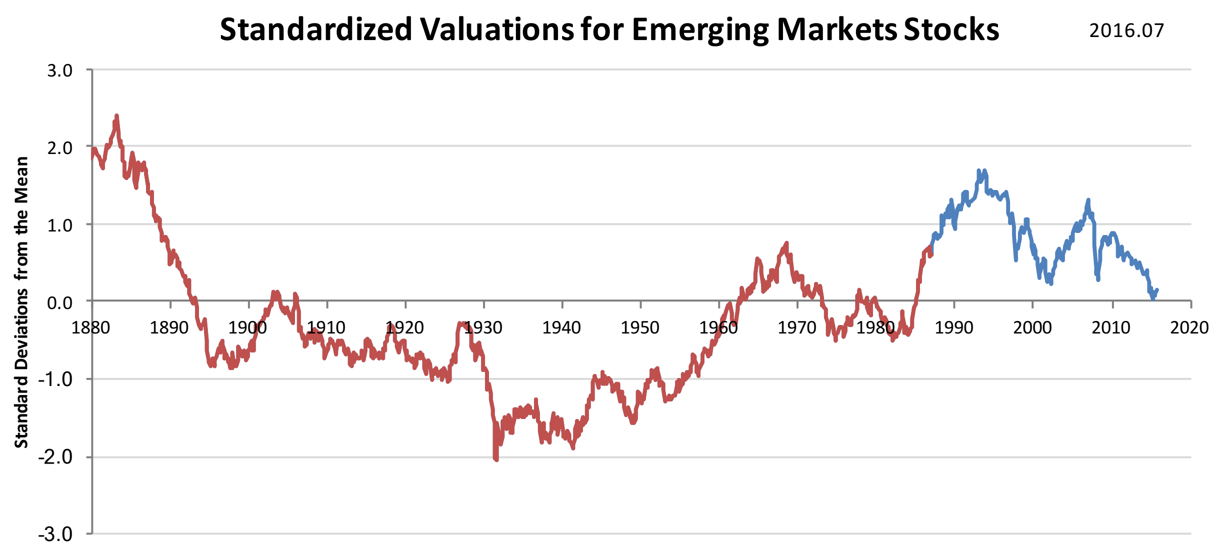
Data Source: Eugene Fama and Kenneth French

The Hi 30 Index (large stocks) is the 30% of US stocks in the database that have the highest market capitalization. The Lo 30 Index (small stocks) is the 30% of US stocks in the database that have the lowest market capitalization. The relative TR index represents the total return index of the Lo 30 divided by the total return index of the Hi 30. The valuation shown is the relative valuation between Lo 30 and Hi 30. A reading of 0% indicates that small stocks are fairly priced compared to large stocks and the relative valuation between the two is at its historical average. A total return index divided by its log-linear trend line is used as the valuation methodology. The trend line is calculated by regressing LN (Lo 30/Hi 30) on time.

Developed International and Emerging markets are exhibiting fair value as shown in the two charts below. With higher growth expectations in Emerging Growth regions and strong economic stimulus in Europe these regions could have some advantages.



Data Source: www.msci.com, Robert Shiller, Standard & Poor's, Morningstar, and Yahoo Finance
A proxy for the MSCI EAFE was constructed using the MSCI EAFE's statistical relationship with the S&P 500 from 12/31/1969-4/30/2015 and the actual performance of the S&P 500 before 12/31/1969. The proxy is used to represent the MSCI EAFE for history shown before 12/31/1969. Valuations in this chart are expressed in terms of standard deviations from the mean.



Data Sources: www.msci.com, Robert Shiller, Standard & Poor's, Yahoo Finance, and Morningstar
A proxy for the MSCI Emerging Markets Index was constructed using the MSCI EM's statistical relationship with the MSCI EAFE from 12/31/1987-4/30/2015 and the actual performance of the MSCI EAFE before 12/31/1987. The proxy is used to represent the MSCI EM for history shown before 12/31/1987. The MSCI EAFE's actual history only goes back to 12/31/1969, so a similar proxy is used for its history before 12/31/1969 where its statistical relationship with the S&P 500 is used. Valuations are expressed in terms of standard deviations from the mean.

Summary:

Investors who focus on the things that matter ***and*** factors they have control over can then filter out the increasing level of noise that exists in the investing universe. The increased focus on the four factors within investors control will lead to portfolios that will have increased impact, satisfaction and results.

About the Author

Robert Klosterman, CFP® is Founder, CEO and Chief Investment Officer of White Oaks Investment Management, Inc. and Founder of White Oaks Wealth Advisors, Inc. Bob has been a Certified Financial Planner licensee since 1989. He has a clear vision for the future having worked in financial planning since 1975, and feels a strong need to provide people with expert and independent wealth advisory services. As a Certified Financial Planner and certificate holder for Family Wealth Advising, Bob's expertise and guidance have helped to fuel the steady growth of the firm. Today, White Oaks Wealth Advisors boasts a talented staff of advisory professionals, hand-picked for their financial planning and wealth management knowledge as well as their dedication to client service.

"My mission is to serve our clients through the combined expertise of our advisory team. I want to use my experience to really impact the lives of the people who place their trust in us."

Bob's leadership within the firm's Advisory Committee regularly encourages fresh thinking and new approaches that provide clients with innovative wealth management solutions in the areas of economic and investment market analysis, stock option strategies and wealth transfer techniques.