Small Cap & Value Stocks: Fashionably Late to the Party

We at Rockwood seek to deliver investment returns via purposefully constructed, evidence-based portfolios. For this reason, you hold a diversified portfolio with strategic tilts to value and small-company stocks that have been shown to generate return premiums over long horizons.

Small cap and value stocks certainly do not outperform the broad market in every year. In fact, since 1926 outperformance in any given year has occurred around 60% of the time — essentially a coin-flip. However, when small cap value delivers positive returns, it tends to do so with unexpected rapidity. There is perhaps no better example of this than calendar year 2016.

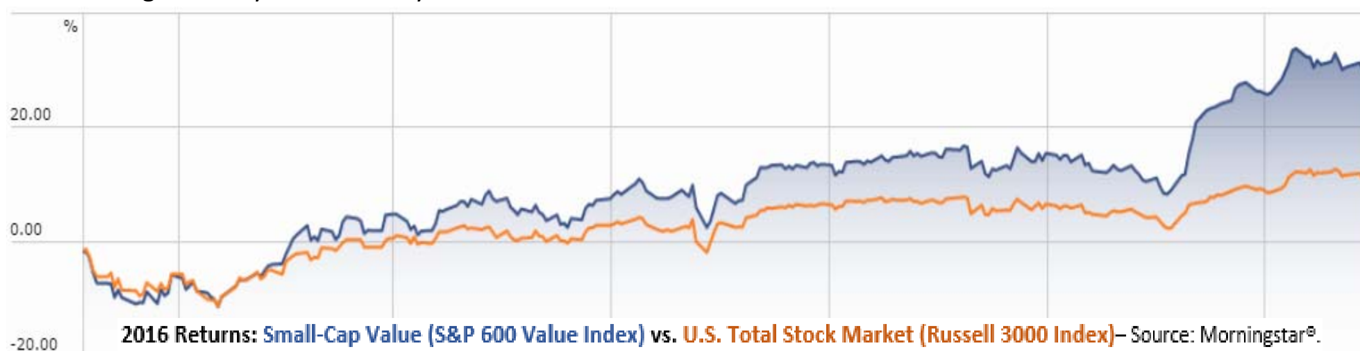
At no time in 2016 did leading indicators or pundits predict that Small Cap Value would outperform the broad U.S. market by nearly 20%. The chart below shows us that most that outperformance occurred in only a few short weeks at the end of the year. Experienced Small Cap Value investors know that they must be in their seats when those returns arrive and not become impatient when Small Cap Value intermittently lags the market (as it often will).

Capturing the Small Cap Value premium in the right proportions is part of our commitment to building empirically tested portfolios for our clients. Regardless of which strategies we use to construct portfolios, our advice is to acknowledge that investor behavior and strategic asset allocation impact returns much more significantly than security selection does.

Accordingly, we require precise and ultra-reliable allocation within the strategies we implement. We demand low-cost and efficient investment vehicles, and we are thoughtful yet brand-agnostic about which mutual funds we utilize. We often need to work flexibly around limitations in our clients' current employer retirement accounts.

Some of the strategies with which we build portfolios are those of Dimensional Fund Advisors (DFA). As the second fastest-growing mutual fund company in the U.S., DFA has pioneered a quasi-index fund approach. It designs its own indexes, often with a nod toward small cap and value stocks, and then waits until eager sellers are willing to part with shares at favorable prices. Eschewing the blindly mechanical nature of index reconstitution, DFA engineers its funds by avoiding ill-timed trading simply to arbitrarily map to an index.

Efficient market research by Nobel laureate Eugene Fama and Ken French (of the University of Chicago and Dartmouth, respectively) guides our investing philosophy here at Rockwood. Since our investment recommendations are informed by our mission to provide low-cost diversified portfolios, rather than by hawking products from a handful of vendors, we are constantly evaluating the market of offerings to ensure that our clients are well served.



2016 Returns: Small-Cap Value (S&P 600 Value Index) vs. U.S. Total Stock Market (Russell 3000 Index) – Source: Morningstar®.

The Pounding Pundits of Pessimism Punished … Yet Again

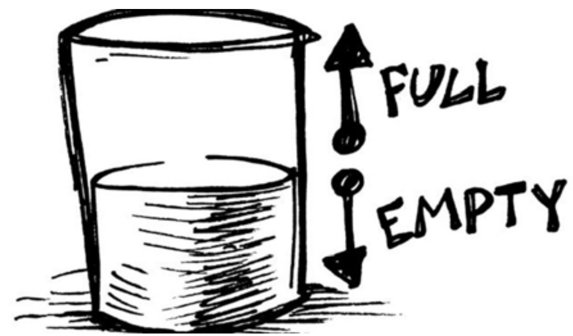
Let it be recorded that in the six weeks from the morning after Election Day to the winter solstice, common stocks in this country increased in value by $1.6 trillion dollars. All the major stock indexes advanced far into new high ground.

Like so many of the signal events of 2016—Brexit, the Chicago Cubs, and the election of Donald Trump—this was not supposed to happen. It is far too easy to see this whole year as an outlier—an exception to the rule, importantly out of the norm. Be assured that it was nothing of the kind. Instead, it was in the largest sense—for the patient, disciplined long-term investor—the pure, Platonic essence of the "same old same old."

Some of the recent melt-up in stock prices can be attributed to the world's perception that the incoming administration will provide pro-growth and pro-capital opportunities. Some reflects significantly strengthening corporate earnings and, indeed, the prospect that both earnings and dividends may record new all-time highs in 2017. Some, surely, is attendant on the stabilizing of oil prices and a nascent resumption of America's drilling boom.

But to focus on the near-term trends propelling a near-term breakout in the equity market is to miss the larger point, which is that this year pessimism has been—as indeed it always has been—relentlessly and even mercilessly punished.

It was ever thus. Sometimes the punishment comes on relatively slowly, as after the Great Panic of 2008-09. Sometimes it comes on quite rapidly, as it did after the relatively mundane (and indeed overdue) market corrections of August 2015 and January-February 2016. And sometimes it comes on so fast it makes your head spin, as it did in a matter of a few days after the shock of the Brexit vote. But—historically, at any rate—retribution in the form of higher corporate earnings, increasing dividends, and, most pointedly, new high stock prices has always come, to break the heart of the pessimist.



If you doubt this—and you wouldn't be human if you hadn't doubted it sometimes—I would encourage you to look at where the S&P stock index was when you were born, and contrast this with wherever it is today. (This is admittedly an excessively conservative comparison, in that it ignores dividends, but for most of us it's still dramatic.)

Then, list all the allegedly existential crises our country and the world have passed through in your lifetime. You will find this not at all a fanciful exercise; indeed, you may discover a profound and powerful message in it, to wit: **Pessimism has always turned out to be terribly wrong**, and has usually done so rather sooner than later.

This is historically inarguable. One's only defense against it is what I've always thought of as the four-word death song of the hardcore pessimist: **This time it's different.** And indeed, I heard that song a lot in 2016, as I'm sure you did: after the straight-down first six weeks of the year, again after the stunning outcome of the Brexit vote, and once more at about 2:30 in the morning after Election Day. It was wrong every time.

In an economy as dynamic, innovative, and entrepreneurial as ours has historically been (albeit not so much lately), betting against the

values of good companies has rarely been very rewarding—and never for very long. In just the last 80 years (since 1935), U.S. population has gone up two and a half times, but real GDP has risen about 17 times. That's an increase in real *per capita* GDP on a scale never experienced in a country even remotely this size. And it had to have been a very good thing for American companies.

Indeed it was, and continues to be. The S&P stock index closed out 1935 at 13; as I write this, it's 2,250. And why? That's simple: **the growth of corporate earnings.** How came the index to be up 170 times (again, ignoring dividends)? Because that's almost exactly how much earnings have risen. In fact, according to Bloomberg, the correlation between earnings and stock prices since 1935 has been 0.95, which is probably about as close to statistically perfect as you can get.

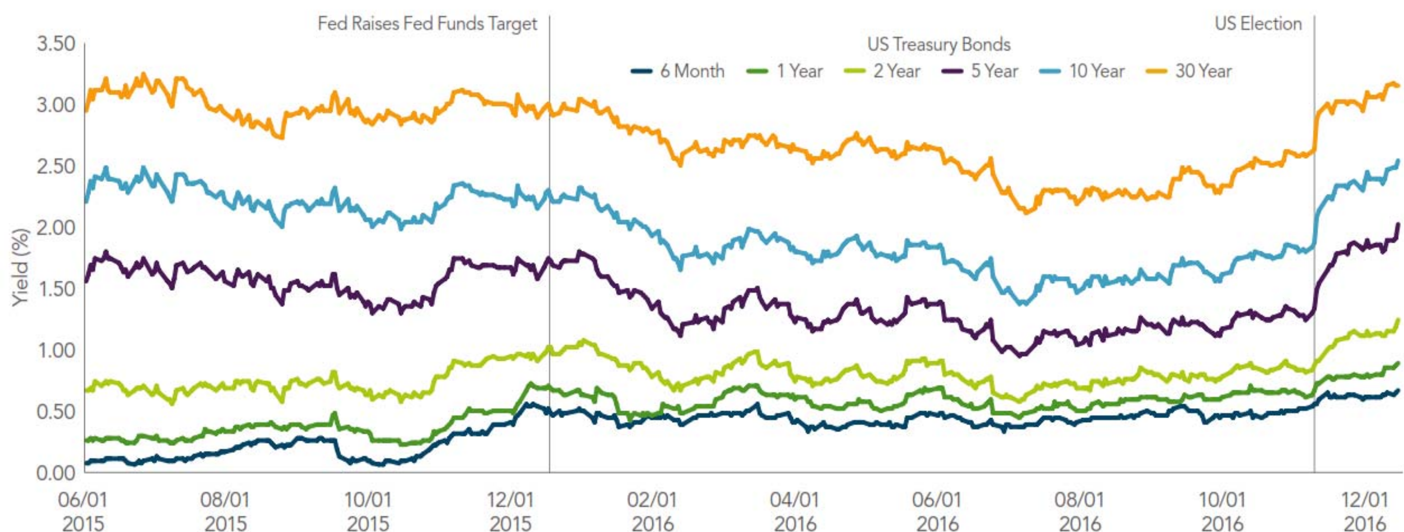
Hence the same old same old—2016 was a singularly bad year for an investor to be a pessimist. *2017 Nick Murray. All rights reserved. Used by permission. ©*

The Fed, Yields, and Expected Returns

On December 14, 2016, the Federal Open Market Committee (Fed) concluded its final meeting for the year and announced its decision to raise the federal funds target rate from its range of 0.25%-0.50% to 0.50%-0.75%.

As we have mentioned before, Fed-watching is a favorite pastime for many market participants, who often presume that Fed actions will lead to specific market outcomes. On December 16, 2015, the Fed raised the federal funds target rate for the first time since 2006. Some market commentators believed this was a signal that multiple rate increases would occur in 2016.

As we now know, the Fed failed to prove the market prognosticators right; the Fed did not change the target rate until its last meeting of the year. Despite this, interest rates in the U.S. have varied throughout the year. In fact, as shown in **Exhibit 1**, immediately following the Fed's rate increase in 2015, yields on many U.S. bonds *decreased* until the second half of 2016.



Securities data provided by Bloomberg Barclays LIVE. Bloomberg Barclays data provided by Bloomberg.

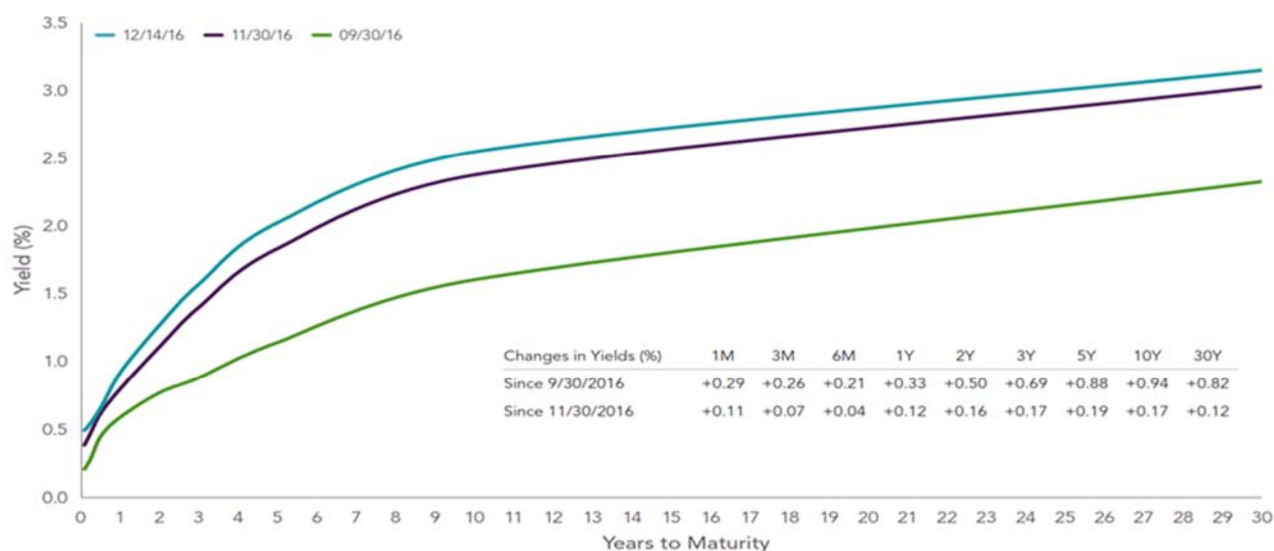
The increase in U.S. interest rates that started at the beginning of the fourth quarter prompts a question: Did the market lead the Fed to raise its key interest rate, or did the Fed lead interest rates higher by setting expectations?

Trying to answer the question may be futile, however. In liquid and competitive markets such as the U.S. Treasury market, current interest rates represent the expected probability of all foreseeable actions by the Fed and other market forces. Market participants, using publicly available information, estimate the probabilities of different outcomes. Those expectations are collectively reflected in current interest rates. As publicly available information changes, market participants adjust their expectations, which are immediately reflected in new interest rates.

While market participants use publicly available information to set expectations, unanticipated future events or surprises relative to those expectations may trigger interest rate changes in the future. The nature of those surprises cannot be known by investors today. As a result, we believe that no reliable way has been found to systematically benefit from trying to outguess market prices when forecasting changes in interest rates. We can say, however, that there is known and observable information in current interest rates, or bond prices, that we can use to set expectations about returns.

The expected return of a bond can be decomposed into three components: (1) the yield of a bond over its holding period, (2) capital appreciation (or depreciation) of the bond due to the shape of the yield curve, and (3) changes in bond prices due to future changes in yields. As we mentioned earlier, there is no reliable way to predict future changes in yields due to future events that are not yet known.

Exhibit 2: US Treasury Yields (%) ***as of December 14, 2016***



Changes in Yields (%)	1M	3M	6M	1Y	2Y	3Y	5Y	10Y	30Y
Since 9/30/2016	+0.29	+0.26	+0.21	+0.33	+0.50	+0.69	+0.88	+0.94	+0.82
Since 11/30/2016	+0.11	+0.07	+0.04	+0.12	+0.16	+0.17	+0.19	+0.17	+0.12

Source: US Department of the Treasury.

Our research and experience in the fixed income markets inform us that there is reliable information in the first two components of expected return that enables us to use current bond prices to identify securities with higher expected returns. As we can observe in **Exhibit 2** above, yields on U.S. Treasury bonds have increased since the end of September, which has had a negative impact on fixed income.

Rockwood Wealth Management
www.RockwoodWealth.com
(267) 983.6400

John Augenblick, MBA, CFP® - President

Brian Booth, CFP® - Senior Partner

Mark Kelly, CPA, CAIA, MST - Partner

Ted Toal, CFP® - Senior Partner

Jerry D. Andrade, MBA, MST

Samuel Feldbaum, CFP®

Scott H. Kelley, MBA

Megan J. Lottier, CPA, MST

Dina Megretskaia

Eric D. Siss, CFP®

Rob T. Stephenson, AIF®

Patti A. Vidakovic

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