

# EQUIUS ASSET CLASS<sup>SM</sup>

Modern asset class investing principles, research, and perspectives for long-term investors

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## Is It 1999 All Over Again?

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It's starting to happen. As the wise philosopher Yogi Berra once said, "It's déjà vu all over again!"

Many investors today know that active management—stock picking, market timing, interest rate forecasting, and so on—is very unlikely to produce better returns than buying and holding a basic stock market index over a typical investor's investment time horizon. Fewer investors know that small-cap and value stocks are riskier than large-cap and growth stocks and should therefore offer a higher expected return, but that knowledge is also becoming more widespread. Finally, a relative handful of investors (among them Equius clients) know that combining these asset classes in a portfolio and rebalancing to agreed-upon target allocations mitigates some of the individual asset class risk while offering a weighted average of their expected returns over time.

So we are always amazed at times like these when we are asked why we have not shifted more of our portfolio allocations to large growth stocks since those stocks have outperformed small value stocks *over the past several years*.

As Mr. Berra also said, "You've got to be very careful if you don't know where you are going, because you might not get there."

### Recency thinking is a plague

Much like the 1998-2000 period, we're also reminded by some investors of how well Facebook, Apple, Amazon, Netflix, and Google have performed. Wasn't it obvious to us at some point in the recent past that these were transformational companies that would drive the market higher? These investors aren't trying to make a case for stock picking, mind you. They're just trying to make a case for a deliberate shift from small-cap and value stocks to the S&P 500. They know these stocks dominate the index performance. So what they are demonstrating is considerable skills at 20/20 hindsight and the too-common urge to "buy high (growth) and sell low (value)."

It's occurred to me that 1) maybe investors today see "asset class shifting" as not really *market timing*

and 2) maybe we're at a point in this investment cycle that's starting to resemble the late '90s.

### Asset class timing is still market timing

In terms of the first observation, it might be that as traditional active management using individual stocks is dying out and the use of ETFs (exchange-traded funds) to build diversified portfolios is growing in popularity, investors are being sold a new kind of market timing.

I alluded to this in my article *Simplifying Complexity* back in [October 2010](#) when discussing Charles Schwab's purchase of Windward Investment Management. Windward was applying a timing strategy across 40 different asset classes. (After I characterized this as "sail[ing] with prevailing investment winds," I wasn't shocked when Schwab changed the name to Windhaven at the time they closed the deal.)

My disdain for Schwab's decision to buy Windward was clear from the article. It has only grown as Schwab's legion of brokers have directed billions more in client assets to the strategies over the years despite very disappointing returns. An article from another advisor from 2014 titled "[Windhaven portfolios: Is Schwab just blowing hot air?](#)" offers another perspective.

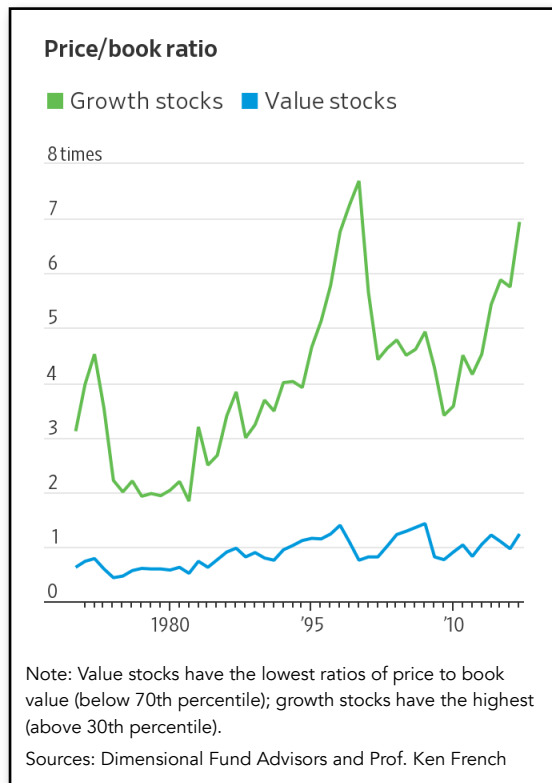
### This time is different...again

As for this second observation, I wrote an article in [January 2000](#) that acknowledged the run-up in the S&P 500 due to the success of *that* period's "transformational companies" and suggested a more diversified asset class portfolio might better survive an inevitable market "correction" (let alone outperform over the long term).

I was right, but not because I had a crystal ball. I simply observed the changes in valuation ratios of the asset classes over the previous 5 years and the parallel that period had to the U.S./foreign experience of 1982-1988. At that time, Japan dominated the Morgan Stanley EAFE index like technology stocks dominated the S&P 500 in 1999—and dominate once again in 2018. Investors who

shifted allocations to the S&P 500 (or, heaven forbid, a NASDAQ) index in the late '90s or to the Japan-heavy MS EAFE index in the late '80s paid a large price for their recency thinking.

Jason Zweig wrote an article recently for *The Wall Street Journal* titled "[Value Should Do Better. But When Is Anybody's Guess](#)" that might serve to set better expectations this time around. Below is a chart from the article. The big spike for growth stocks is the year 2000.



Market or asset class timing is not the answer to this “problem.” Patience, asset class diversification (including bonds in some cases), focus, and disciplined rebalancing are.

### When market timing goes bad

It’s a beautiful sunny day and I’m at a marina in San Rafael looking out over the moored boats to the city of San Francisco in the distance. My 3-year-old granddaughter is asking Papa to push her harder in the swing. This is after she insisted on climbing a ladder that was clearly meant for bigger kids rather than take the stairs—the safe route Papa suggested—to get to the big slide. What can I say, she’s a determined, independent go-getter just like her mom, the youngest of my four children.

Sitting on a bench watching another young child is a nicely dressed woman a bit older than me. I assume the child is her grandchild, but I ask and find out he’s not. She’s his nanny. It turns out she raised her family in Cupertino, the home of Apple, and her husband was a long-time tech executive. He passed away recently of Parkinson’s disease after 43 years of marriage. She is renting a home in Marin County to be close to her three children who live in San Francisco.

She told me she’s renting because she and her husband were financially devastated by the global financial crisis in 2008 and early 2009 since they had all their investments in real estate and stocks. Having been a schoolteacher for most of her life and not wanting (understandably, at her age) to deal with 30 young kids in a classroom, she told me she became a nanny for two families to earn enough money to live in what has become one of the most expensive housing markets in the country.

I didn’t have the heart to probe further into the decisions she and her husband made that resulted in locking in the real estate and stock market losses rather than riding through the declines. They didn’t seem to fit the profile of short-term speculators. At their ages and with his medical challenges, they should have had a balanced portfolio that included short-term fixed-income securities to meet their needs and serve as a hedge against an inevitable market decline. Instead, it appears they engaged in very costly market timing that caused them to miss a tripling in stock prices and substantial gains in Bay Area real estate prices since then.

Her story took a bit of the wind out of my sails and added some sadness to an otherwise beautiful morning with my granddaughter. But just like the former owner of a BMW dealership in Silicon Valley I met who had sold his business at what seemed like the perfect time—only to lose the millions he had earned speculating in Reno real estate during the global financial crisis and who was now selling boats for someone else—what I saw in front of me was a strong, determined woman doing what she had to do to go on with her life.

Ours is a business of probabilities. Understanding them through great research and placing our clients on the right side of the numbers is our mission. Market timing is perhaps the worst gamble an investor can make, and the potential financial destruction is magnified, not reduced, during the most extreme market cycles.

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