January 05, 2018

Dear Friends and Clients,

2017 was quite a year if you didn't notice….

Last year we enjoyed 11 months with positive S&P 500 index returns, that doesn't happen very often. Seeking Alpha tells us it has only happened 4 other times in the last 90 years. March was the outlier posting a -0.31% return…. beware the ides of March said the soothsayer. So the rest of the months were pretty good, we didn't predict up +20% but we did "really like" stocks, January – December.

If you can't measure it, you can't manage it….

Compared to what? Par, birdie, strike, spare, golden globe, oscar….our lives are full of benchmarks. Even though par is expected you often hear, "nice bogie." So things are always relative and your playing partners always seem to know when a reward is in order. Money managers use the S&P 500 to measure equity performance while the general public seems to favor the Dow. As you have read in these epistles before, the S&P is market cap weighted while the Dow Jones Industrial Average is price weighted. Market cap weighting is sold to us as a method designed to insure that a 10% change in a $20 stock will have an effect on the index equal to a 10% change in a $50 stock.

The Dow is price weighted. Basically it is the sum of the members closing prices divided by 30, then adjusted by a factor which accounts for splits, stock dividends, mergers, etc. Since prices change daily, the index weights change with those fluctuations at the end of every trading day. The current factor is less than 1.00 so the index has a value higher than the sum of the 30 stock prices. Ingenious in its simplicity, this methodology was developed by Charles Dow and Edward D. Jones in 1885.

The total return (price plus dividends) generated by the S&P in 2017 was 21.83%....pretty good. The price weighted Dow Industrial Average killed it at 28.08%. The problem with both of these measuring sticks is they do not describe the manner in which money is managed…..more later. The 6.25% spread is an exceptionally wide one, it is usually 1.0-3.0%, regression to the mean will draw these two indexes together over time. Considered the "popular" indexes or average, there is a fair amount of commonality…..all 30 of the Dow stocks are included in the S&P. The Dow was managed from inception until 2011 by the Wall Street Journal and owned by Dow Jones & Co, the S&P is a child of McGraw Hill which evolved into S&P Global. Both indexes earned front page attention from their publishing parents. In 2007 Rupert Murdoch's News Corp purchased Dow Jones as well as the Wall Street Journal and eventually all the related indexes. Shortly thereafter, S&P Global, CME Group (think Chicago Mercantile Exchange) and News Corp announced a joint venture designed to produce, manage and maintain all the indexes they owned, the Dow and the S&P were included in that group.

What about the real world?

So which benchmark should a manager be using? Investors do not shadow indexes and indexes make no effort to emulate portfolios. It is very unusual for an investor of any type to construct portfolios using price or market cap weights. It is, however, a fairly standard practice for portfolio managers to build equally weighted portfolios. P&A has been using equally weighted disciplines ever since Dean Witter days. If

we really like a sector we overweight it, if we don't, we underweight it, the rest of the portfolio is equally weighted with stock picking generating alpha.

So for the last 130+ years the popular indexes have not offered an accurate comparison for the industry. Kind of like kilometer per hour speed limits with a mile per hour speedometer….getting arrested becomes the rule rather than the exception. Using market cap weights would put the Dow and S&P on equal footing, but we would still be dealing with the real world issues generated by portfolio construction. An equally weighted pair of indexes would resolve a lot of issues.

Relief keeps getting closer. For several years we have been able to witness the performance of an equally weighted S&P 500. Guggenheim Investments sponsors the S&P 500 Equal Weight ETF, symbol RSP, which is based on the equally weighted S&P index….RSPNV. In 2017 this fund generated a total return of 19.20%....pretty good, but less than the more popular S&P. However, more than "less" of a trail to the 28.08% price weighted Dow. How many of you can I convince that it is better to beat a 19.20 equal weight than a 28.08 price weighted index?

There is another player waiting in the wings. DEOW is an equal weighted Dow Industrial index born on 2/13/17. so it doesn't even have a year under its belt. However, you will be happy to know that it beats the equally weighted S&P during its brief lifetime, 20.61% to 13.69%. So how happy can we be when things are resolved at lower return levels? Well, you know what they say, be careful what you ask for…..you just might get it. The saving grace for all this index rodeo is that our composite equity return was just shy of 24.50% this year. You are correct, I knew about that before I started this food fight.

The equally weighted S&P actually beats its market cap weighted cousin over a 10 year period, when its old enough I would expect the equally weighted Dow to do the same. While I would like to shift our comparative focus to an all equally weighted world, the history is just not there yet and it is hard to manage what you can't measure. You can expect to see equally weighted benchmarks in our future because the methodology describes THE WAY MONEY WORKS!

The world according to Pitt and Dan….

During 2017 we retooled our diversification criteria, liquidating stocks of low conviction and re-investing those dollars into ETFs and stocks of high conviction. This process reduced the typical number of stocks in a portfolio by 25% and made a nice contribution to performance. For most of the year our portfolios held this heavier percentage of high conviction stocks instead of just good companies. We used both stocks and ETFs to emphasize the sectors we were most confident in and added a few managed mutual funds that we liked. If you noticed these changes don't be concerned about the direction of our portfolios, what you are seeing is just evolution and the mix of investments will continue to morph over time. We meet as an investment committee often and use those encounters to challenge our affection for equities. We have been paying close attention and see a bull market that started 3/09/09, had a full 16% correction in 2011 and a series of rolling corrections in 2015-16. We wrote about these events as they transpired. If the current bull is older and weaker than we think it is, we have reduced single stock risk and have low interest rates, tax relief and strong economic growth on our side….we do not see corrections exceeding 10% for some time into the future. If it is stronger than we expect, we are fully invested and have low interest rates, tax relief and strong economic growth on our side. The long and short of it is, we still really like equities.

Anyway you cut it, 2017 was a very good year for stocks…. our clients did well and we are happy about that. Actually, our clients have done well for the last 10 years and the reason is pretty simple…. we stayed long and were too dumb to take the fake. Truth be known, we need these 20%+ years because we're going to get some 3.0% years as well. Do we think 2018 will bring a correction? Not really, any corrections will be shallow and we will steal our own thunder by telling you we still "Really Like" equities. The low interest rate, low inflation and high corporate earnings environment we are in can last for several more years. The re-patriation of foreign earnings generated by the new tax bill will bring a huge tailwind by itself. There will be corrections over the next few years but once again, they will be shallow and most likely brief. For the foreseeable future, stocks will do anything bonds can do….better.

Let us help….

Some say you can never have too much cash. You can have too much unemployed liquidity, put the cash to work. If you are an equity investor, all the money you let sit still this year cost you north of 20%. If you let $100,000 sit, it cost you $20,000. If you let $200,000 sit, it cost you $40,000. Don't give me that "Only if you can guarantee me another 20% year" stuff. A well diversified portfolio should not have to beat cash by 23% just to spark interest. All of our accounts have a liquidity function and this is an area where we deliver real value. If your account is balanced, the foregone income is less. If you have children the money came out of their pockets. Let us help. If you favor charities these dollars will house the poor and feed the starving. Let us help.

We have no idea what kind of returns the next few years hold. I am an incurable optimist and always frame my thoughts around the long term equity average….12.0%. Money market funds continue to wallow around 1.0%. If you want to think of them as 2.0%, history still gives you a 10.0% advantage. If current events restrict that advantage by half, you're still looking at a 5.0% increase. Ray Charles could see the advantage of adding to your portfolio, let us help.

As Always,

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