FOURTH QUARTER SUMMARY

2019
As we reach the end of a decade – and the start of a new one! – it can be a good time to revisit some of our basic investment fundamentals. It is far too easy to get caught up in the day to day gyrations of markets, so having some guideposts for how we invest is critical. For us, there are three basic tenets that we use to guide us in the portfolio construction process, all of which are rooted in academic research, historical results, and a healthy dose of common sense:

1. **DIVERSIFICATION** – It is very difficult to know exactly which asset will be the best performer in any given year. By blending together a number of different assets that aren’t perfectly correlated with each other, we can improve long term returns and reduce risk.

2. **VALUATION MATTERS** – Cheap assets should outperform more expensive assets over time. People are too often willing to extrapolate heady growth out far into the future, but rarely does it make sense to overpay for that growth.

3. **DOWNSIDE PROTECTION** – If you are spending from a portfolio, which most of us are, it is imperative to minimize the risk of severe loss. With a 5% spend rate, a 20% loss suddenly becomes a 25% decline in value. If you keep spending the same dollar amount, you now have to earn almost 43% the following year to get back to where you started.

Let’s take a closer look at each of these, including how well they have worked in recent years, and how we anticipate they will apply to portfolios in the coming years.
DIVERSIFICATION

This one shouldn’t be too surprising – it’s in our name after all! And while diversification was important to us 26 years ago when the firm began, it is equally as important to us today.

Diversification is the classic “don’t put all your eggs in one basket” approach to investing. By spreading the risk between multiple investments, you end up with a more robust portfolio. Also, the ability to rebalance from outperforming assets into underperforming ones allows you to take your gains and buy a less loved asset with them. This “rebalancing alpha” has been shown to increase portfolio returns, sometimes substantially. A basic example of the benefit of diversification is shown below; a combination of 60% stocks and 40% bonds yields a better risk-adjusted return than either of the individual assets on their own. If we add even more assets into the mix (international equities, diversifiers, private investments, etc.), we can create even more robust portfolios.

VALUATION MATTERS

I will lean on two quotes from one of the most celebrated value investors to help me with this one:

“Price is what you pay. Value is what you get.”

“For the investor, a too-high purchase price for the stock of an excellent company can undo the effects of a subsequent decade of favorable business developments.”

- WARREN BUFFETT

The central principle of value investing is paying a low price for an asset relative to the intrinsic value of the investment. All too often investors become enamored of sectors or companies that are growing rapidly. The fear of missing out on a big gain motivates us to pay an increasingly large premium for these rapid growers. Thus, the more boring, slower growing sectors can fall out of favor, posting lower recent returns, but trading at substantial discounts to those growth companies. When the inevitable hiccup for the high growth sector comes, investors often take a new look at those boring assets.

What this adds up to is a significant amount of outperformance historically for “value” stocks. Whether you measure it by Price/Earnings, Price/Book, Price/Sales, or a combination of the three, less expensive stocks have outperformed their more expensive counterparts during most historical periods. Below is a look at the performance of the value factor over the last 90 years:

As a result, we have tended to tilt our portfolios towards more reasonably valued areas of the market. In addition to generally producing better long-term performance, owning cheaper assets is usually a good way to protect you on the downside since those assets have less room to fall in comparison with more expensive “growth” stocks. Although the last 10 years have seen the worst value underperformance on record, we believe this is creating some attractive opportunities. More on that later.
DOWNSIDE PROTECTION

Chances are the first thing you look at when evaluating your investment portfolio is performance. This is logical – we all want to make as much money as we can. However, most investors are, or will be in the future, spending something out of their portfolios. Because of this it is imperative to look at how volatile your portfolio is, especially in terms of how large the potential is for significant drawdowns. This was highlighted earlier where we pointed out that a withdrawal compounded with a loss in market value can permanently impact a portfolio.

As an example, assume you are an investor who retired at the end of 2006 with $5 million and invested it in a portfolio of 70% global stocks and 30% in bonds. You decide to take a $250,000 annual withdrawal from your portfolio (5%) to live off of, and that withdrawal will grow by 2% each year to keep up with inflation. Everything worked fine for the first year, but the Financial Crisis soon had a devastating impact upon your portfolio. By early 2009 your investments are down to $3 million and that $250k annual withdrawal is now a whopping 9% of your portfolio!

While the tremendous bull market we have enjoyed over the last 10 years helped the portfolio recover somewhat, it was never able to get back up to the $5 million starting point. As 2019 comes to a close the spend rate is now ballooning up over 8%. So, even though this portfolio had an annualized return of 5.5% over the entire period and the hypothetical investor started with a reasonable 5% withdrawal rate, 12 years later they are now just one major correction away from seeing their portfolio enter a death spiral. Total returns are what frequently get all of the attention, but the goal of any portfolio should be the preservation of its ability to support the required spend rate. This requires downside protection.
THE PAST DECADE

By many measures, the past 10 years have been tough for investors focused on diversification, value, and downside protection. The S&P 500 has dramatically outperformed most other markets:

10 Year Cumulative Performance

- S&P 500
- MSCI ACWI Ex USA
- MSCI EM
- BBgBarc US Agg Bond

Source: FactSet
Growth stocks have beaten value, both here and abroad. This has been driven to a large degree by the spectacular performance of a handful of large technology companies (mainly Facebook, Apple, Amazon, Alphabet, Netflix, Microsoft).

And, unlike previous decades there has hardly been a meaningful correction:

A well-constructed, reasonably priced and drawdown conscious portfolio really hasn’t had a chance over the last decade. The world has effectively said, “Buy growth in the U.S. stock market – that’s all you need!”

Source: FactSet. Data as of 12/31/2019.

*A bear market is defined by being more than 20% below its previous 52-week high.

Source: The Financial Times.
LOOKING AHEAD

While the results of the past few years would seem to argue for investing 100% in U.S. growth stocks, you might not be surprised to hear that we do not see things that way. For one, diversification is not broken. It is not unusual for one market or sector to dramatically outperform the others – this has been the case for decades. In the 1980’s it was Japan, the tech sector in the 90’s, emerging markets (and to some extent developed non-US) in the 2000’s, and large cap US stocks in the 2010’s. Diversification is predicated on different investments behaving in different ways, so if anything the differentiated performance we have seen lately is reassuring that things aren’t all that different this time around.

What we can learn from history is that generally when one market significantly outperforms the others, it is frequently setting itself up for underperformance down the road. Even though there are strong fundamentals, in this case a robust recovery from the financial crisis, strong returns have drawn more investors in and distorted valuations. We are starting to see this take place today. U.S. equities traditionally trade at a premium to their international counterparts, but this premium is as high today as it ever has been. Growth stocks and small cap are even pricier (see above).

<table>
<thead>
<tr>
<th>Index</th>
<th>Next 12 Months PE</th>
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<tbody>
<tr>
<td>S&amp;P 500</td>
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<td>Russell 2000 (Small Cap)</td>
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<td>MSCI EAFE (Developed Int’l)</td>
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Source: FactSet. Data as of 12/31/2019.
Also, as we saw earlier, growth stocks have been significantly outperforming their value counterparts. This is also unsurprising, as the two areas tend to trade off leadership, even though value has outperformed over the long run. What is surprising is just how much more stretched the valuations have become for growth stocks, both here and abroad. In fact, this has led growth stocks to be trading at valuations we haven’t seen since the later stages of the tech bubble. And, when compared with the relative Price to Earnings ratio (P/E) of value, growth stocks globally are trading at extreme premiums:

This surge in equities, especially growth stocks, has been fueled in large part by lower interest rates. Companies have been able to borrow very cheaply, in many cases using a lot of that money to buy back their own stock, pushing earnings per share higher even in the absence of meaningful organic growth. In addition, lower interest rates mean that bond yields are also low, so the safe alternative to owning stocks becomes less and less attractive. This leads investors to become willing to pay more and more for stocks, driving their valuations up. While this has delivered exceptionally strong returns for investors, it means that assets everywhere are becoming more and more expensive. Just look at how low bond yields are – the yield of the Bloomberg Barclays Aggregate Bond Index is just 2.3%, one of the lowest readings in history. This does not bode well for future bond returns.

Looking Ahead

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U.S. Bonds

In addition, lower interest rates mean that bond yields are also low, so the safe alternative to owning stocks becomes less and less attractive.
All of this talk about expensive assets, low yields and the near certainty of low bond returns ahead could understandably have you feeling a bit down. But while we aren’t anticipating especially strong returns from a diversified portfolio, we aren’t anticipating a recession on the immediate horizon either. The economy continues to grind along, growing modestly, which should lend itself to continued support for the stock market. In such an environment we would expect stocks to still outpace bonds, bond returns to be slightly better than inflation, and cash returns to be at or below inflation. So, we still want to hold meaningful stock market exposure, just with a strong preference for less expensive companies.

But make no mistake – although we are not especially bullish on future returns, we are steadfast in our commitment to our guiding principles:

• While equity performance has been very concentrated over the past decade, history shows that it is unlikely that US large cap growth stocks will continue to outperform indefinitely. Although it may take a bit longer for things to turn, we believe that they ultimately will.

• Value stocks have underperformed mightily over the past few years, but these are solid companies that are now trading at a discount to both their growth peers and the market as a whole. The valuation discrepancy between high growth and value stocks is so extreme that value should do quite well when a reversal comes, providing us with an opportunity moving forward.

• There have not been meaningful drawdowns during this extended bull market, but history shows that is unlikely to continue on forever. If you are spending from your portfolio, it remains imperative to insulate it from catastrophic loss. If anything, the more richly valued stocks and bonds become, the more likely we are to experience volatility and significant drawdowns when growth slows.

Even though we would have been better off financially if we had gone all in on US growth stocks, doing so would have invited undue risk upon our clients. You don’t get paid for avoiding catastrophes that don’t materialize, but you do sleep a lot better at night along the way. Looking at where we stand today, diversification, downside protection, and a strong awareness of the price you are paying for an asset are more important than ever.
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