HARMONY
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The Weather has been Favorable these Past Five-plus Years

As we all know, the U.S. equity markets have performed quite well in the past 5 years. Since the end of 2009 through year end 2014, the S&P 500 and Russell 200 (which is comprised of the 200 largest stocks by market capitalization) have provided annualized total return of 15.45% and 15.0%, respectively. Therefore, each $1 invested in the two would now have had a value of $2.05 and $2.01, respectively. Similarly, each $1 in the Russell mid and small cap indexes would have had a value of $2.21 and $2.06, over the same five years. As we will see, it is rather unusual for large, mid and small caps to be performing in sync. As terrific as recent years' performance has been, many investors also have searing memories of the recent bear markets of March 24, 2000 through October 10, 2002 and October 11, 2007 through March 9, 2009. During both periods, the S&P 500 declined by more than 50%. Clearly, investment timing matters.

At the risk of repeating myself yet again in a déjà vu fashion, the reason why many investors experience returns that are lower than the arithmetic or time weighted return for the index comes down largely to timing decisions (when capital is committed and withdrawn). Historically, investors have tended to commit more capital into equities after strong performance and to withdraw investments after declines. There is little doubt that these actions can seem comfortable and prudent. However, this practice tends to translate into buying high and selling low – and that dog won't hunt.

In my last letter, I discussed how and why components of active management approaches, including: 1) often high investment fees; 2) low tax efficiency and 3) the need for good timing decisions impose very real impediments to achieving "above market returns". Some 20 or so years ago, what was then known as John Nuveen & Company (primarily a muni bond manager) used to run what I have always considered poignant ads. Their tagline was, "It's not what you earn, it's what you keep." How true! Index solutions are highly tax-efficient, but they are not perfect. Therefore, I thought it appropriate to take a critical eye to cap-weighted index based solutions.

Understanding How Index Based Solutions Work

Admittedly I am a little odd. The construction and operating practice of various indexes including cap-weighted indexes interest me. With respect to indexes, it is important to understand how capital is allocated across the members. Is it concentrated or is it broadly distributed? In addition, it matters whether or not capital is "re-balanced" along the way.

Like all investment approaches, cap-weighted index strategies do not work well in all environments. After all, there are extended periods of time when cap-weighted indexes yield what most investors reasonably deem unacceptably low returns. For example, 1929 through 1948, 1966 through 1982 and 2000 through today, were all environments when index returns were very lean. By understanding the composition and practices of indexes, we can make judgments about how we can and should allocate our capital.

Cap-weighted indexes reflect the aggregate change in market value for all components in the index weighted by relative market capitalization of each member of the index. If two companies have an equal market cap, they will have an equal weighting in the index. Then if one stock doubles in value and the other remains the same, the first one will have twice the weight in the index. In effect, the index has ***natural momentum*** wherein the best performing stocks take on greater weight in the aggregate index and drive long-term returns for the whole index. For the most part, this operating practice provides benefit to long-term investors.

Taking a Look at Capital Allocation

The Russell 3000 is an index of the largest 3000 publicly traded stocks as determined by market value of each company. This index comprises about 99% of the value of all publicly traded U.S. stocks. It is interesting to break down this index of 3000 stocks by aggregate market value. As mentioned above, the Russell 200 is comprised of the 200 largest of the Russell 3000 stocks. These “mega caps” account for only 6.67% of the number of companies. However at any time, these members account for roughly 70% of the total market value/allocation of all 3000. Indeed the top 10 stocks (of 3000) account for about 15% of the value of the total index. Clearly these big fish matter. As I illustrated in my last letter, if you bought and held a finite number of securities, over time it is likely that a relatively small number of the initially equally sized investments would account for the majority of the portfolio’s aggregate value in 20 or 30 years. Indeed this is what happens in cap-weighted indexes. In that regard, I consider these passive portfolios to be quite smart as the practice is to allow the best performing stocks to take on greater weight in the portfolio and drive change in aggregate market value. However because capital is so concentrated into a relatively small number of mega caps, if this elite group delivers poor results, good results of the other parts of the portfolio can be eclipsed. Indeed there are extended periods of time when this is true.

It’s important to consider how stocks are valued at bull and bear market extremes. During long bull phases, valuation often increases so that returns from owning stocks greatly exceeds the growth in the underlying economy and corporate earnings. Specifically valuation measures like the PE expand and magnify the underlying fundamental growth. For instance in the late 1990s, the economy was performing quite well. During this time period many large cap growth stocks experienced large increases in share price. Indeed if a company grows its earnings at approximately 18% annually then each $1.00 in earnings will grow to $2.00 in 4 short years. If during this same time the stock’s PE ratio increased 4x (from 15x to 60x or 20x to 80x or 25x to 100x), then the stock price would have increased 8x. This creates a great deal of goodwill among investors and belief in the company, its management and stock. However, the primary reason why stock indexes performed so poorly during the bear markets of 1973-‘74 and 2000–‘02 was because valuations were so high for mega caps at the top of the preceding bull markets. In each instance, the period prior to the start of the bear market was marked by an enormous increase in valuation, compared to long-term averages, especially among large cap growth stocks.

At bull market extremes (1929, 1972, and early 2000) natural momentum means the index gets more skewed into a handful of mega cap darlings with rich valuations. For instance, if two companies each earn $1 billion and one is accorded a PE of 100x and the other 10x. In other words, the allocation per $1 invested is 10x more in the high PE stock compared to the one with the low PE. If we were allocating the capital ourselves we might choose to own less of the richly valued stock and more of the low PE stock. The good news for astute investors is that historically during the bear market phase for cap-weighted indexes, mid and small caps have often exhibited favorable performance especially relative to mega caps. For example in the past 15 years, the Russell 200 and 1000 (e.g. mega + mid-caps) have generated modest annual returns of just 3.2% and 4.6%, respectively. Therefore, concentration risk is inherent in all cap-weighted portfolios like the Russell 3000 or S&P 500. Conversely over this same time, the Russell midcap and small cap indexes were up 8.9% and 7.4% annually.

Allocation Matters – Stack the Odds in Your Favor

There are ways to counter these risks via diversification. Specifically investors can help offset the risk inherent in cap-weighted indexes that sometimes get out of kilter by deliberately allocating capital into other segments in order to broaden the opportunity set.

These include mid and small cap overlays, international equities and bonds and appropriate U.S. fixed income. Further we can make *active* tilts into sectors and market segments we deem attractive or segments like "value" or "growth". With our diversified approach, we will <u>*never*</u> be concentrated solely in the right place at the right time. However, we will be more insulated from the adverse impact of mega caps during all extended periods when their returns lag other market segments of U.S. cap-weighted indexes. Risk management through capital allocation is paramount. Cap-weighting simply does not do this for us.

Risk Matters: Capital Allocation is Key

The table below contains a great deal of data so I hope this commentary will help. Specifically the table shows the annual return for various Russell indexes over the past 20 years. Then in the bottom right hand portion, the table shows the annual rate of return and growth of $1 over the past 3, 5, 10, 15 and 20 years ending December 31, 2014, respectively. A few things stand out to me. In any given year, the returns for the Russell 200 (mega caps), Russell 1000 (mega caps plus 800 mid-caps) and Russell 3000 (e.g. Russell 1000 plus Russell 2000 small caps) are quite similar. In years when mega caps lead performance among stocks generally, the Russell 200 modestly outperforms the Russell 1000 and 3000 indexes and vice versa. Over extended multi-year periods, the growth of $1.00 across these indexes also tends to be quite similar. Please see the differences in the Rows labeled "R 200 – R 1000 and R 200 – R 3000". In other words, the Russell 200, 1000 and 3000 effectively provide **a distinction without a difference**.

On the other hand, there are often significant differences in single years and over multiple years between these indexes and the Russell mid and small cap indexes. With the notable exception of the five year period 1995 thru 1999 (when mega caps performed best by a significant margin), investors would have been well served to have a separate overweight into the Russell small and mid-cap (in particular) indexes. The Russell 200 Growth (e.g. the 50% of the Russell 200's total cap allocated into the companies with the highest valuation multiples) performed exceptionally well during this five year span. Each $1.00 invested in that same 5 year period would have grown to $4.38 compared to just $2.69 and $2.16 for the mid and small indexes, respectively. Many investors were drawn late in this mega cap growth run like moths to a flame. After all, this sleeve of the Russell 200 contained all of the darling tech and telecomm companies. Returns over the 15 years since have been radically different than the golden age for tech and telecomm. If an investor committed capital into the Russell 200 growth at the end of 1999, each $1 invested would have a nominal value of $1.25 at the end of 2014. The modest rate of return has been 1.5% annually for this once "can't miss" segment of the market these past 15 years. To add insult to injury the opportunity cost for folks that went "all in" was really high. As mentioned previously, the Russell mid and small indexes delivered annual returns over the same 15 years of 8.9% and 7.4%, respectively. Therefore, each $1 invested in the Russell mid and small cap indexes have grown to $3.59 and $2.91, respectively. On the other hand, each $1 invested in the "broad market" Russell 3000 only grew to $2.03 or 4.8% annually. Again the mega caps are all important and if they are not performing well cap-weighted returns may disappoint for extended periods.

It may be that mega caps are poised to outperform in the years ahead. If this proves to be the case, many investors may wish they only own mega caps. Nevertheless, a healthy allocation into these sub-indexes can aid diversification and it can potentially enable investors to capture higher intermediate and long-term returns. At a minimum, it seems likely that by adding an allocation into small and mid-caps as well as international markets, investors can reduce the risk associated with being concentrated in the wrong place at the wrong time. This is the inherent risk in all unrestricted cap-weighted indexes including broad market indexes like the Russell 3000. However the operating practice of small and mid-cap indexes is dramatically different than that of unrestricted indexes like the Russell 200, 3000 and S&P 500.

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	ANNUAL RETURNS and Growth $1.00 INVESTED by INDEX															
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Russell Top 200® Index	39.4%	24.0%	34.5%	34.0%	21.8%	-12.1%	-14.6%	-23.4%	26.7%	8.3%	3.8%	15.5%	5.9%	-36.1%	24.2%	12.5%
Russell 1000® Index	37.8%	22.5%	32.9%	27.0%	20.9%	-7.8%	-12.5%	-21.7%	29.9%	11.4%	6.3%	15.5%	5.8%	-37.6%	28.4%	16.1%
Russell 3000® Index	36.8%	21.8%	31.8%	24.1%	20.9%	-7.5%	-11.5%	-21.5%	31.1%	12.0%	6.1%	15.7%	5.1%	-37.3%	28.3%	16.9%
Russell Midcap® Index	34.5%	19.0%	29.0%	10.1%	18.2%	8.3%	-5.6%	-16.2%	40.1%	20.2%	12.7%	15.3%	5.6%	-41.5%	40.5%	25.5%
Russell 2000®	28.5%	16.5%	22.4%	-2.6%	21.3%	-3.0%	2.5%	-20.5%	47.3%	18.3%	4.6%	18.4%	-1.6%	-33.8%	27.2%	26.9%
R 200 - R 1000	1.6%	1.6%	1.7%	7.0%	0.9%	-4.4%	-2.1%	-1.7%	-3.2%	-3.1%	-2.5%	0.1%	0.1%	1.5%	-4.2%	-3.6%
R 200 - R 3000	2.6%	2.2%	2.8%	9.8%	0.9%	-4.7%	-3.1%	-1.8%	-4.4%	-3.6%	-2.4%	-0.2%	0.8%	1.2%	-4.1%	-4.5%
R 200 - R Midcap	4.9%	5.0%	5.5%	23.9%	3.6%	-20.4%	-9.0%	-7.2%	-13.4%	-11.9%	-8.9%	0.3%	0.3%	5.4%	-16.3%	-13.0%
R 200 - R 2000 (small)	10.9%	7.5%	12.2%	36.5%	0.5%	-9.1%	-17.1%	-2.9%	-20.6%	-10.0%	-0.8%	-2.8%	7.5%	-2.3%	-3.0%	-14.4%
						Growth of $1.00						CAGR				
	2011	2012	2013	2014		2012-14	2010-14	2005-14	***2000-14***	1994-14		2012-14	2010-14	2005-14	***2000-14***	1994-14
Russell Top 200® Index	2.8%	16.0%	32.4%	13.3%		$ 1.74	$ 2.01	$ 2.03	***$ 1.60***	$ 6.07		20.3%	15.0%	7.3%	***3.2%***	9.4%
Russell 1000® Index	1.5%	16.4%	33.1%	13.2%		$ 1.75	$ 2.07	$ 2.15	***$ 1.97***	$ 6.78		20.6%	15.6%	8.0%	***4.6%***	10.0%
Russell 3000® Index	1.0%	16.4%	33.6%	12.6%		$ 1.75	$ 2.07	$ 2.15	***$ 2.03***	$ 6.68		20.5%	15.6%	7.9%	***4.8%***	10.0%
Russell Midcap® Index	-1.6%	17.3%	34.8%	13.2%		$ 1.79	$ 2.21	$ 2.49	***$ 3.59***	$ 9.65		21.4%	17.2%	9.6%	***8.9%***	12.0%
Russell 2000®	-4.2%	16.4%	38.8%	4.9%		$ 1.69	$ 2.06	$ 2.11	***$ 2.91***	$ 6.29		19.2%	15.5%	7.8%	***7.4%***	9.6%
R 200 - R 1000	1.3%	-0.4%	-0.7%	0.0%		$(0.01)	$(0.06)	$(0.12)	***$ (0.37)***	$(0.70)		-0.3%	-0.6%	-0.6%	***-1.4%***	-0.6%
R 200 - R 3000	1.8%	-0.4%	-1.1%	0.7%		$(0.01)	$(0.05)	$(0.12)	***$ (0.42)***	$(0.60)		-0.2%	-0.6%	-0.6%	***-1.6%***	-0.5%
R 200 - R Midcap	4.4%	-1.2%	-2.4%	0.0%		$(0.05)	$(0.20)	$(0.46)	***$ (1.99)***	$(3.58)		-1.1%	-2.2%	-2.2%	***-5.7%***	-2.6%
R 200 - R 2000 (small)	7.0%	-0.3%	-6.4%	8.4%		$ 0.05	$(0.05)	$(0.08)	***$ (1.31)***	$(0.22)		1.1%	-0.5%	-0.4%	***-4.2%***	-0.2%

"Past performance is not indicative of future results. Examples are hypothetical for illustrative purposes only. Price Earnings Ratio (P/E) is the price of the stock divided by its earnings per share. Inclusion of these indexes is for illustrative purposes only. Keep in mind that individuals cannot invest directly in any index, and index performance does not include transaction costs or other fees, which will affect the actual investment performance. Individual investor results will vary."

Over time, stocks can appreciate, stay relatively the same or lose value. Typically most sustained and substantial increases in market value accrue to the companies that generate the greatest growth in sales, earnings, cash flow and dividends. I believe that it is likely that under buy and hold, the aggregate value of the small and mid-caps stocks will rise faster than the aggregate value of the mega caps. In other words, those 200 or so companies that comprise 70% of today's market value might fall to a lower aggregate amount over the next 5, 10 or more years. Outliers are what matter most. Market history and math principles suggest that a significant number of today's mid and small caps will likely join the top tiers by market cap in the future. Therefore, the remaining 2800 or so stocks that account for roughly 30% of today's value may grow to a higher % of aggregate value. Recall the hypothetical example of the company with very healthy earnings growth and a sharp rise in its valuation. These profiles are more likely found as one moves down the capitalization scale since dominant companies in relatively mature markets have difficulty generating exceptional sales and earnings growth. Moreover, it seems likely that quite a few of today's behemoths will falter much like Bethlehem Steel, Woolworth's, Sears, Enron, WorldCom and Wang Laboratories of hundreds more darlings of prior eras.

The Operating Practice of Small & Mid-Cap Indexes is Fundamentally Flawed

The problem with the Russell 2000 is that it fails to capture the full potential benefit of the winners while it "capitalizes" on the other two categories. Specifically, stocks that perform well are removed so if they subsequently expand their market cap from $3 billion to $100 billion or more, none of this compounding is realized in the Russell 2000.

When they transition from the Russell 2000 to the Russell MidCap they go from having a relatively large weight in the former to a very modest weight in the latter (e.g. they are effectively sold). On the other hand, all stocks that are small caps today and remain small caps for the next 20 years affect performance but not in a beneficial way – they are the true Zombies of small cap stock indexes. The worst are the "fallen angels" who enter into the top of the index and exit out of its bottom.

Research by two finance professors serves to validate my long held beliefs about mid and small cap indexes. Specifically in research article published in the ***Financial Analysts Journal*** in summer 2008, Professors Jie Cai and Todd Houge, CFA calculated the returns for the Russell 2000 under buy and hold versus the annually reconstituted index. Their key finding was, "A buy-and-hold portfolio outperformed the annually rebalanced index in the 1979-2004 period by an average of 2.22 percent over one year and 17.29 percent over five years." These results are not surprising as one need only to consider the return characteristics of stocks held in the Russell 2000 due to rebalancing.

Fortunately there are some index solutions like the S&P expansion/completeness indexes which invest in most of the market capitalization outside the S&P 500 (e.g. the mid and small caps). This means that smaller caps that do well will remain in the index for longer periods than is the case in small cap indexes. There are also alternative index solutions that effectively broaden capital at the outset via a reduction of allocation into the largest components in favor of increased ownership of all other members.

Contrarian Investment Strategies can Complement Cap-weighted Indexation

A complementary approach to index based solutions which have natural momentum may lie in contrarian investing. True contrarians are akin to those who only shop at the bargain bins in the basements of outlet stores. Merchandise that is marked down appreciably gets there attention while things that are pretty and priced accordingly do not interest them (unless they are inclined to go short). They are well outside the herd and most of us feel uncomfortable with their investments, especially during the extend periods when their approach is not working well. Before vindication they will be deemed to be at a minimum early, but perhaps just plain wrong. After all, they are seen to be "loner oddballs". Today, some contrarians might be finding longer-term value in Russian banks and oil and gas companies.

I believe it is hard to be a true contrarian and as an adviser, I confess it is nearly impossible for clients to allocate significant portions of their capital into out of favor investments. The good news is I believe a practical and effective approach may lie in buy and hold with contrarian tendencies. For instance, we may layer in greater then cap-weighted allocation into market segments and economic sectors that have been performing rather poorly. This can make sense if the valuation for these segments appears to be inexpensive compared to cap-weighted indexes. This can include a healthy allocation into international markets, particularly when sentiment around those economies is negative. We will try to identify "slow ideas" where the risk/reward for the intermediate and long-term appears favorable.

As I did in my last letter on the challenges to active management, I have written an addendum that allows you to read about the observations I made and advice I gave many years ago. During the late 1990s I repeatedly espoused caution about the then darlings. During this time, you will also see that I advocated ownership of mid-caps with much more reasonable valuations. Finally you will see that I encouraged my clients to stay the course and/or commit capital into equities when pessimism was the sentiment of the times. The selloffs in in the early 2000s and 2007 through early 2009 were obviously disconcerting but valuations became quite attractive.

In my next letter, I plan to share information and observations about various economic sectors and international markets through the prism of performance compared to the U.S. (it can be dramatically different) and valuation. This may help us make some contrarian allocations over time. In any event, I am confident that we will be able to help you during periods of pessimism and euphoria – when our resolve is most often tested and the goal of realizing favorable outcomes is most at risk.

Warmest regards,

W. Richard Jones, CFA
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