Commentary: March 2017

LABELS CAN BE MISLEADING

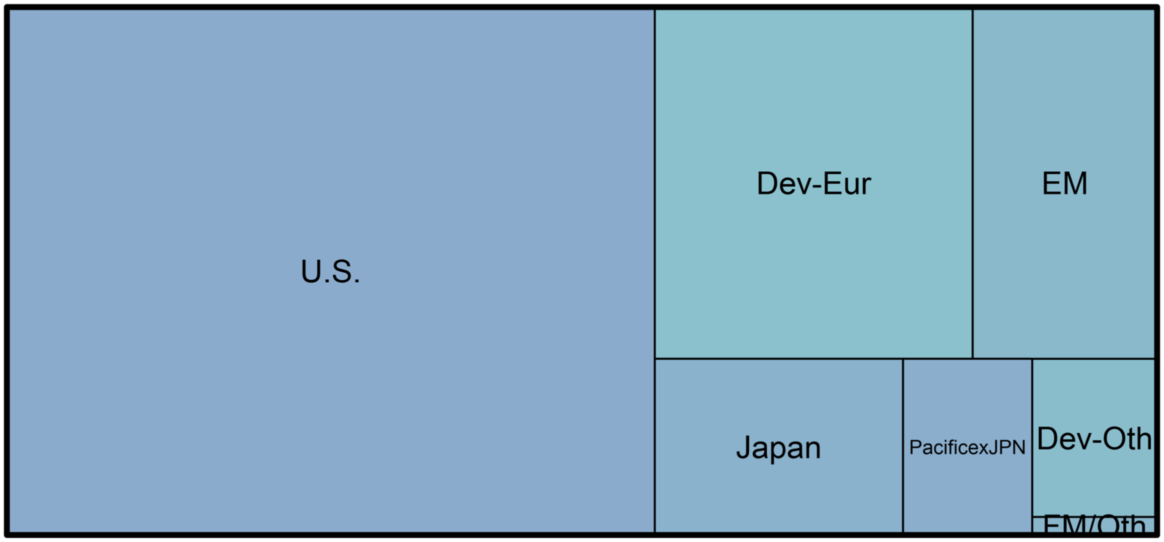
We're never surprised to see several "growth" exposures in prospective client portfolios we review. Naturally, Growth sounds so much more interesting than Value. But these names, which we'll define shortly, can be deceiving. In fact, the return series for Growth-oriented portfolios generally are not as attractive as those built to emphasize less-expensive stocks. What might seem a more fashionable label often ultimately isn't so functional when it comes to meeting long-term financial goals. Function is our sole focus when building investment solutions.

Ingredients Matter

Whether defining the appropriate strategy to implement, or assessing the potential fit of the vast range of unique investment exposures that are available to our portfolios, we base our decisions on the roles of each ingredient we consider and ultimately choose. Broadly, for each investment we include in a portfolio, we seek a particular "exposure" to capital markets, which offers a unique mix of potential risk and return in the context of all the other exposures in the portfolio. In turn, each group of exposures defines a particular portfolio that collectively fills a slice on a spectrum of relative risk. In all, we maintain eleven portfolios defined by their relative level of potential risk; the key determinant in that relative level is the weight of equity in the portfolio. At a very high level, this work defines the portfolio construction component of our Investment Strategy.

Focusing in on the equity side of our portfolios, we favor a specific set of characteristics among our exposures. The first characteristic is access to local equity markets. In our portfolio construction process, we attempt to include access to as many local equity markets around the world as we can. For most investments in our portfolios, local regions are grouped together into regions (e.g. Europe) and/or levels of development (e.g. emerging). Figure 1 offers a sense of the relative size of the broader markets we review on a regular basis.

Figure 1: Composition of Global Equity Market Capitalization



Estimate as of 03.12.17. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from MSCI via Bloomberg

We seek this broad range of exposures to enhance the diversity of the equity in the portfolio. For myriad reasons – relative macroeconomic development and demographics to political stability and investor interest – various equity markets do not always move by the same amount or even in the same direction all the time. This zig/zag tendency has the potential to decrease overall risk presented by the equity portion of the portfolio. By including as many exposures as we can, and barring undue cost or diversion of attention, we seek to enhance the overall potential return of the portfolio for any given amount of risk that we expect to absorb.

After region of origin, the characteristics get a bit more interesting. The two primary components in the mix of ingredients we emphasize are Size and Value. We'll start with some basic definitions. By Size we mean the value of the companies we include in the portfolio as represented by each company's market capitalization. Market capitalization is simply the total number of all a particular company's shares presently outstanding multiplied by the present price of one share. When we read a headline such as, "Apple is Once Again the World's Largest Company at $700 Billion," that dollar figure is the market capitalization. There are various ways to measure market capitalization, but that basic multiplication math is the root of any of those measures. We also can think of Size as the cost of a company were we to seek to buy it.

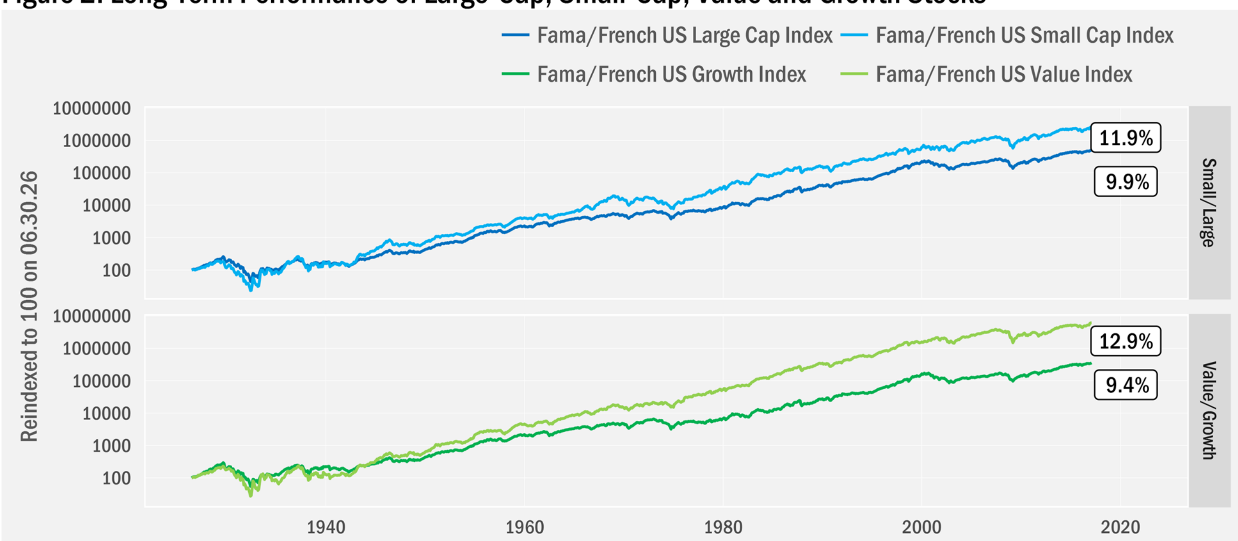
In turn, Value generally represents the ratio of some measure of company size and some measure of company assets or income. Assets might include all the buildings and equipment a company maintains. Income can be measured in all sorts of ways, from "topline" revenue or sales to "bottom line" profit or net income. All those measurements in some way capture how much money the company generates from its assets. Where Size represents the cost of a company, we can think of Value as the actual goods we are buying. In other words, it helps to think of the investment process not as buying a company, but rather buying the work that the company does. That distinction is helpful when we turn to why we look at both Size and Value.

It's All Relative

By measuring Size and Value for all companies, we establish a relative spectrum. Companies come in all range of sizes. And some companies offer more bang-for-the-buck, as it were, in terms of income for the dollars we'd have to spend to buy it. What's interesting about the Size and Value spectrums is that, in terms of longer-term relative performance, within each spectrum one side outdoes the other. For Size, smaller companies historically have outperformed larger ones, while over time less expensive companies (more Value) have outperformed more expensive ones.

Relative outperformance is substantiated in Figure 2[1]. From mid-1926 onward, U.S. Small companies have outperformed Large companies by 2 percent per year. And U.S. Value stocks have beaten Growth stocks by 3.5 percent per year on average[2]. This relative performance is a key element informing our preference when it comes to portfolio construction.

Figure 2: Long-Term Performance of Large-Cap, Small-Cap, Value and Growth Stocks



From 06.30.26 to 01.31.17. Logarithmic scale. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all of the invested capital. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Professors Eugene Fama and Kenneth French via Dimensional Fund Advisors

[1] The two groupings are mutually exclusive. Taken together, Small and Large companies comprise the entire market. Value and Growth companies together comprise that same market. We could also show combinations of the two (e.g. Small Value) and likely will do so in upcoming commentaries.

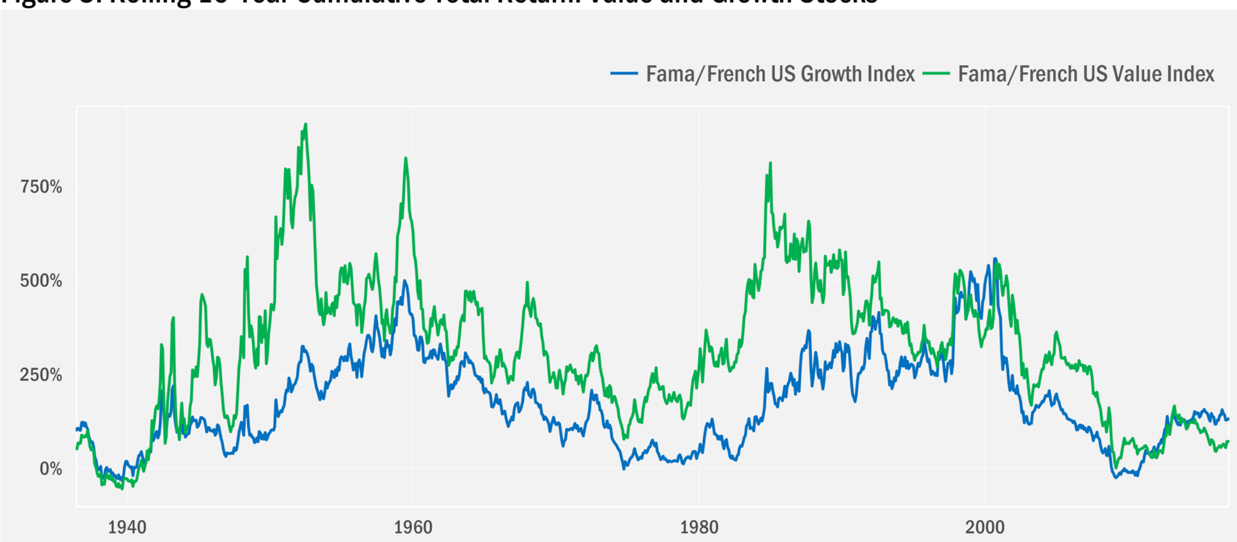
[2] It's important to note that those annual returns are a *geometric average* of the cumulative return overall those years. Put simply, a geometric average is the compounded return (meaning each periodic return acknowledges the effects of the return over each period prior) required to achieve the ending value, given the starting value. We nearly always refer to the geometric average when we talk about average annual returns. Perhaps even more importantly, the average is just that. Any given year's return might differ wildly in either direction from that average. So, while the average annual return best reflects where we have arrived over some period of time, it's a very poor indicator of how we got here. We'll offer more on this topic in a future commentary. Meanwhile, readers may reach out to their Advisors for a deeper discussion.

While we can reflect on the empirical *evidence* for investing in Small stocks and Value stocks, we just as much like to emphasize the *intuition* for the preference. For Small, we can think of the Law of Large Numbers applying. It makes sense that smaller, perhaps collectively more agile companies might grow more quickly than larger, perhaps stodgier, more bureaucratic companies. On the other hand, it's easier for smaller companies to fail, but a beneficial characteristic of the smaller group is that there are far more of them. The noise of even many failures can be drowned out by the successes of a few.

Patience, Perhaps, Required

Regarding Value, why pay more for less? Of course, like all things money-related, the world of investing does not allow such simple refrains always to ring true. Importantly, neither Small-beats-Large, nor Value-beats-Growth is a rule for all seasons. Over various periods (even a decade or more), Small has at times historically failed to surpass Large in terms of total return. Same for Value, versus Growth. Indeed, as we show in Figure 3, Value has underperformed Growth for some time now[3]. Meantime, Small stocks have struggled to maintain pace with Large stocks over the past decade or so.

Figure 3: Rolling 10-Year Cumulative Total Return: Value and Growth Stocks



From 06.30.26 to 01.31.17. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all of the invested capital. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Professors Eugene Fama and Kenneth French via Dimensional Fund Advisors

Still, interim underperformance does not discourage us from our chosen course of action as we do not focus exclusively on either Small or Value. Rather, we tilt our portfolios to emphasize both. And we do so to varying degrees, depending on the nature of risk we are seeking for the portfolio. Risk in this case can be seen as underperforming a portfolio that did not include such tilts to Small and Value. For those investors with a greater tolerance for risk, which might also include a longer-term investment horizon, we allow more time for the propensity of Size and Value characteristics to impart beneficial relative performance to the portfolio.

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[3] Readers may recall that we discussed rolling-period returns in our February 2017 Commentary.

Conversely, the nearer one's investment horizon (e.g. the closer one is to retirement), the more we might like to see our portfolios defined by the nearer-term movements of the broader investment markets. So we reduce – but do not entirely remove – our tilts to Small and Value in portfolios targeting successively lower levels of overall risk.

Not New, But Still Fresh

To focus on Small and Value is not a fresh tack. Investors have been heralding the approach for nearly a century, with Warren Buffett perhaps the most prominent proponent of the basic methods. Surprisingly, though, many still ignore the basic merits of the approach. For the rationale expressed above, and for a range of reasons our Advisors are happy to discuss, we believe our emphases on Small and Value are substantiated by their success in the test of time. We further believe that the intuitive sensibility of the predispositions suggests we'll continue to benefit from our focus going forward.

Important Information

Investing involves risks. Past performance is not indicative of future results.

One cannot invest directly in an index. Index performance does not reflect the expenses associated with the management of an actual portfolio.

The Fama/French US Large Cap Index is provided by Professors Eugene Fama and Kenneth French (Fama/French) from the Center for Research in Security Prices (CRSP) securities data. The index is composed of the upper-half of market capitalization of NYSE securities (plus AMEX equivalents since July 1962 and NASDAQ equivalents since 1973). The Fama/French US Small Cap Index is provided by Fama/French from CRSP securities data. The index is composed of the lower-half of market capitalization of NYSE securities (plus AMEX equivalents since July 1962 and NASDAQ equivalents since 1973).

The Fama/French US Value Index is provided by Fama/French from CRSP securities data. The index includes the lower 30 percent in price-to-book value of NYSE securities (plus NYSE Amex equivalents since July 1962 and Nasdaq equivalents since 1973). The Fama/French US Growth Index is provided by Fama/French from CRSP securities data. The index includes the higher 30 percent in price-to-book value of NYSE securities (plus NYSE Amex equivalents since July 1962 and Nasdaq equivalents since 1973).

Price-to-book value is an equity valuation metric defined as the ratio of market capitalization to the balance sheet net value of assets.

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