Educational Video

We hope you enjoyed our first educational video published and sent out in April. We are planning to do another video in May on reverse mortgages. Joe DeMuro has been in contact with an expert on this topic, and will work with him in the coming weeks on getting together material he feels will be both interesting and informative to our client base. There are many strategies available to you, some of which we were unaware of, where you can use the equity in your home to your advantage.

Long-Term Growth Portfolio Changes

On April 19th Invariant purchased a 4% position in a small cap hedge, Direxion Daily Small Cap Bear (TZA). This Fund is designed to move in the opposite direction of the Russell 2000 times three. So, a 4% position impacts the portfolio allocation like a 12% typically would. It should be noted that we also own a 5% in iShares Russell 2000 Value Index (IWN). Instead of selling the IWN position and paying capital gains tax on the money, we chose to purchase a hedge for protection.

The purchase of this hedge brings the Long-Term Growth portfolio’s market correlation down to about 16%. While portfolios still have a slightly positive correlation to the market from a statistical perspective, we currently have assets positioned in a ‘market neutral’ allocation by most practical standards. There is not a lot of market risk in the model at this time.

Market Update

The broad U.S. stock market index (Dow Jones Industrial Average) experienced a slight gain of .5% for the month of April. The Dow was down 1.8% from April 20th through the end of the month. Invariant’s Long-Term Growth model was able to grind out similar gains during the month, while not losing any ground from April 20th through the end of the month. These gains include the fee deduction for the second quarter, and Apple (AAPL) reporting disappointing earnings and the stock declining by nearing 15% during the back half of the month. Given the headwinds portfolios faced throughout April, and the low risk profile, we are relatively pleased with gains which mirror the broad U.S. equity market.

As we have stated in prior commentaries and in our face-to-face meetings with clients, it is our goal to be nimble and use the market volatility to our advantage for as long as this environment persists. And it is our belief that these conditions will linger for a bit longer. Right now, the major question looming over the markets is, ‘Was the drawdown in late April simply a consolidation of the gains experienced since February 11th, or the start of another, more significant move lower, like that experienced at the start of 2016?’ While it is very tough to tell, we believe that the risk of another selloff is high enough that we should provide protection and position portfolios accordingly.

One financial market we are watching very close to assist in determining how much risk portfolios should be exposed to is the Japanese Nikkei 225 Index. Over the past few months, the Japanese market has been leading the U.S. market in both directions. During the back half of April the Nikkei was down around 8%. This is another reason for our conservative posture at this
moment. The stability of the Japanese market would go a long way to making us feel more comfortable increasing portfolio risk.

**1999 Redux**

When investment commentaries such as this reference 1999, it is typically followed by ‘doomsday’ predictions. What better way to sell your investment thesis and strategy then to scare people. This is not case here. The late 1990’s was a unique time, with the technology boom creating a mania in stocks. Today it is hard to argue that the same mania exists, in our opinion. When the stock market flat lines for two years, it is hardly a mania. Valuations remain high in parts of the market today, but dwarfs in comparison to 1999.

With that said, there are parallel conditions which we feel could serve as the drivers of future outperformance for our clients. These conditions are:

- Falling inflation expectations
- Declines in emerging market currencies
- Extreme relative valuations for emerging markets versus U.S. stocks and bonds
- The underperformance of value stocks relative to growth stocks in the U.S.

The last time all four of these conditions existed simultaneously was December of 1998. And much like the late 1990’s these asset classes are hated today, after years of underperformance.

**Falling inflation expectations**

Economic factors, largely driven by the crash in oil prices, has caused a substantial decline in inflation expectations. Over the past three years, 10-year inflation expectations have plunged by over 50% from 2.6% in February of 2013 to 1.2% in early February 2016. Since the end of March 2016, over a matter of weeks, inflation expectations have rebounded to 1.6%; still low by historical standards, but quite the move on a percentage basis in one month. In December of 1998, inflation expectations hit an even more extreme low of .9%. Within six months they had jumped to 2%. Our Long-Term Growth model has a 7% position in iShare Barclays TIPS Bond Fund (TIP), which is designed to track inflation expectations.

**Emerging market currencies**

Over the last four years EM currency valuations have fallen from a 20% premium to a 21% discount as of March 2016. When we examine Emerging Market currencies on a *purchasing power parity (PPP)* basis, we find that they have only been cheaper once, in 1998, when these markets were hit by the Asian currency crisis and the Russian default. Cheap currencies translate into an improvement in export competitiveness which in turn leads to positive earnings shocks in EM equities. This has the potential to reward those investors who hold meaningful allocations to both stocks and bonds in these regions (‘Emerging Markets’ are considered to be Brazil, Russia, India, and China).

Furthermore, the recent U.S. bull market rally has pushed U.S. valuations into the top decile historically, while a five year bear market for Emerging Market stocks leaves them at valuations well into the bottom decile for the last quarter-century. Today, the discount of EM-to-S&P500 Index is 60%. The all-time low was 70%, in August of 1998. Invariant currently holds a 5% position in Templeton Global Bond Fund (TGBAX) and a 7% position in Driehaus Emerging Markets Growth Fund (DREGX).

Lastly, global stocks which are categorized as ‘value’ have underperformed ‘growth’ stocks by nearly 11% over...
the last three years (ending in March 31, 2016). As the chart shows, value stocks are the cheapest now relative to growth stocks than at any time, other than the tech bubble and the global financial crisis. Invariant’s equity allocation in the U.S. is largely focused on value over growth. Berkshire Hathaway (BRK.B) is thought to be one of the best value investing companies in the world. Our exposure to the Small Cap Index, through iShares Russell 2000 Value Index (IWN) is focused on value over growth in the Small Cap sector. Apple (AAPL) and Goldman Sachs (GS) are trading at a value relative to many of their peers. And our largest equity holding, Oakmark Fund (OAKMX) is a Large Cap Value Fund as well.

**Summary**

In the 5 and 10 years following December 1998, assets other than U.S. and developed-market equities and U.S. notes and bonds outperformed the traditional 60/40 (stock/bond in U.S. and developed markets) portfolio by 8.8% and 6.2%, respectively. Additionally, U.S. and developed market value stocks outperformed their growth counterparts by nearly 6% a year in the 5 years following December 1998. It is our belief that the potential for these hated sections to repeat their outperformance in a fashion similar to the post-tech bubble era, is very real. The magnitude may not be as great, due to the divergences in the aforementioned sectors being less extreme, but we believe that allocations to these sectors will vastly improve future returns, and assist our clients reaching their financial goals.

Thank you for your trust and confidence

Seth W. Arbogast, CFP®