Spring 2017

360 Insights

Quarterly Investing and Financial Perspectives

Investing *for* the Future, Not *in* the Future

by **J. William G. Chettle**, VP, Loring Ward

What's Inside

Premiums Can Appear, Disappear and Reappear Quickly

The Lesson of $1

In the 1967 movie, *The Graduate*, the young college graduate is advised that the future is about one word: "plastics." The advice was a deliberately absurd laugh line, but in today's era of unprecedented technical and societal change, we hear similar advice delivered with perfect seriousness. Self-driving cars will change the world! We are on the cusp of revolutions in biotech, renewable energy, robotics, genetics, etc. Heck, we might even get flying cars and jet packs one day soon.

These great changes could very well revolutionize society, but things rarely work out quite as predicted — and even when they happen exactly as planned, trying to invest in the future is still a very risky thing to do.

Some investors believe they will make a fortune if they can only identify the companies that will create the revolutionary products and services of tomorrow. Others believe that established industry leaders such as Apple, Facebook or Amazon will continue to grow, innovate and dominate their competitors and thereby reward investors with strong returns.

If only investing were so easy.

To demonstrate some of the perils of investing in the future, let's consider a groundbreaking and prescient *Time Magazine* article published in 1965, "The Computer in Society," which detailed the ways computers were changing the world.

Time noted that IBM was then the leading global computer company, with 74% of the

U.S. computer market, "a dominance that leads some to refer to the industry as 'IBM and the Seven Dwarfs.' The dwarfs, small only by comparison with giant IBM: Sperry Rand, RCA, Control Data, General Electric, NCR, Burroughs, Honeywell."

But *Time's* reporting was already behind the times, neglecting to mention a computer firm that would transform computing and become one of the 20 largest companies in America. Founded in a garage in Menlo Park, CA, in 1947, Hewlett Packard (HP) would enter the computer market in 1966 with the HP 2116A minicomputer — one of the first portable and "plug and play" computers.

As a thought experiment, let's say that you were convinced by the *Time* article that computers would change the world and called your stockbroker and invested $100 in IBM as well as in each of the Seven Dwarfs at the beginning of 1966. You've also heard something about HP, so you invest $100 in their stock, as well as $100 in the S&P 500 for a little more diversification. If you'd stayed invested for the next

See "Investing *for* the Future, Not *in* the Future" *continued on page 4*

Premiums Can Appear, Disappear, and Reappear Quickly

by **Payel Farasat,** Chief Investment Officer, Loring Ward

Weather — a topic everyone likes to talk about and few seem to be able to predict accurately. You know how it goes...the forecast calls for sunshine so you don't bring an umbrella, but then get stuck in a downpour. Even with all the high-tech devices for predicting the weather, sometimes Mother Nature surprises us.

Similarly, as investors, we often think we can figure out what is going to happen in the market, only to be completely surprised by something we never saw coming. Predicting which sectors of the market will do well at any given time is a perfect example. In the long term, as with the weather, certain larger patterns are more predictable. It is highly unlikely, for example, to see a snowstorm in August.

Science and research have identified certain risks that may be worth taking when it comes to investing. First, that stocks are riskier than bonds (but also provide greater potential returns). Second, that small and value stocks are riskier than large and growth stocks (but also have greater potential for returns).

When we talk about these categories of stocks and compare their returns, we refer to them as premiums. For example, the U.S. Small Cap premium is the difference between the total return of an index of U.S. small capitalization stocks and the total return of an index of U.S. large capitalization stocks.

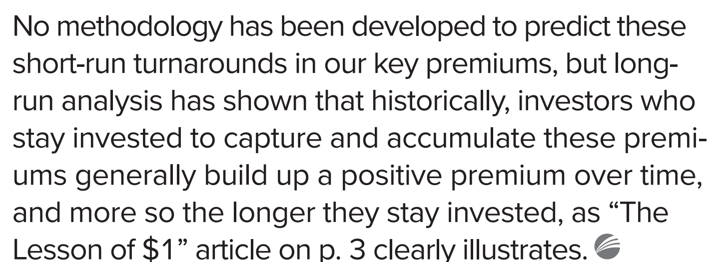
Individual premiums are unpredictable in terms of when they arrive, disappear and reappear, so to capture them you must constantly be in position to receive them. In other words, you need to be in the market. Premiums can not only reappear suddenly, but when they do, they can do so with gusto.

Consider the U.S. Value premium: If you were looking at the 12 months of market returns prior to August 2000 and hoping to see a decent Value premium, you would have been disappointed. It had been the "go-go" period of the Tech Boom where the one-year return of the Russell 1000 Value Index was 4.2% as of August 2000 as compared to a solid 33.5% for the Russell 1000 Growth Index. Growth had recently beaten Value over a one-year period by more than 29%, when just six months later, 12-month returns for Value stocks were 16.6% compared to -31.1% for Growth stocks. The Value premium, running at nearly 48%, was back in business.

Similarly, consider the U.S. Small Cap premium: In February of 1991, the Russell 2000 Small Cap Index was lagging behind the Russell 1000 Large Cap Index on a 12-month basis by more than 10%. Later that same year, in October, the Small Cap premium had fully turned around on a 12-month basis and was running at more than 22% over Large Cap.

We think it is reasonable to believe that we have seen a similar reversal in recent months in both the U.S. Value premium and the U.S. Small Cap premium. The U.S. Value premium was running negative on a 12-month basis for two years up until about July 2016, and has been running at a positive value, on a 12- month basis, in each of the seven months since (as of March 1, 2017).

Likewise, the Small Cap premium had been running negative for a couple of years until around August of 2016, but has started to show signs of positive performance since.



No methodology has been developed to predict these short-run turnarounds in our key premiums, but long-run analysis has shown that historically, investors who stay invested to capture and accumulate these premiums generally build up a positive premium over time, and more so the longer they stay invested, as "The Lesson of $1" article on p. 3 clearly illustrates.

The risks associated with investing in stocks and overweighting small company and value stocks potentially include increased volatility (up and down movement in the value of your assets) and loss of principal. Small company stocks may be subject to a higher degree of market risk than the securities of more established companies because they may be more volatile and less liquid.

The Lesson of $1

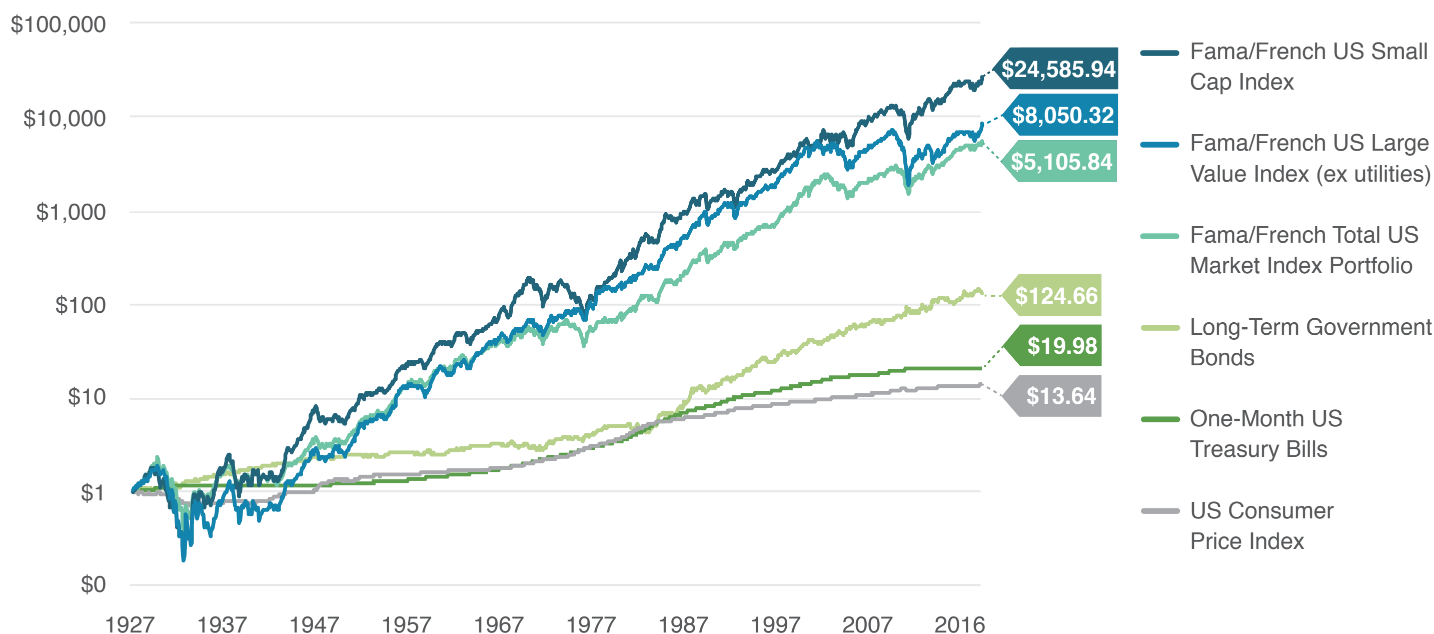
One of the best opportunities to grow your money over the long term may come from making an investment in the stock market.

This chart illustrates the long-term growth of U.S. businesses over the past 90 years. If your grand-parents had invested $1 in the U.S. Stock market, as measured by the Fama/French Total US Market Index, in 1927 and just left it alone, by the end of 2016 that $1 would have grown to $5,106. Invested in U.S. Small Cap Stocks, as measured by the Fama/French US Small Cap Index, that $1 would have grown to $24,586 and $8,050 if invested in U.S. Value Stocks, as measured by the Fama/French US Large Value Index. That same $1 invested in One-Month T-Bills would be worth $20 and if invested in Long- Term Government Bonds it would be worth $125.

Those who invested $1 back in 1927 would have had plenty of reasons to want to pull out of the market along the way — The Great Depression, World War II, Korea, Viet Nam, stagflation, the Great Recession — but by staying invested they could take advantage of every market recovery.

While we can never be certain about market direction in the short term, over the long term we believe patient investors will be rewarded for staying invested.

Growth of $1: Jan. 1927 – Dec. 2016



Hypothetical value of $1 invested at the beginning of 1927 and kept invested through December 31, 2016. Assumes reinvestment of income and no transaction costs or taxes. This is for illustrative purposes only and not indicative of any investment. Total returns in U.S. dollars. Past performance is no guarantee of future results.

U.S. Stock Market represented by the Fama/French Total US Market Index Portfolio, which is an an unmanaged index of stocks representing stocks of U.S. companies. U.S. Small Cap Stocks represented by the Fama/French US Small Cap Index, which is an unmanaged index of stocks of small U.S. companies. U.S. Value Stocks represented by Fama/French US Large Value Index (ex utilities), which is an unmanaged index of stocks of large U.S. companies with low relative price, excluding utilities companies. The Consumer Price Indexes (CPI) program produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services. Long-Term Government Bonds, One-Month U.S. Treasury Bills, and U.S. Consumer Price Index (inflation), source: Morningstar's 2016 Stocks, Bonds, Bills, And Inflation Yearbook (2016). Indexes are unmanaged baskets of securities that investors cannot directly invest in. Index performance does not reflect the fees or expenses associated with the management of an actual portfolio.

The risks associated with investing in stocks and overweighting small company and value stocks potentially include increased volatility (up and down movement in the value of your assets) and loss of principal. Bonds are subject to market and interest rate risk. Bond values will decline as interest rates rise, issuer's creditworthiness declines, and are subject to availability and changes in price. T Bills and government bonds are backed by the U. S. government and guaranteed as to the timely payment of principal and interest. T Bills and government bonds are subject to interest rate and inflation risk and their values will decline as interest rates rise. The Consumer Price Indexes (CPI) program produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

Investing *for* the Future, Not *in* the Future… continued from page 1

50+ years through 2016, here's how your investment in the future would have done…

Growth of $100 Investment (1966 – 2016)

HP (HPQ)	$18,889.06	NCR	$471.45
Honeywell	$13,328.09	RCA (Voxx)	$250.67
S&P 500	$11,383.61	Sperry Rand (Unisys)	$5.61
General Electric	$6,279.03	Burroughs	Purchased by Unisys
IBM	$1,273.82	Control Data	Out of Business

Source: S&P 500: DFA Returns 2.0, IBM and GE: Morningstar Direct; HPQ, Unisys, Voxx, NCR and Honeywell: Yahoo Finance

Looks like investing in the future was a pretty good idea, until you consider the top-performing stock of that same period — a company that makes a heavily regulated, low-tech product. If you had invested $100 in Phillip Morris/Altria, it would have grown to $549,087 by 2016. Who would have thought in 1966 (and certainly in 2017) that tobacco, not computers, would win the future (at least in terms of returns).

Some of the other top-performing stocks over this period were also surprisingly non-innovative and low tech. For example, Coca Cola returned $34,403 and its cola rival Pepsico returned $21,084, better than any of the tech companies that would change the future.

Or in the shorter-term, let's look at the summer of 2004 when two firms went public, Google and Domino's Pizza. Many rational investors given the choice would probably assume that Google was the better investment. And they certainly did well over this period, returning 1,555% through January 14, 2017. But Domino's delivered a cumulative 2,401% return.

What are some of the risks in investing in innovation?

Many times, innovative companies fall victim to second mover advantage as other firms build on and enhance the original technology. Think of how social media platforms like My Space were superseded by Facebook or smartphone makers like Blackberry were outmoded by Apple's iPhone. It is hard to know whether a company will be a failed leader or a successful follower.

Also, the initial results of innovation can be hard to maintain. Think of once great firms such as Wang Computers or Nokia or Kodak (the inventor of the digital camera) that could not keep up and fell by the wayside. By market capitalization, Apple is the largest company in the world. Millions of people use and love their products. But will they still be a tech leader 10 years from now? 20?

In comparison to growth stocks, which are very often innovative, forward-looking companies with strong earnings growth (or potential growth), value stocks are usually associated with generally less-innovative corporations that have experienced slower earnings growth or sales, or have recently experienced business difficulties, causing their stock prices to fall. Academic research has shown, however, that value company stocks have greater expected return potential — and greater risk — than growth company stocks. Since 1927, U.S. Large Value stocks, as measured by the Fama/French US Large Value Index, have returned 10.51% vs 9.43% for U.S. Large Growth stocks, as measured by the Fama/French US Large Growth Index. This makes sense, since riskier companies must offer a higher potential return to attract investors.

The future may be uncertain, and the companies of tomorrow may not always be the best investments now. But the future, taken as a whole, may be the best investment many of us make.

If we are prepared to take a patient, long-term perspective and buy and hold securities from thousands of great companies around the world, we may benefit from two powerful forces:

1. Compounding, which allows your money to grow exponentially over time. If your portfolio grows an average of 6%, for example, it will double every 12 years. In 48 years, $100,000 growing at this rate becomes $1.6 million.
2. The dynamic potential of stock markets, fueled by human innovation, to create wealth over time.

We don't know which firms will soar and which will fail, which will invent amazing new products and which will make money by doing what they have always done. But if we own many of them and invest for the future, chances are we will be rewarded over the long term.

All investing involves risk. Principal loss is possible. Past performance does not guarantee future results.

Diversification neither assures a profit nor guarantees against loss in a declining market.
©2017 LWI Financial Inc. All rights reserved. Investment advisory services provided by LWI Financial Inc. ("Loring Ward"). Securities transactions offered through its affiliate, Loring Ward Securities Inc., member FINRA/SIPC. R 17-076 (3/19)