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Market Outlook:

Everyone is Underweighted in Value

Market history shows that applying a low P/E value discipline to stock selection has rewarded investors with such powerful long-term results it seems inconceivable that they can be underweighted in the strategy. The reason is that in a melt-up market, like the one we just experienced, growth stocks and index funds increasingly get bid up over value stocks as the market becomes less and less concerned about risk and valuation. **However, once a melt-up market ends, a period follows where value dramatically outperforms for a long time.** Below you can see how year after year value outperformed the passive S&P 500 index following two other similar extreme melt-up periods.

After the 1996 – 2000 Melt-up

Year	S&P 500 (Passive)	Bottom 20% of Stocks by P/E	Difference
2000	-9.1%	+24.2%	**+33.3%**
2001	-11.9%	+16.2%	**+28.1%**
2002	-22.1%	-8.9%	**+13.2%**
2003	+28.7%	+38.6%	**+9.9%**
2004	+10.9%	+22.3%	**+11.4%**
2005	+4.9%	+15.9%	**+11.0%**
2006	+15.8%	+18.1%	**+2.3%**

After the 1969 – 1974 Melt-up

Year	S&P 500 (Passive)	Bottom 20% of Stocks by P/E	Difference
1974	-26.5%	-10.9%	**+15.6%**
1975	+37.2%	+59.3%	**+22.1%**
1976	+23.6%	+48.0%	**+24.4%**
1977	-7.3%	+8.5%	**+15.8%**
1978	+6.6%	+14.1%	**+7.5%**
1979	+18.5%	+30.8%	**+12.3%**
1980	+32.3%	+32.8%	**+0.5%**
1981	-4.8%	+17.5%	**+22.3%**
1982	+21.6%	+27.9%	**+6.3%**
1983	+22.4%	+28.1%	**+5.7%**
1984	+6.1%	+17.1%	**+11.0%**
1985	+31.7%	+34.2%	**+2.5%**
1986	+18.6%	+32.1%	**+13.5%**

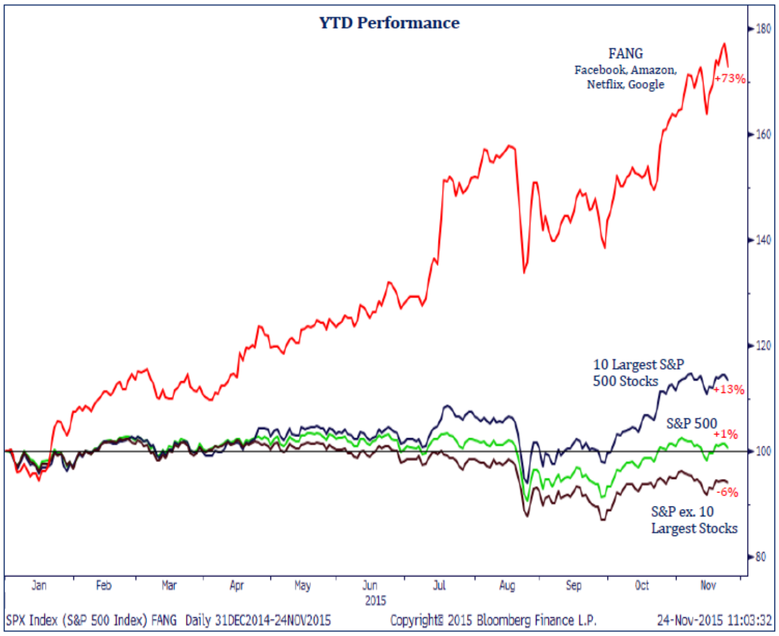
Source: Capital IQ; SCCM Research 2014

The Dynamics That Drive a Melt-Up Market

During a market melt-up, the performance of the leading index, the S&P 500, becomes inflated by inflows into the largest, most popular, high-multiple stocks. The speculative phenomenon feeds on itself as the value of the index climbs ever higher while risk is increasingly ignored.

In this present period, a few examples of extreme speculation are popular stocks such as Tesla, Netflix, and Amazon – all of which are all selling over 100x earnings. Additionally, Facebook, Amazon, Netflix, and Google, which were collectively given the nickname FANG last year by market watchers, surprisingly, were up 73% in a mostly flat market.

In the chart below, you can see the huge impact the FANG stocks had on the index. In fact, if you took the ten largest stocks out of the index, the S&P 500 would have been down 6% instead of up 1% for the year.



Source: Strategas 2015

How the Melt-up Distorts Performance

The S&P 500 index is supposed to represent the average stock – but in melt-up markets, a few very popular stocks wind up distorting the index and its performance. **A better representation of the average stock would seem to be the 490 (98%) out of the 500 in the S&P 500 that were down 6% for the year.**

To show how extreme the distortion was, our high dividend fund was +0.35% for the year, ranking in the top 7% of the Morningstar universe. Even so, the fund underperformed the S&P 500, which was up +1.35%. Meanwhile, the average value manager was -4.04%, dramatically trailing the index. **But using the more representative -6% the average value mutual fund actually would have outperformed the index by a whopping 200 basis points. And so despite all of the hoopla to the contrary, most of the value funds would have outperformed the index.**

Mutual Fund Flows

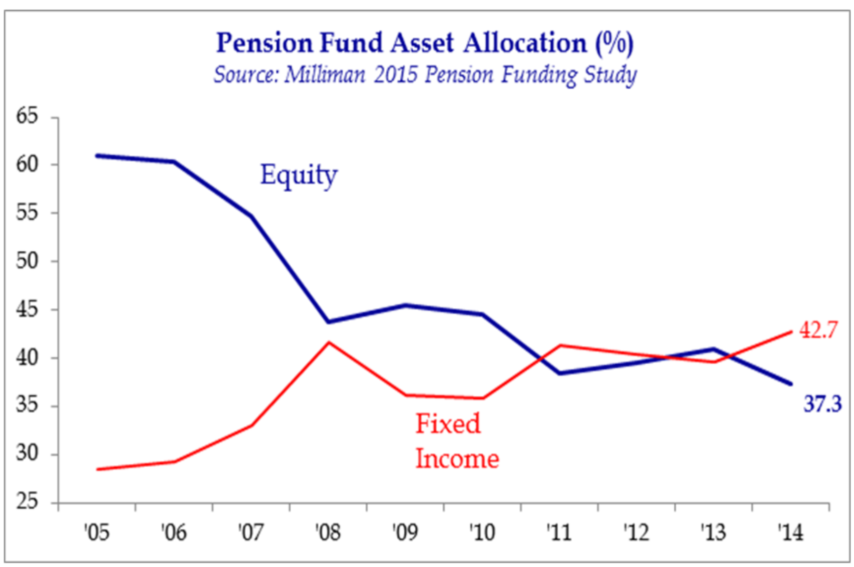
Largely because of the distorted performance of the S&P 500, mutual fund flows from active management to passive have reached extraordinary levels. For example, last year, a record $163 billion moved out of actively managed equity mutual funds, whereas a record $107 billion flowed into index funds. At year-end 2015, $2.5 trillion were invested in passive funds, a staggering amount, that approached the $3.7 trillion in actively managed mutual funds.

This unprecedented stampede has been fueled by the financial media and aggressive marketing by firms like Vanguard that specialize in selling index funds. As the market climbed ever higher, every day it seemed that the media and spokesmen for Vanguard were touting the invincibility of a passive strategy.

Investors and the press seem to forget that Vanguard was the leader in marketing index funds into the 2000 market top. **What no one mentions is how the index funds dramatically underperformed active management every year for the next seven years (2000 – 2007).**

Institutional Money Flows

Institutions should be especially sensitive to long-term investing; however, they, as well as individuals have been bailing out of value and equities in general. The institutions never got over the combination of the Tech Bubble collapse (2000) and devastating financial crisis (2008). **The graph below shows how pension fund allocations to equities have gradually dropped from 62% to 37%. Much of that money has gone into bonds, which have moved up from a 27% allocation to 43%, despite the low yields offered by fixed-income instruments.**



Source: Strategas, Updated Through 2014

The asset allocation for endowments also shows a gradual shift out of equities. In 2002 equities represented 50% of endowments and alternatives represented 24%. Today, it is just the opposite; alternatives are now over 50% of the allocation and equities are down to 36%. **Last year, we did a study on the five most popular alternatives, and the general performance for these vehicles was terrible on a 1-, 3- and 5-year basis.**

Invest with a Discipline and Invest for the Long-Term

Below, we once again present a study that demonstrates how powerful performance can be if investors are disciplined and invest for the long-term. The span from 1968 to 2012 shows how consecutive five-year periods produced consistently strong results, even while almost every single five-year period included a serious bear market or recession, or both.

As you can see in the table, on an annualized basis, value was +15.1% versus +9.5% for the S&P 500. While a major argument for passive investing has been a low fee, selling underperformance based on a lower fee seems misguided.

Long-Term Investing

5-Year Performance: 1968 – 2012
Annualized Returns

	Bottom 20% Stocks by P/E	S&P 500 (Passive)	Recessions	Bear Markets
1968 – 1972	9.7%	7.5%	1969 – 1970	2/1968 – 05/1970: - 36%
1973 – 1977	14.2%	-0.3%	1974 – 1975	1/1973 – 2/1974: - 46%
1978 – 1982	24.4%	14.1%	1979 1981 – 1982	4/1981 – 8/1982: - 24%
1983 – 1987	20.1%	16.4%		8/1987 – 10/1987: - 33%
1988 – 1992	18.1%	15.1%	1990 - 1991	7/1990 – 10/1990: - 20%
1993 – 1997	22.5%	20.3%		
1998 – 2002	7.0%	-0.6%	2000 - 2001	7/1998 – 8/1998: - 19% 1/2000 – 9/2001: - 34% 3/2002 – 10/2002: - 34%
2003 – 2007	18.2%	12.8%		10/2007 – 3/2009: - 56%
2008 - 2012	5.6%	1.7%	2008 - 2010	4/2011 – 10/2011: - 19%
Annualized Average:	**15.1%**	**9.5%**		
1968 – 2012 ($1 million)	**$570 million**	**$59 million**		

Source: Ned Davis; SCCM Research 2016

Summary

As we said at the start of this letter, because investing with a discipline (low P/E) has provided such powerful long-term results, it is almost inconceivable that investors can be underweighted in the strategy. **With the end of the melt-up market, we find it equally puzzling that passive investing in index funds has become so popular at a time when history suggests they will again underperform.**

Jim Cullen