



Artemis
FINANCIAL ADVISORS LLC

Market Outlook & Strategy

Second Quarter of 2016

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Executive Summary

- The U.S. market was the outperformer in the quarter, with the overall equity market increasing 2.2%, helped by rising energy prices. Emerging markets gained 0.7%, but international developed markets fell by -1.5%, in large part due to the Brexit vote. The U.S. market showed particular resiliency given that the Bureau of Labor Statistics reported the economy added just 38,000 jobs in May.
- The big story for the quarter was in the bond markets. Returns in most all segments of the bond market were strongly positive, with higher-yielding bond segments performing particularly well. Weak employment growth in the U.S. and the Brexit vote drove down Treasury yields, giving a further boost to an already overvalued asset class. U.S. Treasury yields are also being affected by the expansion of negative interest rates abroad.
- Real estate and commodities were also winners. The Bloomberg Commodity Index Total Return gained almost 13% on the back of rising energy prices, and US REITS (real estate investment trusts) posted a solid +5.4% return.
- In this quarterly update, we take a closer look at the history of value investing, a key tenet in Artemis's approach to investing. It is no secret that value investing has underperformed growth investing sharply over the last five years, and some investment analysts are now saying that such underperformance proves that in today's world value investing no longer works.
- We still believe in value investing. Yes, at times it has underperformed growth investing, but it has always sharply rebounded. There is scant evidence that today's world is different and, indeed, so far in 2016, we are seeing a strong resurgence in value.
- Artemis portfolios are performing particularly well in 2016, in part because value is outperforming, but also because several of our other structural overweights are also doing well.
- The only move we made in Q2 was to reduce our allocation to Europe in favor of real estate in early June. So far this shift has been a money-maker thanks to the surprising Brexit vote at the end of June.

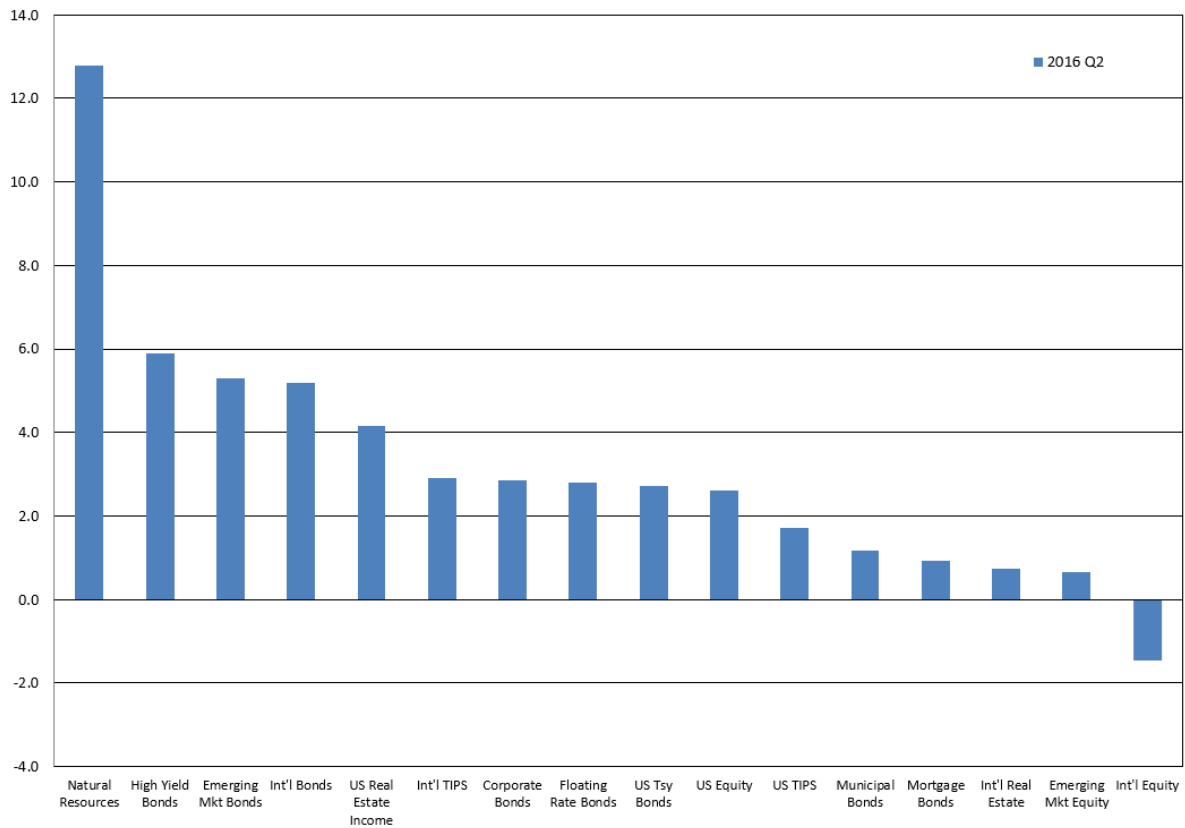


Quarter in Review

The 2nd quarter kicked off in the midst of a nice rally as fears over China, oil, economic data and Eurozone banks began to fade midway through the first quarter and the Federal Reserve indicated a slower pace of rate hikes. Global stocks continued to climb modestly during the quarter until the surprising Brexit vote on June 23, which caused the market to drop sharply. Yet a quick and strong bounce-back rally erased most of the losses, and by the end of the quarter, most equity markets eked out modest gains.

Once again, the U.S. market was the outperformer in the quarter, with the overall market increasing 2.2%, helped by rising energy prices. (See Figure 1.) Emerging markets gained 0.7%, but international developed markets fell by -1.5%, in large part due to the Brexit vote. The U.S. market showed particular resiliency, given that the Bureau of Labor Statistics reported the economy added just 38,000 jobs in May.

Figure 1: Asset Class Performance in Q2 2016 (percentage points)





The big story for the quarter was in the bond markets. Returns in most all segments of the bond market were strongly positive, with higher-yielding bond segments performing particularly well. Weak employment growth in the U.S, and the Brexit vote drove Treasury yields down, which gave a further boost to an already overvalued asset class. U.S. Treasury yields are also being affected by the expansion of negative interest rates abroad. While we might not think earning 1.5% on a 10-year Treasury bond is a good deal, the rest of the world is more than happy to take this rate.

Real estate and commodities were also winners. The Bloomberg Commodity Index Total Return gained almost 13% on the back of rising energy prices, and U.S. REITS (real estate investment trusts) posted a solid +5.4% return.

Value Investing – Is it Worth Hanging On?

If you invest with Artemis, you are, de facto, a value investor. Value investing means favoring stocks that are cheap relative to fundamental measures such as book value or earnings. It is well known that investors favoring value stocks have been able to outperform the market over long periods of time. Indeed, from the beginning of 1927 through January 2016, value stocks have outperformed growth stocks by almost 4% on an annualized basis.

This doesn't mean that value stocks always outperform growth stocks. Indeed, value stocks have trailed the broad market for the last five years (see Figure 2). Over the past decade, the growth stock index has almost doubled, while value stocks were up a measly 39%. Last year was particularly tough, with the Russell 1000 Growth index increasing by 5.7%, a full 9 percentage points ahead of the Russell 1000 Value index, marking the widest performance gap since 2008. Lagging value points to one of the reasons Artemis portfolios had a tough year relative to their benchmarks in 2015.

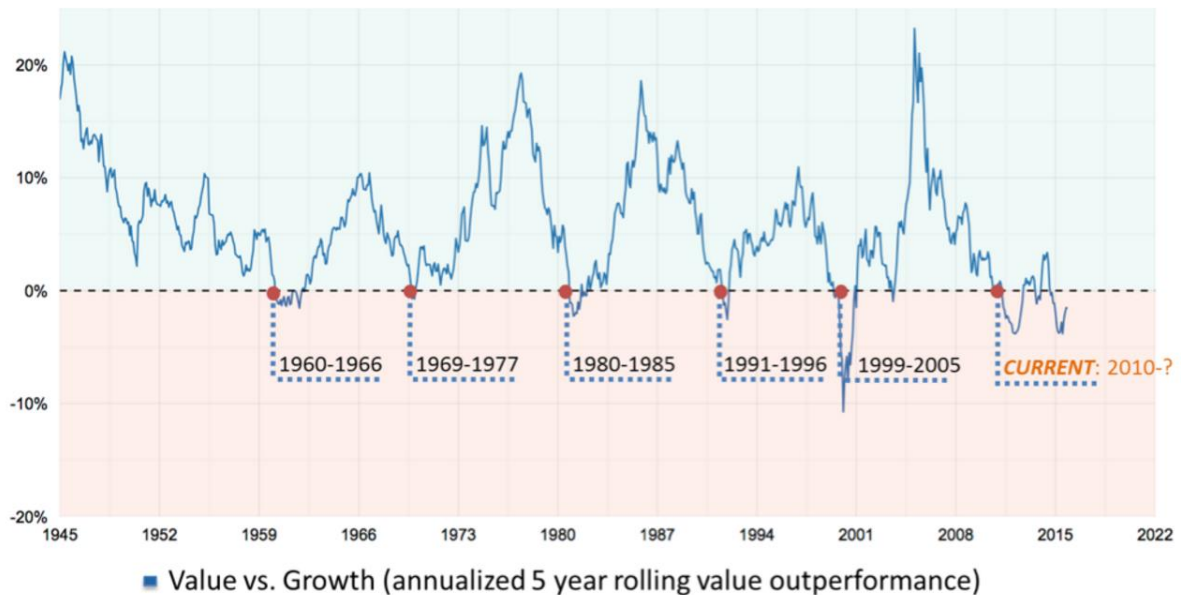
Some pundits are now arguing that such underperformance proves that in today's world value investing no longer works. As Figure 2 demonstrates, today is not the only period that growth has beat value. In fact, growth has outperformed value during six periods since 1945, including the current period. During the previous five periods when growth outperformed value, value subsequently delivered very strong results over the next 5+ years. Historically, this "reversion to the mean" has occurred when value stocks have underperformed growth stocks over at least a five-year period.

Are we at such a turning point? As Figure 3 (on page 5) shows, we might be. Year-to-date through June, the returns to value investing have handsomely beat the returns to growth stocks across all size ranges in the U.S.



Figure 2: Growth versus Value in the U.S.

Growth Has Outperformed Value Six Times Since 1945 Each Time Value Has Had A Significant Recovery



Source: Alberg, John and Michael Seckler. "Now is the Time for Value to Outperform Growth." Advisor Perspectives, February 1, 2016.

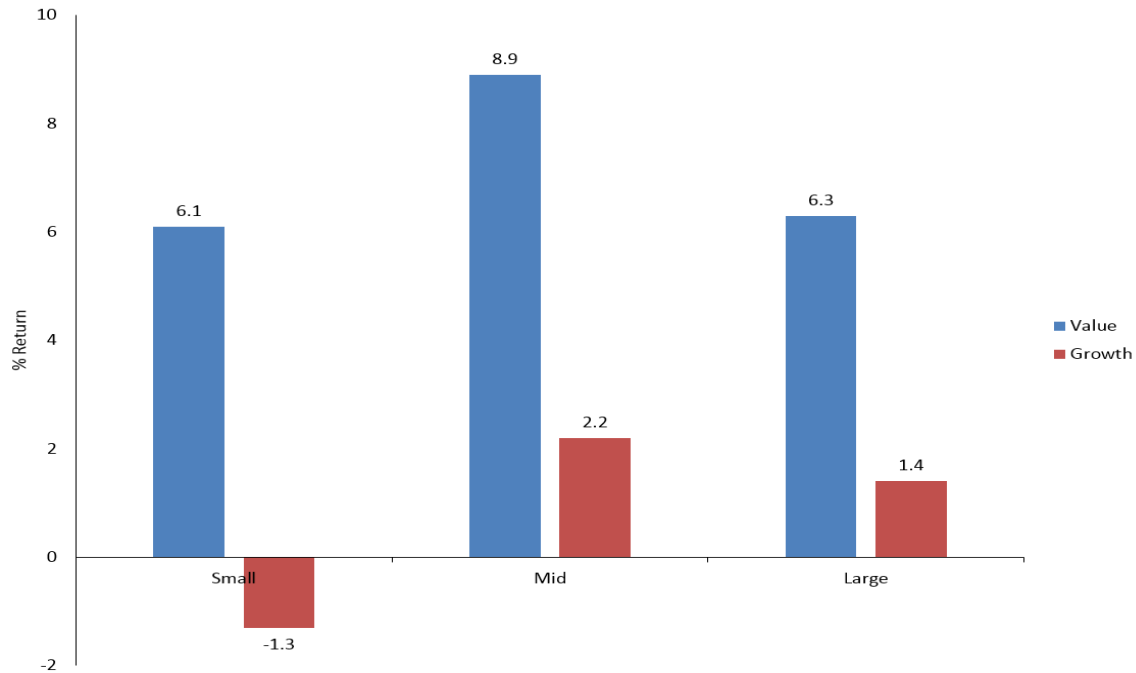
The real problem with predicting turning points is that we don't completely understand why value stocks outperform growth-oriented stocks over the long-run, and why the premium has not been arbitrated away by all investors overweighting value stocks (which would lead to higher prices).

Ben Inker of GMO, a highly-respected institutional investing house (and a huge proponent of value investing), argues that the basic driver for long-term value investing working historically has been the excessive volatility of asset prices relative to their underlying fundamental cash flows.¹ Another way of saying this is that prices often overshoot in response to news, enabling value investors to buy stocks that have suddenly become cheap relative to their underlying value.

¹ Inker, Ben. "Keeping the Faith." GMO Quarterly Letter: 1Q 2016.



Figure 3: YTD 2016 U.S. Returns on Value vs. Growth Stocks



Source: JP Morgan

As for why this premium has not been arbitrated away, the biggest reason may be the sad fact that investors time their purchases and sales so poorly that they rarely capture the value premium in practice. As has been documented, investors tend to sell funds after periods of disappointing performance, just before they are about to rebound, and to buy funds that have done well, just before they take a turn for the worse. *And there is no evidence that this is changing.* Such timing mistakes can more than wipe out the value premium, leaving it for more patient investors to capture.

Bottom Line

Value investing has proven to be an effective strategy over the long term, and mean reversion has historically occurred after extended periods of growth stock leadership. Let's hope this time is not different.



Artemis Strategy

Artemis portfolios performed well this quarter, as many of the structural overweights we favor (value vs. growth-oriented stocks, smaller companies vs. larger companies, and the U.S. vs. the rest of the world) nicely outperformed in unison. Moreover, earlier in the year we restructured our international developed markets allocation to overweight Asia and underweight Europe vs. the benchmark, which has helped us to outperform in this area.

The only move we made during this quarter was in early June to reduce our allocation to Europe further in favor of real estate. As I wrote earlier this month, we made this change not because we believed that the United Kingdom would vote to leave the European Community (like many, we were shocked by the outcome), but because we continue to be concerned about the lack of growth in the region and various risks (e.g., the banking system) to equity market performance. However, we are still modestly overweight our strategic targets to both Europe and developed Asia because both markets are cheaper than in the U.S. Clearly, this has been a lousy bet over the past two years, but as I have written before, valuation is a far better indicator of returns over a three- or five-year period.

In the meantime, real estate looks pretty good. REITS do well in low inflation and low interest rate environments and they are not (yet) overvalued. Global REITS will also soon get a boost from the recognition of real estate as its own market sector, meaning they will be extracted from the broad financial sector and become a standalone sector within the MSCI global equity benchmark. This should augment demand somewhat. Finally, while higher interest rates can hurt REIT returns, as one analyst has pointed out, REITS don't typically run into trouble until higher interest rates cause real estate prices to crest and occupancy rates to peak. We don't seem to be there yet.

I continue to be worried about bonds, as I wrote about in last quarter's letter. Yields are at historic lows and going more and more negative. While I don't think the bond market is going to implode tomorrow, given that the world is awash in savings with too little investment, there will be day of reckoning. Our next move will likely be to shift some of this exposure although we are still deliberating.

I am getting more positive on equities. We may be at the bottom of the so-called earnings recession, which in large part explains why the U.S. stock market has been trading sideways for almost two years. This, plus continued (and potentially accelerated) stimulus activity by central banks, will drive up stock prices. While some argue that U.S. stocks are expensive, they are cheaper than U.S. bonds.



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I am not as enthusiastic about emerging market assets. Despite their recent rally, structural flaws in many emerging economies remain unresolved. Ultimately, the path of the U.S. dollar will dictate whether asset market trends can continue to outpace economic trends in emerging markets. As the dollar is likely to get stronger this year since the U.S. remains the only game in town to get any yield on government debt, this may hurt returns from emerging markets. Hence, while we are not rebalancing our emerging market equity allocation, we are not adding to it.