

Extremist

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"Extremist," the word and its meaning, is not usually considered in a positive light. The term usually carries a negative connotation when describing a person (or group); one which attempts to bring about change using extreme methods. An "extremist" could be one who favors or resorts to immoderate, uncompromising, or fanatical methods of behavior to the point of being radical. Synonyms for "extremist" include fanatic, radical, zealot, agitator, revolutionary, die-hard, or ultraist. Yet some of the most historically significant moments and events are defined by individuals and organizations that were termed "extremist" – countless names/groups come to mind that could be categorized this way.

Extremist sums up the market action in July, for much of 2018, and over the past year. The stock market seems to be advancing from the action of only a few or select style of stocks. The correlation (how stocks move at the same time) continues to separate or decline. Stated differently, the market is moving not in a synchronized manner; it is bifurcated, or market action appears rotational as money moves from group to group. At the start of a new Bull market, most stocks move rapidly upward in a similar path from a Bear market low. As a Bull market ages and other factors start to influence investment decisions, investors adjust their opinions as to what is anticipated to perform well in the future. That's when rotation begins and correlation among stocks decline – individual stocks (even groups) move in different ways instead of together. Some stocks advance much faster compared to others advancing at a slower pace. This can be observed comparing performance differences among different fund investment styles and investment processes. Performance variation occurs for a number of reasons – often from changing political or fiscal policies, to changing monetary policy, or inflation expectations. As you are aware, there are today many political ideas being pursued simultaneously – tax reform, fiscal spending, tariff talk, and monetary policy; additionally this is a mid-term election year for much of Congress. And, tariff talk affects the global landscape as well.

As we conclude July, seven months of the year are in the books. US stocks are proving resilient despite much negative news, and rewarding investors with gains. Growth stocks in particular, are the strongest performers. They are showing "extremist" performance compared to Value; even radical compared to the S&P500 index. The market as a whole is more sideways than the S&P index might suggest. Growth style stocks sport an almost +1600 basis-point performance advantage to Value over the past 12 months, rising about +23% compared to +8% for Value (see market charts). That's BIG. That is EXTREMIST! That sums up the market action of recent.

Style	July	YTD
Large-Cap Stocks	+3.7%	+5.5%
S&P 500	+3.7%	+6.2%
Avg US Stock Fund	+2.5%	+5.9%
Mid-Cap Stocks	+2.4%	+3.9%
Foreign Stocks	+2.1%	-0.7%
Small-Cap Stocks	+1.7%	+6.6%
Barclays Bond Idx	+0.0%	-1.6%

Client Objectives (Stocks/Bonds)	July	YTD
20/80	+0.8%	+0.7%
35/65	+1.1%	+0.9%
50/50	+1.5%	+1.8%
65/35	+1.9%	+2.4%
80/20	+2.1%	+3.5%
95/5	+2.4%	+4.0%

Twenty years ago in 1998, Fed Chairman Alan Greenspan placed the term "irrational exuberance" on then very expensive tech stocks and the stock market in general. Investors recall that the tech bubble ultimately popped in March 2000 leading to a big market correction. Tech stocks were "extremists" via their performance experience.

Today, this similar stock performance divergence can be observed when comparing the relative performance between growth- and value-style funds. The performance differential is huge. Recall that we always own in client portfolios both value- and growth-style no-load mutual funds and ETFs – focused on large-, medium-, small-size domestic companies, as well as foreign. The purpose is history driven – during the course of any year the market focuses on what is "hot" and what is "cold." Market action changes by style and company size; it's like the wall switch changing from off to on, often quickly. Sometimes growth leads; then value. Then large outperforms; followed by small or foreign. I am not aware of any investor who can time the changing of the performance "light switch".



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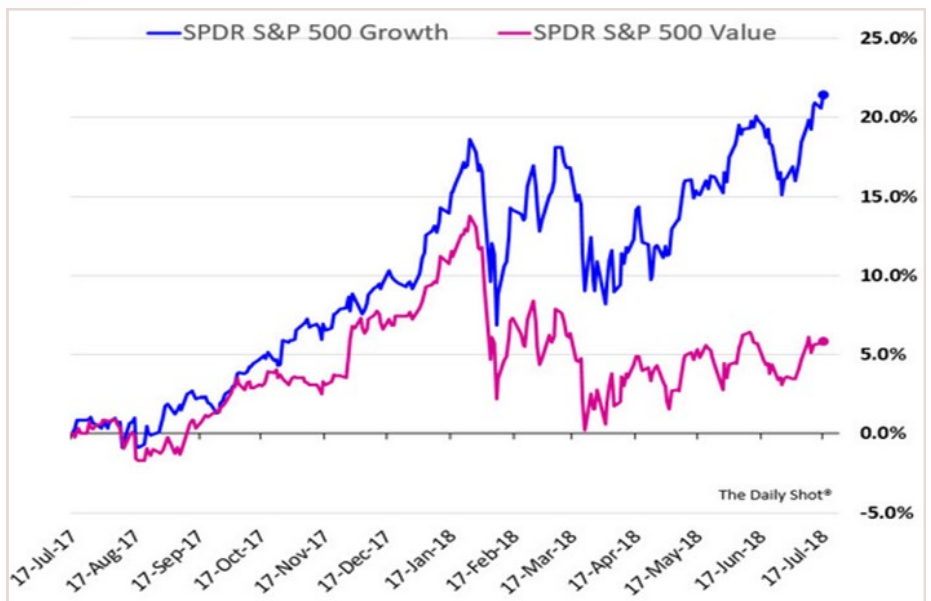
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It is from this perspective that it is wise to utilize a diversification of styles in a portfolio - owning some of the best fund managers in each style category for the long term. Diversification of styles lowers the portfolio volatility and creates a "luxury car ride" instead of a "jeep ride" across a bumpy railroad track. We strive to smooth out the ups/downs in the portfolio values over time. During the last few days of July, as an example, the "FAANG" growth-style stocks revealed their "extremist" traits - being the 12-month performance darlings, but falling quickly with BIG negative price adjustments to conclude the month. What do you think happened to the slow performing Value-style stocks? The Value-style switch moved quickly in the opposite direction leading to their style out-performance. Will the style switch stay favoring Value for a while? We do know that "extremes" always correct. Extremes revert back to normal levels. It's the "high/low" reversal idea - "high" valuation will not endure forever, nor will "low" or cheap value endure forever. Smart investors buy "low" and sell "high"; their action will cause the extremes to revert back to average or to the median.

One could say that we, Nvest Wealth Strategies, are "in front of the market" with our tactical strategy. From a short performance perspective, that creates consternation for us. Client portfolios are advancing as the market does, but at a slower pace. That's not fun from our perspective. But it is because we altered our tactical stock mix at the start of 2018 to dial down market risk. We trimmed exposure from expensive Growth-style stock funds and placed the proceeds into cheaper Value-style stock funds. That is hard to do if one invests via their emotions, but we are attempting to dial-down risk because the current Bull market is older than average (but need not die of old age). Further, the current radical performance difference between growth/value suggested to us, that change will come; we do not know when it will occur; but are confident it will. Investing is about managing portfolio risk. Thus, we closely monitor style valuation differences, particularly when they are wide or extreme, and rebalance portfolios to manage risk. This "valuation driven investing" is often early relative to continuing market action and as a result there may be an interval of time where portfolio performance is soft relative to the market.

Question: Why the extreme stock style performance differential over the past 12 months (observed in chart below)? The root answer centers on the changing policy landscape. The Fed is moving from an "easy" monetary policy that held interest rates low to encourage economic growth (advancing slow and below average) to normalizing monetary policy by raising interest rates (designed to manage inflation expectations and economic growth). In addition, while interest rates are currently rising or normalizing, fiscal policy is being deployed to stimulate. These twin policy changes are impacting the domestic and global economic path. The US is continuing to grow; the economy is actually accelerating to its highest pace of this expansion. Some strategists wonder if current economic growth represents "peak" growth for this cycle. Concurrently, the global path is rotating to a softer pace. They wonder if tariffs will change the economic backdrop.



Presently, we need to believe that the tariff story is mostly one of negotiating, and not likely to sink the US or global economy. Bottom line: the US economy has momentum (even without the fiscal spending spigot turned on), while the Fed pursues its path of gradual rate increases. This momentum will enable the current US economic expansion to become the longest on record. The global economy is softer and rotational for the moment, however it is not synchronized as it was entering the year. To close the loop posed by the original question - the extreme performance differential relates to investors pursuing companies expected to grow faster than the economy, and/or focus on those believed to respond better to changing policy actions by government. An interesting additive, value often shows better relative performance (over growth) when bond yields rise (recent days, and also in 2012 and mid-2015 to 2016).

Near term, market action is historically soft in August-September. These two months have a reputation for being the weakest 2-month stretch of the calendar. [July is often a soft month but 2018 proved otherwise with strong returns; proof that trying to time market action or changing styles is very difficult.] Plus, we are also approaching the Congressional mid-term elections. Markets generally do not make progress in advance of that event. But, as the mid-term election concludes, returns are back-end loaded with positive performance occurring during the last part of the year. This market is bifurcated and narrow in its focus; it is also rotational in its action with some styles becoming "extremists" relative to others, and even to their own appropriate valuations. We believe it's still a good time to invest (underlying fundamental support), and to be tactically diversified by managing risk for changing style preferences.

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