Elm Partners Q4 2019 Report – Separately Managed Accounts

Active Index Investing®

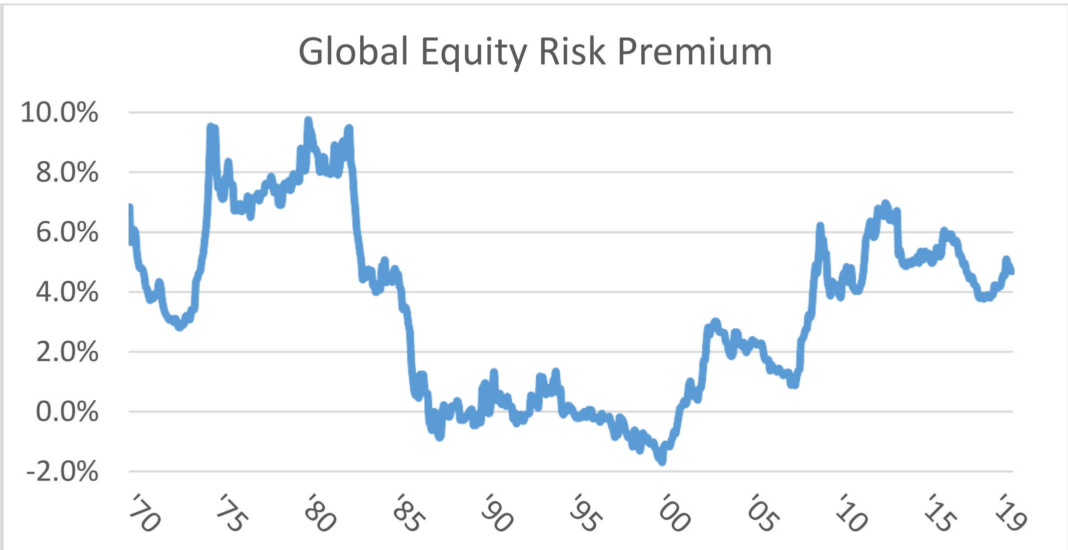
Low Cost, Common-Sense Asset Allocation Combining Diversification, Value and Momentum to Achieve Superior Long-Term Returns[1]

Asset Allocation

Elm's Global Balanced asset allocation started 2019 defensively, with about 40% in equities and other risk-assets, and the balance in high-quality, mostly short-term bonds. This defensive positioning was due to the 13% decline in global equities over Q4 2018, and was the main contributor to outperformance vs. Baseline in 2018 and underperformance in 2019. By the end of Q1 2019 equities had almost fully recovered, momentum shifted back to positive in many asset buckets, and our Global Balanced allocation to equities and other risk-assets was restored to roughly its 75% Baseline weight. As of December 2019, the Global Balanced risk-asset allocation stood at about 90%, the highest level over Elm's eight-year life. This high risk-asset allocation is due to a combination of positive momentum across all risk buckets plus relatively attractive global equity valuations.

Elm's Global All-Equity allocation was relatively static throughout the year, starting with US equities at just over 50% of total assets and ending with US equities at just under 50%. This relatively even split between US and non-US equities is the result of non-US equities having significantly cheaper valuations, but US equities having consistently higher momentum.

The chart below provides a history for our primary valuation metric for global equities: the spread between the Cyclically Adjusted Earnings Yield (CAEY) and the US long-term real interest rate. CAEY is an accepted predictor of long-term real returns, and we want to scale allocations proportionally to the excess return over the long-term risk-free real rate. This excess expected return, also known as the 'equity risk premium,' stood at 4.7% at the end of 2019, meaning our central long-term expectation is for global equity returns 4.7% above the current real-yield on US Treasury Inflation Protected bonds (TIPS). Although many market observers believe equities have gone up so much that they no longer offer attractive returns, the history in the chart below suggests the current global equity risk premium of 4.7% is actually more attractive than it has been for 62% of the time since 1970.



Sources: Bloomberg, MSCI, Robert Shiller (http://www.econ.yale.edu/~shiller/data.htm), King and Low (2013), Federal Reserve Bank of New York, Federal Reserve Bank of Philadelphia[2]

[1] This quarterly note and related materials are not intended to solicit future investment, but rather to elicit discussion and exploration of better ways to invest. Please see www.elmfunds.com for supporting research. This is a preliminary "flash" return estimate, net of fees; the official source of returns is your Fidelity statement **Past performance is not necessarily indicative of future results.**

[2] Data for US CAEY uses the standard Shiller series. Data for non-US-CAYE is from MSCI and Bloomberg. From 1970-1985, US 10-year real rates are generated by subtracting Federal Reserve expected inflation survey data from nominal 10-year Treasury yields, then smoothing and volatility-adjusting the resulting real rate. From 1985-1999 we use real yields from UK inflation-linked bonds smoothed to match US TIPS real yields in 1999. From 1999 we use the real yield of 10-year US TIPS. From 1970-1999, the start of the US TIPS series, constructed real yields were in the range of 1% - 5%.

Some of the current attractiveness of global equities based on this metric stems from the moderate-to-high earnings yields in Europe, Asia, and Emerging Markets, and some from the historically low level of long-term US real rates. Of course, we cannot say with confidence that equities will provide a strong return in 2020 or in any given year, but we do believe the long-run relative attractiveness of global equities, in combination with their short-term positive momentum, warrants the current high allocation to equities at the start of this new year.

Efficiency
This past year saw further reductions in the fees charged on the ETFs and index mutual funds we use to build client portfolios. Most recently, Vanguard cut their fees on the main ETFs we use for non-US equity exposure and certain fixed income exposure by 1-3 basis points (a 10%-30% reduction), bringing the weighted average expense ratio of the vehicles owned across all SMA account to 0.095%. In addition to cost efficiency, we also are focused on tax-efficiency, and we're pleased that returns for 2019 were achieved relatively tax-efficiently.

Other Developments
Over the summer we moved from rebalancing each account every 40 days to rebalancing 25% of each account every week, implemented with the objective of keeping turnover and transaction costs roughly constant. We've been very pleased so far with this change, and also with Fidelity's welcome elimination of trading commissions which we've fully incorporated into our portfolio management systems. Lastly, we have decided to increase the minimum required SMA investment to $500,000 from $300,000, with the goal of being able to spend more time with each of our clients within our existing 0.12% fee structure.

Asset Allocation Tables
Below are links to tables providing details on Elm's quarter-end asset allocation for each type of SMA we manage:

Global Balanced Portfolios:
- Taxable
- Non-Taxable
- US/UK

All-Equity Portfolios:
- Taxable
- Non-Taxable
- US/UK

If you would like a call with us to discuss anything about Elm or your current financial situation, please schedule it here: **Schedule a Call**. **If your financial situation has materially changed in a way which may impact the suitability of Elm's strategy for you, please do let us know and we'll be happy to discuss.**

And as always, we value your questions and suggestions.

With warm regards,

Victor and James

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