Elm Partners SMA Q3 2018 Report

Active Index Investing®

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

US equities had another good quarter, with the S&P500 up 7% in Q3, and up 9% for the year, with the rest of the world's equity markets about flat for Q3 and down 3% for the year. Emerging markets have had a rough year, especially relative to the US, being down 2% in Q3 and down almost 10% for the year.

Taken all together, global equities including the US are up about 3.5% for the year. Given Elm's allocation to equities1[1] of roughly 60% on average over 2018, our SMA model return of about 1% on the year is in line with expectations.[2] Core US Fixed income is down about 3% on the year, but we've ignored it in this rough estimate because almost all of Elm's fixed income exposure was in short-term fixed income with a low weighted-average duration of about one year.

One result of US equities outperforming non-US equities by 12% over this past year, and by about 105%[3] since the end of 2011 (when Elm got started), is that US equities have become significantly richer than non-US equities according to CAPE, our preferred measure of prospective long-term real return.[4] We expect non-US markets to deliver long-term real returns materially in excess of US equities, as suggested by the cyclically-adjusted earnings yield of non-US equities being about 2.5% higher than that of the US market. Please take a look at our note of about a month ago, The Most Important Number not in the WSJ, for more detail.

Your strategy's baseline ratio of US to non-US equities is about 50%/50%, which represents a much higher allocation to non-US equities than the 15% that US investors on average allocate internationally.[5] It's also 5% higher than the 45% weight of non-US equities in MSCI and FTSE's global market-cap-weighted indices, which are adjusted for investability and free-float considerations. On the other hand, our allocation to non-US equities is substantially lower than their 63% weight in a pure, unadjusted market-cap-weighted index.[6]

While our current Baseline weights are not far from today's conventional market-cap-weights, we find it useful to think about the ultra-long-term when it's possible we'll see public equity markets around the world converging to similar ratios of their domestic economies (GDP). In that scenario, based on today's relative national GDPs, the market-cap weight of non-US equities would be 85%.[7] And, if we take this premise one step further to envision convergence of per capita GDP across regions—admittedly the ultra-ultra-long-term-- then US investors might be feeling a bit like the British do today, wrestling with how much international exposure to hold given a home market weighing in at just 5% of global market cap.[8] Elm's Baseline equity weights are determined by balancing these different perspectives, while factoring in a modest adjustment for investor 'home' preference.

Our goal in constructing a baseline is to create a portfolio that is as representative of the global market portfolio as possible, based on the principle that the global market portfolio is the most efficient and diversified starting point for portfolio construction, and that less diversified portfolios are missing out on some of the "free lunch" potential from extra diversification. One of the consequences is that our Baseline will nearly always underperform the best-performing market of the moment, US equities currently, but it also should lead to superior risk-adjusted returns over a long horizon. For a more detailed reminder of how of we construct our Baseline, please see this methodology note on our website.

In other indexing news, Fidelity became the first index fund manager to offer funds with a 0% expense ratio. An interesting sub-story that got less attention is that Fidelity is going to be using their own proprietary index to benchmark these funds, rather than more standard indices from MSCI or FTSE, who charge managers several basis points for this privilege. This custom indexing may have a secondary benefit of reducing the potential drag on index funds caused by a cottage industry of traders who try to get ahead of index inclusions and exclusions, as these custom indexes should lead to aggregate index changes happening in a more gradual fashion.

One place where fees do not seem to be falling is on money market funds that operate as sweep accounts at major brokerage houses. In this story in the WSJ, Jason Zweig sheds light on a recent move by Merrill Lynch to effectively increase fees on short-term fixed income holdings. He explains: 'The giant firm thus joins many other major brokerages, including Morgan Stanley and Charles Schwab Corp., in potentially capturing more of the income on cash balances for themselves, rather than passing most of it through to clients.' At Elm, we keep a close eye on the cost efficiency of your investments in cash and short-term fixed income, using a mix of efficient ETFs and mutual funds to minimize the use of money market sweep accounts.

You may also have heard that there are some changes afoot in the Global Industry Classification System (GICS). We don't see these changes as having a material impact on your Fund, but if you're interested to know what's happening, the main event is that the industry group named Telecommunications Services is having its name changed to Communications Services, and Facebook and Alphabet (Google) are moving to that group from the Information Technology industry. At the same time, Walt Disney, Comcast and Netflix are also joining this new industry group from the Consumer Discretionary industry. The result will be that Communications Services will now represent upwards of 10% of the S&P500.

Below are links to tables providing details on Elm's asset allocation for each of SMA we manage:

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

If anything about your financial situation or financial goals has materially changed which might affect the suitability of Elm's strategy for managing your savings, please do let us know as soon as possible and we'll be happy to discuss with you.

With warm regards,

Victor and James

October 4th, 2018 victor@elmfunds.com james@elmfunds.com

[1] Including related risk assets such as REITs and High-Yield bonds. For the rest of this note, when we say 'equities' we'll mean the term in this broader sense.
[2] Actual returns for individuals accounts vary somewhat based upon the timing of the account's contributions amongst other idiosyncratic account differences. Average returns for accounts which have been invested since before Jan 1, 2018 and made no new contributions in 2018 match model returns closely.
[3] 160% vs 55% total return for SPY vs VXUS, or 8.5% annual outperformance.
[4] 10-year cyclically-adjusted earnings yield, i.e. 1/CAPE.
[5] Estimate from Morningstar. The ratio of US vs non-US equity mutual fund and ETF assets at Vanguard is about 80/20.
[6] As per data from the World Federation of Exchanges website.
[7] https://www.statista.com/statistics/270267/united-states-share-of-global-gross-domestic-product-gdp/
[8] https://www.census.gov/popclock/