INVESTMENTNEWSLETTER

From 1928–2017 the value premium[1] in the US had a positive annualized return of approximately 3.5%.[2] In seven of the last 10 calendar years, however, the value premium in the US has been negative.

WHERE'S THE VALUE

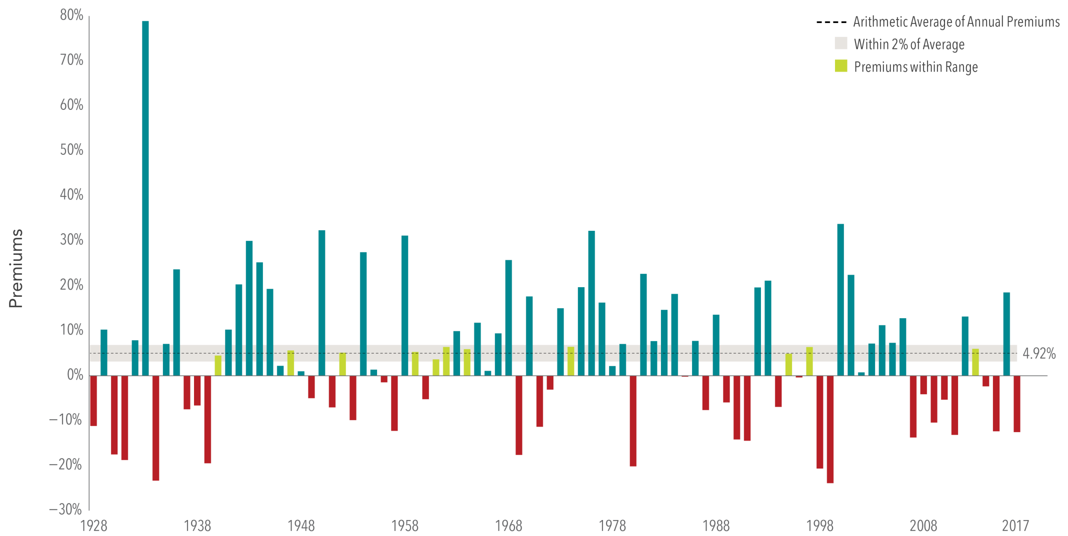
JULY 2018
Dimensional Fund Advisors

This has prompted some investors to wonder if such an extended period of underperformance may be cause for concern. But are periods of underperformance in the value premium that unusual? We can look to history to help make sense of this question.

SHORT-TERM RESULTS

Exhibit 1 shows yearly observations of the US value premium going back to 1928. We can see the annual arithmetic average for the premium is close to 5%, but in any given year the premium has varied widely, sometimes experiencing extreme positive or negative performance. In fact, there are only a handful of years that were within a 2% range of the annual average—most other years were farther above or below the mean. In the last 10 years alone there have been premium observations that were negative, positive, and in line with the historical average. This data helps illustrate that there is a significant amount of variability around how long it may take a positive value premium to materialize.

Exhibit 1. Yearly Observations of Premiums, Value minus Growth: US Markets, 1928–2017



In US dollars. The one-year relative price premium is computed as the one-year compound return on the Fama/French US Value Research Index minus the one-year compound return on the Fama/French US Growth Research Index. Fama/French indices provided by Ken French. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results.

1. The value premium is the return difference between stocks with low relative prices (value) and stocks with high relative prices (growth).
2. Computed as the return difference between the Fama/French US Value Research Index and the Fama/French US Growth Research Index. Fama/French indices provided by Ken French.

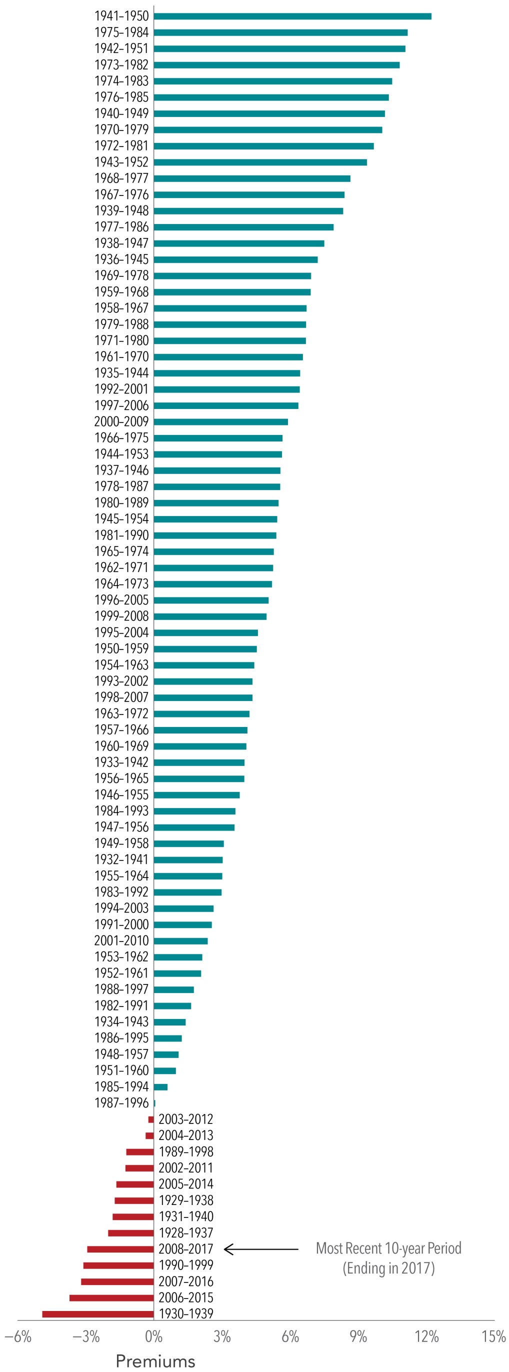
Wealth Management

LONG-TERM RESULTS

But what about longer-term underperformance? While the current stretch of extended underperformance for the value premium may be disappointing, it is not unprecedented. Exhibit 2 documents 10-year annualized performance periods for the value premium, sorted from lowest to highest by end date (calendar year).

This chart shows us that the best 10-year period for the value premium was from 1941–1950 (at top), while the worst was from 1930–1939 (at bottom). In most cases, we can see that the value premium was positive over a given 10-year period. As the arrow indicates, however, the value premium for the most recent 10 year period (ending in 2017) was negative. To put this in context, the most recent 10 years is one of 13 periods since 1937 that had a negative annualized value premium. Of these, the most recent period of underperformance has been fairly middle-of-the-road in magnitude.

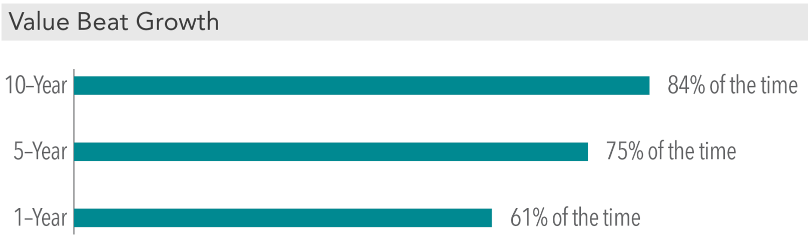
Exhibit 2. Historical Observations of 10-Year Premiums, Value minus Growth: US Markets 10-Year Periods ending 1937–2017



In US dollars. The 10-year rolling relative price premium is computed as the 10-year annualized compound return on the Fama/French US Value Research Index minus the 10-year annualized compound return on the Fama/French US Growth Research Index. Fama/French indices provided by Ken French. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results.

While there is uncertainty around how long periods of underperformance may last, historically the frequency of a positive value premium has increased over longer time horizons. Exhibit 3 shows the percentage of time that the value premium was positive over different time periods going back to 1926. When the length of time measured increased, the chance of a positive value premium increased. For example, when the time period measured goes from five years to 10 years, the frequency of positive average premiums increased from 75% to 84%.

Exhibit 3. Historical Performance of Premiums over Rolling Periods, July 1926–December 2017



Value is Fama/French US Value Research Index.
Growth is Fama/French US Growth Research Index.
There are 979 overlapping 10-year periods, 1,039 overlapping 5-year periods, and 1,087 overlapping 1-year periods

In US dollars. Based on rolling annualized returns using monthly data. Rolling multiyear periods overlap and are not independent. Fama/French indices provided by Ken French. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results.

CONCLUSION

What does all of this mean for investors? While a positive value premium is never guaranteed, the premium has historically had a greater chance of being positive the longer the time horizon observed. Even with long-term positive results though, periods of extended underperformance can happen from time to time. Because the value premium has not historically materialized in a steady or predictable fashion, a consistent investment approach that maintains emphasis on value stocks in all market environments may allow investors to more reliably capture the premium over the long run. Additionally, keeping implementation costs low and integrating multiple dimensions of expected stock returns (such as size and profitability) can improve the consistency of expected outperformance.

Source: Dimensional Fund Advisors LP.

Past performance is not a guarantee of future results. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio.

There is no guarantee investment strategies will be successful. Investing involves risks including possible loss of principal. Investors should talk to their financial advisor prior to making any investment decision. There is always the risk that an investor may lose money. A long-term investment approach cannot guarantee a profit.

All expressions of opinion are subject to change. This article is distributed for informational purposes, and it is not to be construed as an offer, solicitation, recommendation, or endorsement of any particular security, products, or services. Investors should talk to their financial advisor prior to making any investment decision.

Fama/French Indices—Results prior to each index's inception date do not represent actual returns of the respective index. Other periods selected may have different results, including losses. Backtested index performance is hypothetical and is provided for informational purposes only to indicate historical performance had the index been calculated over the relevant time periods. Backtested performance results assume the reinvestment of dividends and capital gains.

THE TAO OF WEALTH MANAGEMENT

JULY 2018

Dimensional Fund Advisors

The path to success in many areas of life is paved with continual hard work, intense activity, and a day-to-day focus on results. However, for many investors who adopt this approach to managing their wealth, that can be turned upside down.

The Chinese philosophy of Taoism has a phrase for this: “wei wu-wei.” In English, this translates as “do without doing.” It means that in some areas of life, such as investing, greater activity does not necessarily translate into better results.

In Taoism, students are taught to let go of things they cannot control. To use an analogy, when you plant a tree, you choose a sunny spot with good soil and water. Apart from regular pruning, you let the tree grow.

This doesn’t mean that we should always do nothing. In fact, insights from financial science suggest you should direct your investment efforts to the things you can control. These include taking account of your own preferences and sensitivities when choosing investment strategies, diversifying your allocation to moderate the ups and downs, being mindful of the impact of fees, and exercising discipline when emotions threaten to blow you off course.

Successful investing requires taking actions that can have a positive impact on the outcome. For instance, to maintain their desired asset allocation, investors should regularly rebalance their portfolio by reallocating money away from strongly performing assets.

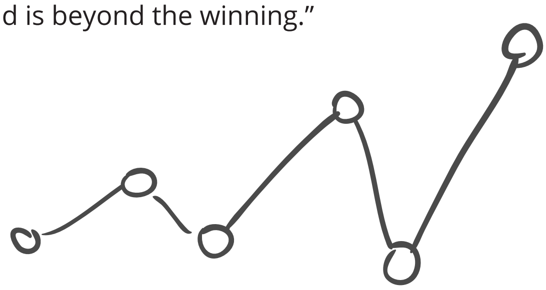
But rebalancing is a disciplined, premeditated activity based on each person’s circumstances. It contrasts with the “busyness” of reflexively following investment trends and chasing past returns promoted through financial media. Look at the person who fitfully watches business TV or who sits up at night researching stock tips. That sort of activity is likely counter-productive and can add cost without any associated benefit. With investing, constantly tinkering with an allocation does not perfectly correlate with success.

Now, while that makes sense, many people struggle to apply those principles because the media tends to look at investing through a different lens, focusing on today’s news, which is already priced in, or on speculating about tomorrow. Guesswork can surely be interesting. But is it relevant to your long-term plan? Probably not.

People caught up in the day-to-day may constantly switch money managers based on past performance,or attempt tactical changes in their allocation, or respond in a knee-jerk way to news events that turn out to be noise.

Again, the assumption underlying these approaches is that if you put more effort into the external factors and adjust your position constantly, you will get better results. Unfortunately, people may end up earning poorer long-term returns from trading too much, chasing past performers, or attempting to time the market. Ultimately, that’s just another reminder of the potential benefits available to disciplined investors who stay focused on what they can control.

As the ancient Chinese proverb says: “By letting it go, it all gets done. The world is won by those who let it go. But when you try and try, the world is beyond the winning.”



PURSUING A BETTER INVESTMENT EXPERIENCE

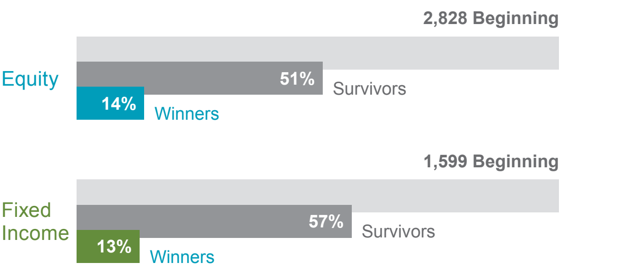
1 Embrace Market Pricing

The market is an effective information-processing machine. Each day, the world equity markets process billions of dollars in trades between buyers and sellers—and the real-time information they bring helps set prices.

2 Don't Try to Outguess the Market

The market's pricing power works against mutual fund managers who try to outperform through stock picking or market timing. As evidence, only 14% of US equity mutual funds and 13% of fixed income funds have survived and outperformed their benchmarks over the past 15 years.

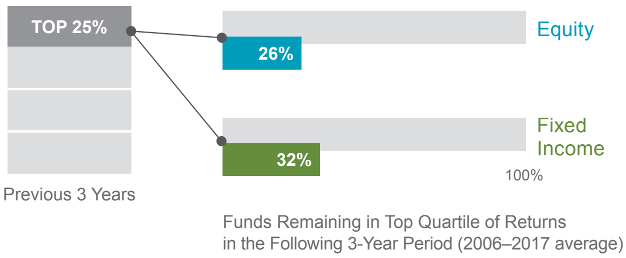
US-Based Mutual Fund Performance, 2003–2017



3 Resist Chasing Past Performance

Some investors select mutual funds based on their past returns. Yet, past performance offers little insight into a fund's future returns. For example, most funds in the top quartile (25%) of previous three-year returns did not maintain a top-quartile ranking in the following three years.

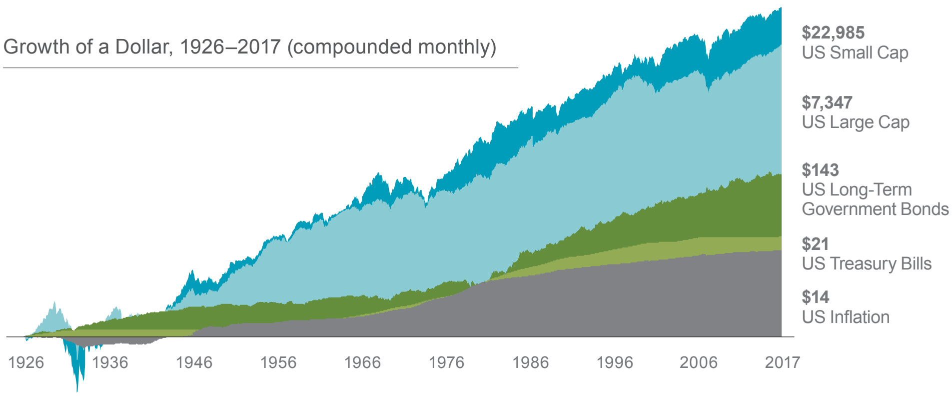
Percentage of Top-Ranked Funds That Stayed on Top



4 Let Markets Work for You

The financial markets have rewarded long-term investors. People expect a positive return on the capital they supply, and historically, the equity and bond markets have provided growth of wealth that has more than offset inflation.

Growth of a Dollar, 1926–2017 (compounded monthly)



5 Consider the Drivers of Returns

Academic research has identified these equity and fixed income dimensions, which point to differences in expected returns. Investors can pursue higher expected returns by structuring their portfolio around these dimensions.

Dimensions of Expected Returns

Equities

- **Market** (Equity premium—stocks vs. bonds)
- **Company Size** (Small cap premium—small vs. large companies)
- **Relative Price** (Value premium—value vs. growth companies)
- **Profitability** (Profitability premium—high vs. low profitability companies)

Fixed Income

- **Term** (Term premium—longer vs. shorter maturity bonds)
- **Credit** (Credit premium—lower vs. higher credit quality bonds)

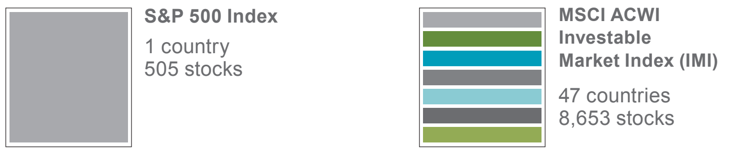
Past performance is no guarantee of future results. Indices are not available for direct investment.
Index performance does not reflect the expenses associated with the management of an actual portfolio.

6 Practice Smart Diversification

Holding securities across many market segments can help manage overall risk. But diversifying within your home market may not be enough. Global diversification can broaden your investment universe.

Home Market Index Portfolio

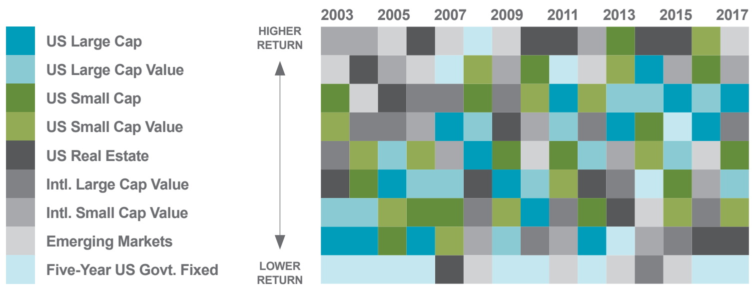
Global Market Index Portfolio



7 Avoid Market Timing

You never know which market segments will outperform from year to year. By holding a globally diversified portfolio, investors are well positioned to seek returns wherever they occur.

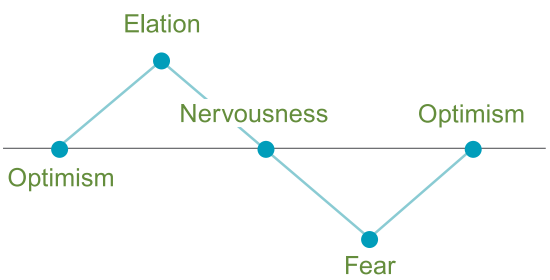
Annual Returns by Market Index



8 Manage Your Emotions

Many people struggle to separate their emotions from investing. Markets go up and down. Reacting to current market conditions may lead to making poor investment decisions.

Avoid Reactive Investing



9 Look Beyond the Headlines

Daily market news and commentary can challenge your investment discipline. Some messages stir anxiety about the future, while others tempt you to chase the latest investment fad. When headlines unsettle you, consider the source and maintain a long-term perspective.

10 Focus on What You Can Control

A financial advisor can offer expertise and guidance to help you focus on actions that add value. This can lead to a better investment experience.

- Create an investment plan to fit your needs and risk tolerance.
- Structure a portfolio along the dimensions of expected returns.
- Diversify globally.
- Manage expenses, turnover, and taxes.
- Stay disciplined through market dips and swings.

Diversification does not eliminate the risk of market loss. There is no guarantee investment strategies will be successful. This information is for illustrative purposes only. See back page for additional exhibit information and important disclosures.

Source: Dimensional Fund Advisors.
Exhibit 1: In US dollars. Source: Dimensional, using data from Bloomberg LP. Includes primary and secondary exchange trading volume globally for equities. ETFs and funds are excluded. Daily averages were computed by calculating the trading volume of each stock daily as the closing price multiplied by shares traded that day. All such trading volume is summed up and divided by 252 as an approximate number of annual trading days.
Exhibit 2: The sample includes funds at the beginning of the 15-year period ending December 31, 2017. Each fund is evaluated relative to the Morningstar index assigned to the fund's category at the start of the evaluation period. So, if, for example, a fund changes from Large Value to Large Growth during the evaluation period, then its return will still be compared to the Large Value category index. Surviving funds are those with return observations for every month of the sample period. Winner funds are those that survived and whose cumulative net return over the period exceeded that of their respective Morningstar category index.
Exhibit 3: This study evaluated fund performance persistence over rolling periods from 2001 through 2017. Each year, funds are sorted within their category based on their previous three-year total return. Those ranked in the top quartile (25%) of returns are evaluated over the following three-year period. The chart shows the average percentage of top-ranked equity and fixed income funds that kept their top ranking in the subsequent period.
Source (Exhibits 2 and 3): US-domiciled open-end mutual fund data is from Morningstar and Center for Research in Security Prices (CRSP) from the University of Chicago. Index funds and fund-of-funds are excluded from the sample. Equity fund sample includes the Morningstar historical categories: Diversified Emerging Markets, Europe Stock, Foreign Large Blend, Foreign Large Growth, Foreign Large Value, Foreign Small/Mid Blend, Foreign Small/Mid Growth, Foreign Small/Mid Value, Japan Stock, Large Blend, Large Growth, Large Value, Mid-Cap Blend, Mid-Cap Growth, Mid-Cap Value, Miscellaneous Region, Pacific/Asia ex-Japan Stock, Small Blend, Small Growth, Small Value, and World Stock. Fixed income fund sample includes the Morningstar historical categories: Corporate Bond, High Yield Bond, Inflation-Protected Bond, Intermediate Government, Intermediate-Term Bond, Muni California Intermediate, Muni California Long, Muni Massachusetts, Muni Minnesota, Muni National Intermediate, Muni National Long, Muni National Short, Muni New Jersey, Muni New York Intermediate, Muni New York Long, Muni Ohio, Muni Pennsylvania, Muni Single State Intermediate, Muni Single State Long, Muni Single State Short, Short Government, Short-Term Bond, Ultrashort Bond, and World Bond. See Dimensional's "Mutual Fund Landscape 2018" for more detail. Index data provided by Bloomberg Barclays, MSCI, Russell, FTSE Fixed Income LLC, and S&P. Bloomberg Barclays data provided by Bloomberg. MSCI data © MSCI 2018, all rights reserved. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. FTSE fixed income indices © 2018 FTSE Fixed Income LLC. All rights reserved. S&P data © 2018 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved.
Exhibit 4: In US dollars. US Small Cap is the CRSP 6–10 Index. US Large Cap is the S&P 500 Index. Long-Term Government Bonds is the IA SBBI US LT Govt TR USD. Treasury Bills is the IA SBBI US 30 Day TBill TR USD. US Inflation is measured as changes in the US Consumer Price Index. CRSP data is provided by the Center for Research in Security Prices, University of Chicago. S&P data © 2018 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. Long-term government bonds and Treasury bills data provided by Ibbotson Associates via Morningstar Direct. US Consumer Price Index data is provided by the US Department of Labor Bureau of Labor Statistics.
Exhibit 5: Relative price is measured by the price-to-book ratio; value stocks are those with lower price-to-book ratios. Profitability is a measure of current profitability, based on information from individual companies' income statements.
Exhibit 6: Number of holdings and countries for the S&P 500 Index and MSCI ACWI (All Country World Index) Investable Market Index (IMI) as of December 31, 2017. S&P data © 2018 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. MSCI data © MSCI 2018, all rights reserved. International investing involves special risks such as currency fluctuation and political instability. Investing in emerging markets may accentuate these risks.
Exhibit 7: In US dollars. US Large Cap is the S&P 500 Index. US Large Cap Value is the Russell 1000 Value Index. US Small Cap is the Russell 2000 Index. US Small Cap Value is the Russell 2000 Value Index. US Real Estate is the Dow Jones US Select REIT Index. International Large Cap Value is the MSCI World ex USA Value Index (gross dividends). International Small Cap Value is the MSCI World ex USA Small Cap Value Index (gross dividends). Emerging Markets is the MSCI Emerging Markets Index (gross dividends). Five-Year US Government Fixed is the Bloomberg Barclays US TIPS Index 1–5 Years. S&P and Dow Jones data © 2018 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. MSCI data © MSCI 2018, all rights reserved. Bloomberg Barclays data provided by Bloomberg. Chart is for illustrative purposes only.

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