October 27th, 2017

The Top-Down

The first look at third-quarter GDP was released this morning showing 3% growth. While the number gets revised several times, this is a high starting point and shows the economy gaining strength. Orders for durable goods also showed positive momentum, growing 2.2% in September which was on the high-side of Wall Street expectations.

According to *Bloomberg,* and three additional sources inside the walls of the White House that reported as such to the aforementioned publication, Gary Cohn is out of the running to hold the position as the next Fed Chair. *Business Insider* speculated that Gary would move on once a tax bill was signed, sealed and delivered.

Gary Cohn at the White House

Source: Joshua Roberts | Reuters

Wall Street's favorite Saudi Prince, Prince Alwaleed bin Talal, made an appearance on *CNBC* from Riyadh where the Saudi Sovereign Wealth Fund was hosting the Future Investment Initiative. The gathering, referred to as "Davos in the Desert", brought out every top-ranking asset manager from around the globe.

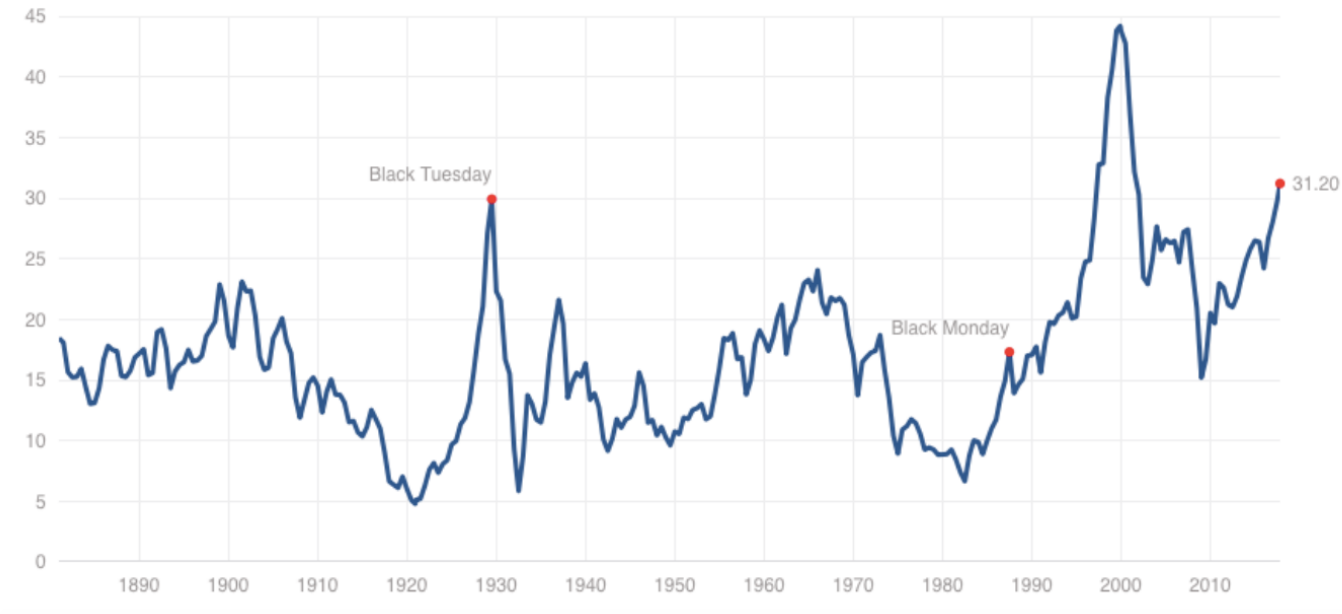
Prince Alwaleed bin Talal

Source: CNBC

He shared his thoughts on Saudi Arabia and the global economy. When it comes to Tesla, "it's too exuberant for me" but Citigroup could go to $100. In his opinion, Bitcoin, "is an Enron in the making". When asked about President Trump he responded that "he is a unique person".

Oaktree's Howard Marks and BlackRock's Larry Fink made their own appearances. Both cautioned investors that they should expect lower returns going forward and that you will need exposure to alternative investments to successfully get there.

Case-Schiller CAPE P/E Ratio



Source: multpl.com

<u>The Bottom-Up</u>

Chipotle stock continues to crater as the once prosperous casual fast food chain struggles to find growth. This week the shares traded down 15% after the company reported another disappointing quarter. While a very crowded short, it's been working. Even Duke basketball star Grayson Allen is, as the hip kids like to say, "throwing shade" on Chipotle. He thinks their new queso concept is "a little underwhelming."

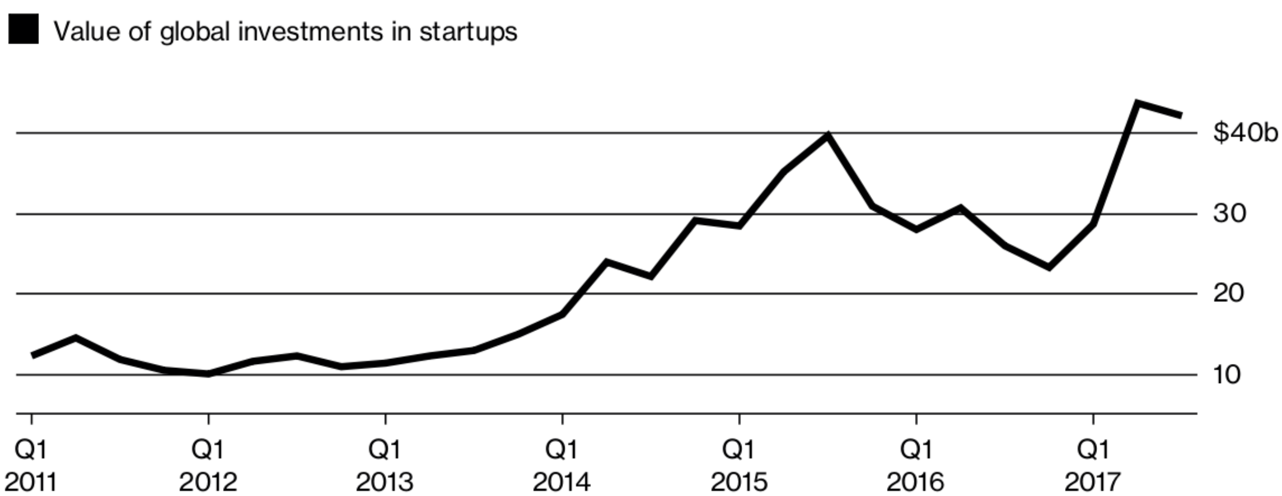
WeWork purchased the Lord & Taylor flagship store on Madison Avenue in New York City for $850 million. The 600,000 square feet of space inside the iconic building will become the company's headquarters.

Lord & Taylor on Madison Avenue

Source: Crain's New York

Money continues to pour into startups as the venture funding and exit windows remain wide open. *The Wall Street Journal* opined that the $20 billion valuation afforded WeWork is certainly the product of Silicon Valley pixie dust.

Dollars Continue to Flow to Startups



Source: Bloomberg Gadfly

Stillwater View: With money chasing every deal that comes down the turnpike, especially the stretch from San Jose to San Francisco, it's no wonder that valuations are ripping higher. Don't hate the players, hate the game.

In a corporate move so bizarre that it took us a few days to figure out if it was real, National Beverage sent out a press release entitled "FIZZ Grows Stronger" in response to a selloff of it's shares. In it the CEO said, "If you have the opinion that I, Nick A. Caporella, am angrily exercised while extremely fortunate to be guiding FIZZ, your opinion is quite accurate!"

Stillwater View: Mr. Caporella, you took the company from an obscure collection of brands to a $4 billion market cap enterprise. The stock has been one of the biggest winners on Wall Street over the last four years. Sit back and relax, and reflect on how much fun it is being a billionaire and enjoy an ice-cold Key Lime La Croix.

National Beverage – FIZZ

Source: NASDAQ

The *Wall Street Journal* wrote a rather blistering piece on publicly traded Morningstar (MORN) and the company's star rating system. The article details how important the system is to fund managers and investors, yet how shifting ratings and wayward performance can undermine their value. The company "strongly disagreed" with the *Journal's* assertions.

Stillwater View: Those with seats on the inside have known for a long time that the star rating system is a necessary game to be played. A former colleague who covered the financial services sector once wrote up a research report on the publicly traded asset management companies, and recommended which one we should own. After a very thorough review and detailed analysis the sector, the conclusion was very simple. Buy the one with most 5-star funds because that's where the assets are flowing.

The article makes a brief mention of the Santa Barbara Dividend Growth fund, a strategy managed inside Nuveen's affiliate, Santa Barbara Asset Management, where I worked as an analyst and portfolio manager.

The strategy was the brainchild of Jim Boothe and was first housed in a non-descript 10x10 office in a pedestrian space near downtown Santa Barbara. In 2005 Jim had a vision that investors would want to own a portfolio of dividend growing companies with stable balance sheets and the ability to weather rough seas. He seeded the strategy with some of his own money and a track record was born.

In 2008, the broad market would suffer a loss of 35% and interest rates for safe securities would decline precipitously. During that time, Jim's stocks held up well and continued to grow their dividends. Fast forward to today and that small thought has turned into a strategy with over $10 billion in assets. Never underestimate the power of a good idea, along with the execution of a plan, and some nice timing. Well done Jim, well done.

Santa Barbara Dividend Growth Portfolio Manager Jim Boothe

Source: Nuveen

Up and Down Wall Street

There was big news in the private equity world this week when the Carlyle Group co-founders Bill Conway, Daniel D'Aniello and David Rubenstein announced their planned successors. The $160 billion firm was founded in 1987 and named after the Carlyle Hotel in New York where the original partners would meet.

Carlyle Founders Bill Conway, Daniel D'Aniello and David Rubenstein

Source: Washington Post

That's it for alternatives this week as we promised to keep *Up and Down Wall Street* focused on asset allocation and the shift in the equity fund industry from active to passive. And from passive to "smart passive".

Bear with me as I try to set the stage using a nautical analogy. But before I do, full disclosure, this distribution goes out to a broad spectrum of investors, partners, fund managers, and asset allocators. For some the discussion that follows may seem like old hat. If you happen to fall into this category, please feel free to scroll down to the *Diversions* section. Otherwise, read on.

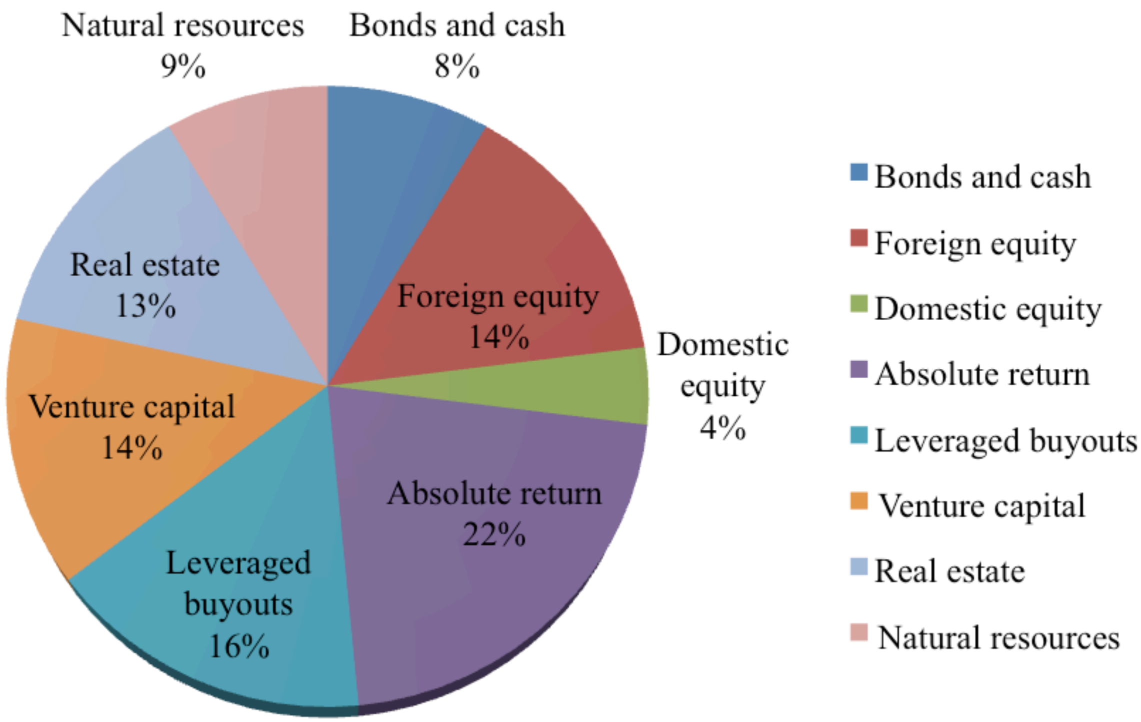
A good way to conceptualize an asset allocation model is to think of it as a four-engine super tanker loaded up with your assets. From the smallest 401(k) or the largest endowment, those four engines are there to power asset growth and income through all kinds of seas. Whether they be smooth or with waves crashing over the bow.

Super Tanker Jahre Viking

Source: Oilcorp

The four engines of your investment supertanker are bonds, equities, diversifiers and alternatives. Bonds are there for stability and yield, equities are for capital appreciation, diversifiers include cash and specialized active managers, and alternatives come in many forms and provide enhanced yield, upside capture or downside protection.

Yale Universities' Asset Allocation

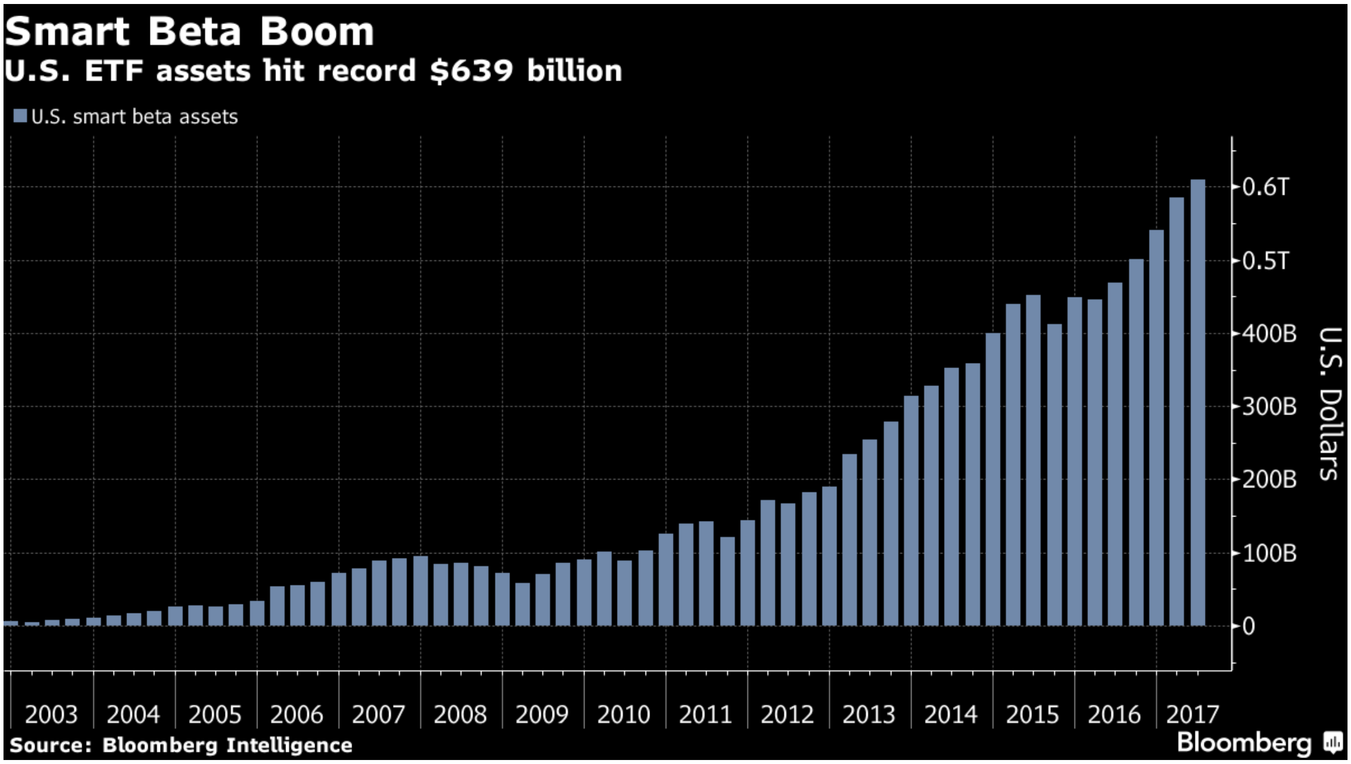


Source: Yale Daily

As mentioned, this week's focus is on the stock engine, more often the largest of the four. Ownership comes in a few forms. Many individuals and institutions have large portfolios of single stock exposure that might be concentrated positions, company stock, or long held securities with a low cost basis.

Then there are actively managed mutual funds, even though they have been under increasing pressure from outflows and fee compression. That leaves us with index funds. Even more specifically those that are engineered to outperform by using factors otherwise known as "smart beta". This segment has seen parabolic growth over the last five years and represents over a half trillion of investor assets.

Assets Under Management in Smart Beta ETFs



Source: Bloomberg

While broad based index ETFs were gaining traction following the 1993 introduction of the S&P 500 "SPY", David Boothe and the resident quants at Dimensional Fund Advisors (DFA) were developing funds that were passive in nature, but with a fundamental twist.

Similar to all great success stories, this $500 billion asset manager had humble beginnings. David was a student of Nobel Prize-winning economist Gene Fama and he started DFA in a Brooklyn brownstone in 1981. In its earlier days, DFA was sometimes referred to as a "Kool-Aid serving cult", based on the selection process used to determine which type of financial advisors it would work with.

Market Beaters Eugene Fama and David Booth - Barron's Magazine

Source: Barron's

Stillwater View: I had the opportunity to meet Gene Fama at a DFA sponsored event several years ago. After a good hour of technical speak the conversation lightened up. Gene had won the Nobel Prize in Economics one month earlier, sharing it with Yale's behavioral economist Robert Schiller. Later I asked Gene, "After you won, did you call Bob or did Bob call you?" With a quizzical look on his face he responded, "I don't think I have Bob's number."

Fama's work with Ken French would become known as the "Fama/French Factor" model. Their thesis was "markets are inherently efficient and near impossible to beat. However, there are fundamental factors that can lead to outperformance…over time". Those factors were company size and company value. Their academic research found that small stocks beat large ones and value stocks beat growth. Again, only over time. Here is the very basic math used to determine if the factors outperform.

SMB (Small Minus Big) is the average return on the small company portfolios minus the average return on three big portfolios,

Small Minus Big =

1/3 (Small Value + Small Neutral + Small Growth)
Less: 1/3 (Big Value + Big Neutral + Big Growth)

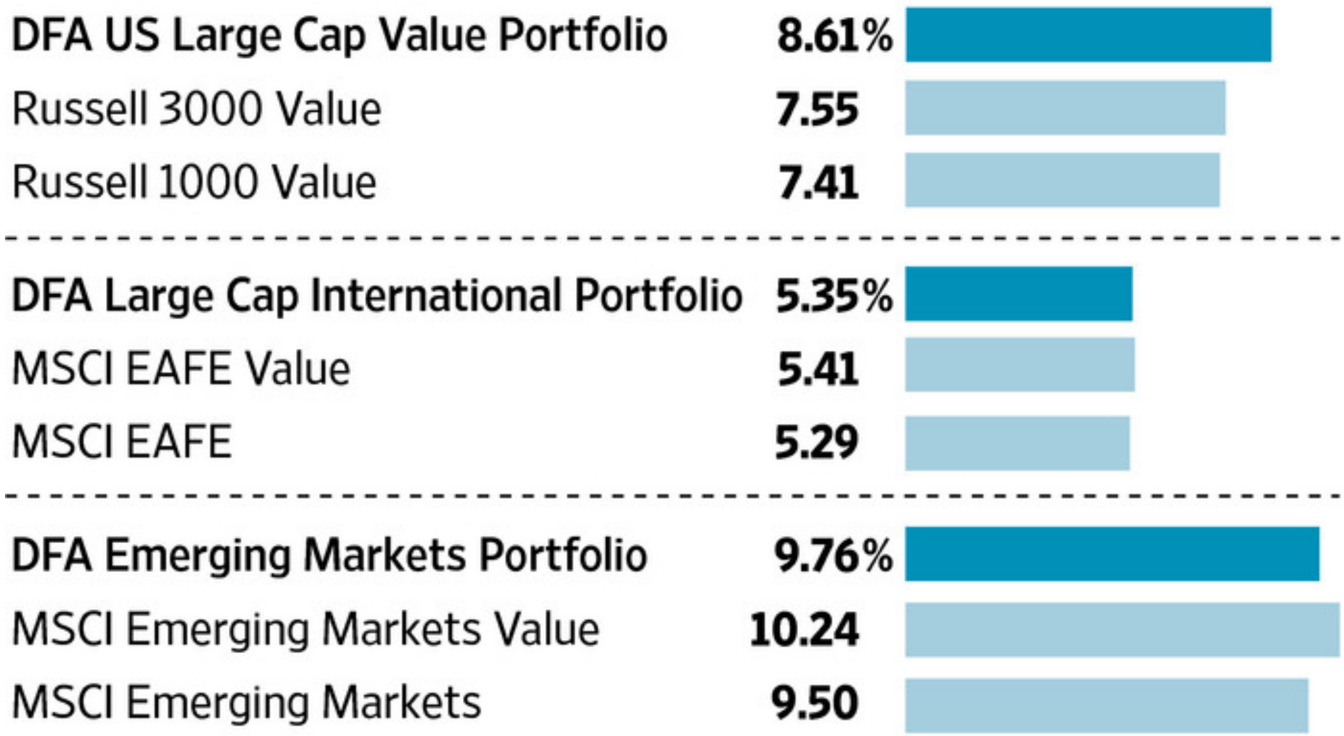
HML (High Minus Low) is the average return on the value portfolios minus the average return on the two growth portfolios.

HML (High Minus Low) =

½ (Small Value + Big Value)
Less: ½ (Small Growth + Big Growth)

The results of their work were integrated into DFA funds and performance has held up when compared to the indexes they compete against. Back out the standard 1% advisor fee and that outperformance narrows. In some cases, going away completely.

Returns for Three of the Larger DFA Funds 15-year Annualized Through Year-End 2016



Source: Morningstar & The Wall Street Journal

Stillwater View: Stillwater Capital manages two asset allocation models that are based on factor investing and provide broad equity market exposure. The international portfolio is up 19.68% YTD versus the MSCI EAFE return of 18.90%. The domestic version has gained 13.30% YTD against a 15.09% return for the S&P 500. The latter has trailed as large stocks have handedly beat small stocks this year.

One of the key tenants to the work of French and Fama is the "over time" perspective. There can be long stretches when growth outperforms value, and we just so happen to be in one right now. Value manager David Einhorn of Greenlight Capital, vented his frustration over the subject earlier in the week.

He said that "After years of running into the wind, we are left with no sense stronger than 'it will turn when it turns,'" Einhorn wrote in his quarterly letter to investors. "Perhaps there really is a new paradigm for valuing equities and the joke is on us. Time will tell." *CNBC* had the exclusive interview with the well-known hedge fund manager.

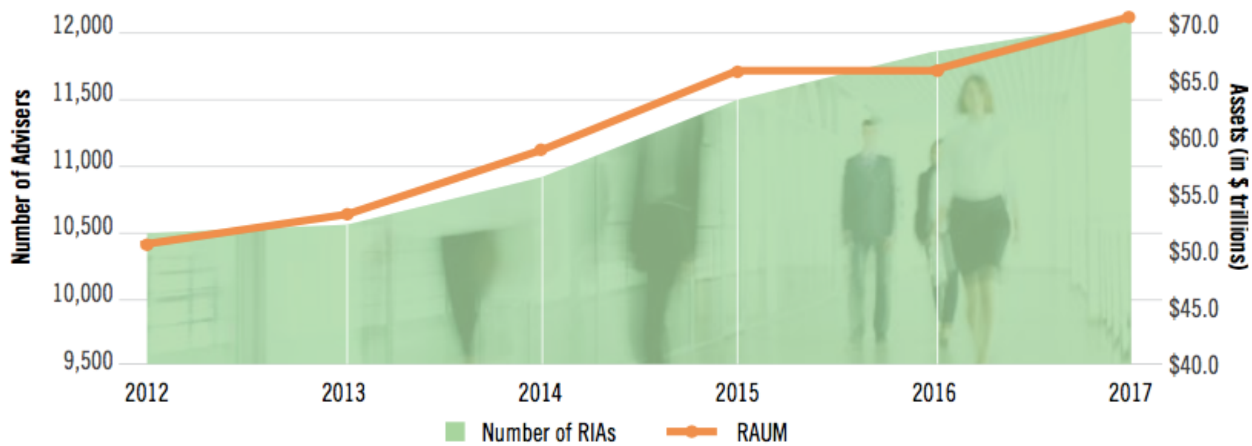
Value Has Significantly Lagged Growth in 2017

Source: Bloomberg

Stillwater View: Today's investment environment is looking more and more like 1999 each and every day. Back then even dyed in the wool value managers were questioning their core beliefs. Some gave up and changed horses late in race. Those that held their position wound up navigating the dotcom bust quite well.

Going back to DFA, their message that the markets were inherently efficient and that timing them was a fool's errand resonated in the RIA world as it dovetails nicely with advisors that have a "financial planning first" mindset. It also resonated with clients who liked the relative simplicity and low fees. Together, DFA and independent advisors they serve, have grown into a $70 trillion industry.

Growth of Registered Investment Advisors and Assets Under Management



	2012	% Change	2013	% Change	2014	% Change	2015	% Change	2016	% Change	2017	% Change
# of Advisers	10,511	(8.9)%	10,533	0.2%	10,895	3.4%	11,473	5.3%	11,847	3.3%	12,172	2.7%
RAUM	49.4	12.8%	54.8	10.9%	61.7	12.6%	66.7	8.1%	66.8	0.2%	70.7	5.8%

Source: Investment Advisor Association "2017 Evolution Revolution" Report

Stillwater View: The Registered Investment Advisor model continues to grow and prosper. As does a durable plan for asset allocation that incorporates the four engines of growth and income; bonds, stock, diversifiers and alternatives. Pay as little as you need to for the first two, reserving dry powder for well-constructed diversifiers and alternatives.

Diversions

The World Series moves to Houston this weekend tied at one game apiece as Dodger manager Dave Robert's rolled the dice and lost game two in Los Angeles. Pulling starter Rich Hill in the 4th then draining the bullpen for the next 7 innings.

The usually unhittable closer, Kenly Jansen, gave up a game tying homer in the 8th and the next reliever Josh Fields had what can only be described as a very bad at the office, giving up two home runs and a double on three pitches before being replaced. Game three is in Houston tonight.

Minute Maid Park in Houston

Source: Major League Baseball

The Jack Daniels National Invitational Barbecue Championships takes place today and tomorrow in Lynchburg, Tennessee. ‘The Jack’ as they like to call it, draws 90 pit masters from around the world to compete in 7 categories of barbecue in front of 25,000 BBQ aficionados. For those looking to kill a little time in between competitions there is a 10k run, live music and of course a “butt bowling” competition where a frozen pork butt replaces the traditional bowling ball.

Judging ‘The Jack”

Source: Jack Daniels

With Halloween just around the corner, it’s time to dust off one of the greatest films ever produced, “It’s the Great Pumpkin Charlie Brown”. This1966 classic will air Sunday night on ABC. To make it a true throwback, mix in a Dolly Madison fruit pie or Zinger Zapper commercial.

Sadly, Charles Schulzs’ home in Santa Rosa was destroyed by the fires earlier this month. Fortunately, most of his collection is already on display or archived at the Charles M. Shulz Museum.

“It’s the Great Pumpkin Charlie Brown”

Source: Peanuts

Dia de los Muertos, otherwise known as the Day of the Dead in Mexican culture, begins on October 30th and goes through November 2nd. As the *Los Angeles Times* points out, the tradition has nothing to do with Halloween.

It commemorates loved ones who have passed from this life to the next. The Hollywood Forever Cemetery is hosting their 18th annual celebration on Saturday with live music from noon to midnight.

General admission will run you $20. Crossing over with Charlie Chaplin, Judy Garland, Rudolph Valentino and Douglas Fairbanks is included in the price.

A Happy Couple Celebrates Dia de los Muertos

Source: Fine Art America

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