Fall 2018

As the days grow shorter, the year grows longer as we race into the final quarter of 2018. The first weeks of the quarter have seen a meaningful pullback in stocks. Concerns over rising interest rates, tariffs and weakening overseas markets, among other factors, have prompted the retreat. An ever-narrowing advance of US growth stocks in the third quarter of the year masked what has been a rolling correction in many US stocks and foreign markets this year.

While the domestic stock market, as measured by the S&P 500, had a total return year to date of 10.6% as of September 30, 2018, many other indices have struggled. The booming domestic economy in the US has not been matched by many overseas economies. In contrast to the S&P 500 for example, the MSCI Emerging Markets Index has declined by 9.5% year to date.

The variability of returns in 2018 was not limited to differences in international markets but was seen within the S&P 500 as well. Year to date as of September 30th in the S&P 500, 297 stocks are up, with a cumulative average gain of 20%, while 208 are down, with an average loss of 11%. (Yes, that's 505 stocks. There can be more than 500 stocks in the S&P 500 due to companies with multiple stock classes.) So, unlike along our rocky shores, a rising tide may not lift all boats.

The picture in the S&P 500 was muddied further in September with the reclassification of many large cap stocks. Alphabet (Google) and Facebook have moved from the technology sector to the communications sector. As pointed out by Argus Research, this move will actually help the year to date returns of the technology sector as Alphabet has lagged the performance of the technology sector this year and Facebook is down.

We commented in our summer newsletter about this diversion of returns. Within the S&P 500, winning sectors like technology and health care were offset by declines in the consumer staple and financial services sectors, among others. Many stocks considered value stocks, generally those companies with lower Price/Earnings (P/E) and Price/Book ratios and higher dividends, continued to lag in performance behind growth stocks, those with faster earnings growth and higher P/E ratios, among other factors.

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Indeed, this outperformance of growth versus value has persisted for at least ten years as measured by the Russell 1000 Growth and Value Indices. This year the Russell 1000 Growth Index has advanced 17.1% versus a gain of only 3.9% for the Russell Value Index. The respective 1, 5 and 10 year returns for Growth and Value are 26.3 vs. 9.5, 16.6 vs. 10.7 and 14.3 vs 9.8%. The largest holdings in the Growth Index as of September 30, 2018 included Apple, Microsoft, Amazon, Alphabet and Facebook. Large holdings in the Value Index included J.P Morgan Chase, ExxonMobil, Berkshire Hathaway, Johnson & Johnson and Bank of America. As of September 30th, the P/E ratio of the Growth Index was 29.2X with a 5-year earnings growth rate of 15.7% and a dividend yield of 1.16 %. The P/E ratio for the Value Index was 16.4X with a 5-year earnings growth rate of 5.6% and a dividend yield of 2.5%.

After 10 years one might despair of the Value Index ever having its day versus Growth, but things can change quickly. Had we reviewed the comparative returns earlier this year, the results would have been quite different. According to Justin Tugman of Perkins Investment Management in an interview on MarketWatch on April 7, 2018, through the first quarter of 2018, the Value index had outperformed the Growth Index over the last 20 years. According to FTSE Russell, the Russell 1000 Growth Index had annualized returns of 4.06% from December 31, 1999 to December 29, 2017 while the Russell 1000 Value Index over the same period had annualized returns of 6.99%. All the "long term" performance advantage enjoyed now by the Growth Index is due to the 17.1% advance this year over the 3.9% rise in the Value Index.

The superior long term returns on the Russell 1000 Value Index from 1999 through 2017 was built up during the significant outperformance of the Value Index from 2002 through 2006. Part of this was due to the collapse in growth stocks in 2000 from unprecedented valuations. Another observation by Justin Tugman, was that the Value Index outperformed during a period, 2002-2006, when the Federal Reserve was raising interest rates. This may bode well for the Value Index relative to the Growth Index as we are now in a similar rising rate environment.

Despite the current market volatility, we do not believe we are in a similar market environment to 1999 as valuations are nowhere near as high now. There are leading stocks such as Amazon, P/E 169X, and Netflix, P/E 147X, that defy conventional analysis, but on balance, the market seems only slightly overvalued. The recent decline in many of these high P/E stocks may have been long overdue.

There remain many stocks selling at reasonable valuations, particularly those stocks in the Value Index.

As a practical matter, many investors have common stock portfolios consisting of both value and growth stocks. Indeed, many individual companies have at times moved between the value and growth categories. Investors also have exposure to foreign developed and emerging market stocks and small cap stocks for example. The relative performance of an individual portfolio versus a broad market index like the S&P 500 may vary over time as the specific holdings in the portfolio enhance or hinder relative returns in the short run.

We wish you the best for the fall season and encourage you to contact us with your thoughts and questions on any investment matter.

John C. Knox CFA John C. Downing CFA

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