

Adam Smith Advisors

A Cherry Tree Affiliate

April 2017

ADAM SMITH INSIGHTS:

Published by John O'Connor, CFA of Adam Smith Advisors, LLC, with insights on investing and wealth management.



INVESTING QUOTE OF THE MONTH:

"It is impossible to produce superior performance unless you do something different from the majority." – Sir John Templeton

VALUE STOCKS - GET MORE FOR YOUR MONEY

I really love a sale. When gas is below \$2 a gallon, it brightens my day. When I buy last year's model of anything from an iPhone to a new car, I feel better knowing that I saved money. Many of you can relate to that same joy. What you may not know is that you can get it from the stock market too.

There are two types of sales in the stock market. There are times when it feels like a going out of business sale—everything must go! Do you remember 2007-2009? Virtually every stock in the world was on sale. It was a great time to buy. Those who did buy found a lot of good deals.

The second type of sale is more seasonal. At any given moment, there are individual companies or groups of stocks that are trading at a discount. A few years ago the price of oil dropped. Lower oil prices translate directly into lower earnings for most energy companies. So energy stocks went on sale. Many other companies like technology stocks and healthcare stocks were unaffected by lower oil prices though. Their prices didn't drop.

The stock market is often sorted into different categories. It can be viewed as groups such as big companies (large-caps), middle sized companies (mid-caps), and small companies (small-caps). It can also be viewed as growth stocks and value stocks. I might choose different names than "growth" and "value," but the financial services industry has settled on those terms.

What makes a stock a "growth" stock or a "value" stock? Stock ownership, at its most basic level, is the right to future profits, or earnings, of a company. Tens of thousands of people work really hard every day to analyze the future prospects of companies, trying to figure out what is a fair price to pay for those future earnings. If it is a fast growing company, people are willing to pay more. If it's a company in a dying industry (i.e. newspapers), people are not willing to pay very much.

When I hear "growth" stocks, I think "expensive" stocks. Often times growth stocks have better growth prospects, hence the name. The problem for investors in those stocks is that they tend to be bid up in price. This makes it hard to earn good returns on your investment.

Value stocks are typically companies that are ignored, unloved, or otherwise forgotten. A great recent example is a regional bank. These are not the giant corporations that helped cause the financial crisis. They are community banks that, for the most part, managed their risks responsibly. They make money by taking customer deposits and loaning them out to individuals and businesses. The last eight years have been a period of historically low interest rates, which makes it hard for banks to make money. Combine that with a new set of regulations crafted after the financial crisis, and regional banks did not make a lot of money. Their stocks went on sale!

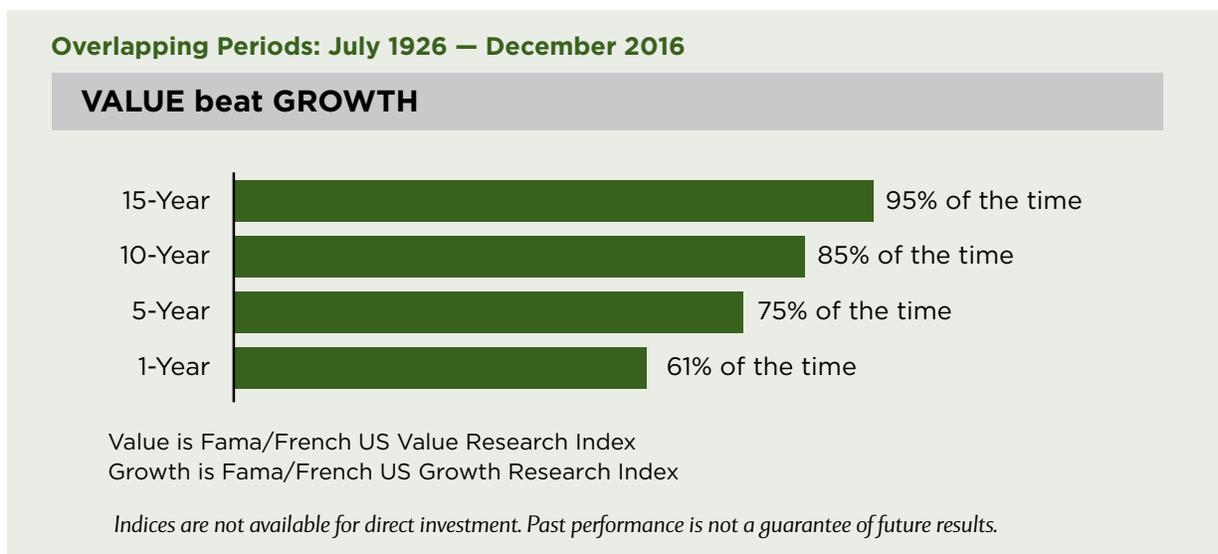
Are you ready for the even better news? You do not need to take the risk of investing in a single industry or in a single company in order to buy on sale. There are literally thousands of stocks on sale any given day. We can sort the entire U.S. stock



Continued on back >>

market (and any other world stock market) by the relative price of each and every stock. Then you can invest in funds that buy hundreds or thousands of stocks that are less expensive. This way you don't need to worry about unpredictable events that may only affect the regional banking industry. You are diversified.

With any good idea, the proof is in the pudding. Does it actually work to buy value stocks in hopes of higher returns? Historically, it has worked well as long as you are patient. U.S. value stocks have outperformed U.S. growth stocks by over 3.5% per year on average since 1926. It doesn't work every year though. It doesn't even work every five years or every ten years. The following table, provided by Dimensional Fund Advisors, shows the percentage of time that value stocks beat growth stocks over the past 90 years in the U.S. stock market. The odds are on the side of value stocks. 75% of the time, you would have been better off emphasizing value stocks for a five-year period. The numbers are similar for international stocks markets. This is a global phenomenon.



Of course, no reasonable investment strategy works all the time. That would be too good to be true. Value does not always beat growth. Predicting when value will beat growth doesn't work either. People have tried, and the evidence is pretty clear. There is no more success in timing the value premium than there is any other stock market prediction. Our approach to value investing is to focus on long-term success and accept that there will be years when it doesn't work. The years when value investing does work have more than made up for it. After a number of slow years for value stocks, 2016 was a banner year. U.S. value stocks outperformed U.S. growth stocks by 19% in 2016. That was enough to swing the most recent five-year comparison back in favor of value stocks.

Value investing has been one of the hallmarks of our investment strategy since our firm's inception in 1998. We keep our client portfolios diversified among all types of stocks, but we add emphasis to value stocks to increase the expected returns. We weave this into a comprehensive strategy that fits each client's unique situation. Let us know if you are interested in hearing more about how it can work for you.

Adam Smith Advisors, LLC (ASA) provides unique wealth management services for a select group of client families to give them peace of mind. Author John O'Connor, CFA, has a broad cross section of successful investment management experience as an analyst for institutional investors, an accountant for a major mutual fund company, and as a wealth management advisor for individual investors and retirement plans. Please FORWARD this e-mail to friends/relatives/business associates that you think may have an interest. Please see our website at <http://www.cherrytree.com>.

ADAM SMITH ADVISORS, LLC

John O'Connor CFA • joconnor@cherrytree.com • Office (952) 893-9012 • Direct (952) 253-6014

Adam Smith
ADVISORS, LLC
A Cherry Tree Affiliate

Legal Disclaimer: These materials do not constitute an offer or recommendation to buy or sell any securities or instruments or to participate in any particular investment or trading strategy. They are for informational purposes only. ASA gathers its data from sources it considers reliable. However, ASA makes no express or implied warranties regarding the accuracy of this information or any opinions expressed by the author and may update or change them without prior notification.