Elm

Elm Partners Q4 2018 Report – Separately Managed Accounts

Active Index Investing®

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

Review of 2018 Performance

In our 2017 year-end investor letter, we discussed how unusual it was that equities experienced positive returns for every month of 2017. Unfortunately, this past year is a lot less unusual. Global equities were up for seven and down for five of the past twelve months, with the downs outweighing the ups. The actual return of your Fidelity account(s) will vary depending on the timing of your contributions and withdrawals, and the individualized management of the account. For Separately Managed Accounts in our Balanced strategies with no activity in 2018, the average full-year return was -3.9%, with 95% of individual-account returns ranging from -4.4% to -3.5%. Our dynamic asset allocation driven by Value and Momentum outperformed the static-weight Baseline portfolio by about 3.8% with 22% less variability of monthly returns.

In 2017, a year of strong equity performance, Balanced accounts had an average allocation to equities and other risk assets of 81%, while in 2018, Value and Momentum combined to make the allocation considerably more defensive, averaging 55% in risk assets, and finishing the year with just 41% in risk assets. With all risk assets except REITs currently exhibiting negative Momentum, the impact of the market going down from here would be to buy more risk assets as valuations improve. In the other direction, global equity markets would need to go up by over 10% in the near term for Momentum to flip positive thereby causing an increase in our desired allocation to risk assets. In sum, Momentum continued to be an effective driver of our dynamic asset allocation in 2018, as it was in 2017, but this past year Value also helped.

Annual Review of our Investment Approach

We perform an annual review of our investment approach, and the outcome this year is a plan to modify the Value metric for equities.[1] For the past seven years we have used the Cyclically Adjusted Earnings Yield as our Value metric. Our new metric will be the spread of the Cyclically Adjusted Earnings Yield over the ten-year Treasury Inflation-Protected bond (TIPS) real yield, to provide a forecast of the asset class's return in excess of the long-term risk-free real rate. We impose a high threshold to changes in our framework, as we worry about such changes allowing subjective views to subtly enter our systematic investment approach. However, after much reflection and discussion with some of our investors, we believe this is a change worth making. It is both more intuitively appealing and more theoretically sound to use an estimate of the excess return of equities over a risk-free investment benchmark.

In practice, the change entails subtracting the real yield of the ten-year TIPS from the earnings yield of equities and comparing that to a new centering point 2% below what we have been using. We believe that US government ten-year TIPS represent the best single benchmark available for the long-term real risk-free rate, but we will be ready to adjust the benchmark if it fails to give us an objective signal - for example, as could occur if the US Treasury stopped issuing TIPS. We will also be reducing the centering point for TIPS and other fixed income buckets to a 2% real yield from the 2.5% we have been using, to maintain consistency and to be more in line with the realized average one-year real rate of just under 2% since 1950.[2]

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[1] And REITS too. For REITS, we use dividends rather than earning for the cyclically adjusted yielded measure.

[2] As per the dataset provided by Professor Robert Shiller: http://www.econ.yale.edu/~shiller/data.htm.

To give you a more specific sense for the impact of this change let's look at the case of Broad US Equities. The earnings yield of US equities is currently 4.08%, which is 38% lower[3] than the 6% we use as the centering point at which we would want to have our Baseline exposure to US equities. Hence currently our desired allocation to broad US equities would be 38% below our Baseline allocation, ignoring the impact of momentum. With our new Value signal based on excess return, we subtract the ten-year TIPS yield, which is currently 0.97%, from the earnings yield and then compare that to the new centering point of 4%. This gives us a desired deviation of 25% below our Baseline. If we made this change at the end of December, it would have resulted in our desired allocation to risk assets in Balanced accounts being about 10% higher than resulted using the previous form of our Value metric. Our plan is to implement this change in stages by the upcoming March 5th scheduled portfolio rebalancing. We value your feedback, so please be in touch if you would like to discuss this change.

Donor-Advised Funds

In other news, we are very pleased to start working with Fidelity's charitable arm as a manager of donor-advised funds through their Separate Account platform. We expect to be able to begin managing donor-advised funds at Fidelity in the first quarter, and we'd love to discuss this with you if you have, or plan to set up, a donor-advised fund. Also, as we reported about a month ago, we have launched an All-Equity program which is available in the form of a Separately Managed Account at Fidelity.

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

Global Taxable Balanced
Global Non-Taxable Balanced
Global US/UK Balanced
All-Equity Strategy

With best wishes for the new year,

Victor and James

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[3] More specifically, it is 38% below in log-space, i.e. $\ln(4.08/6) = -0.38$.