

OWNING APPLE...AND SO MUCH ELSE

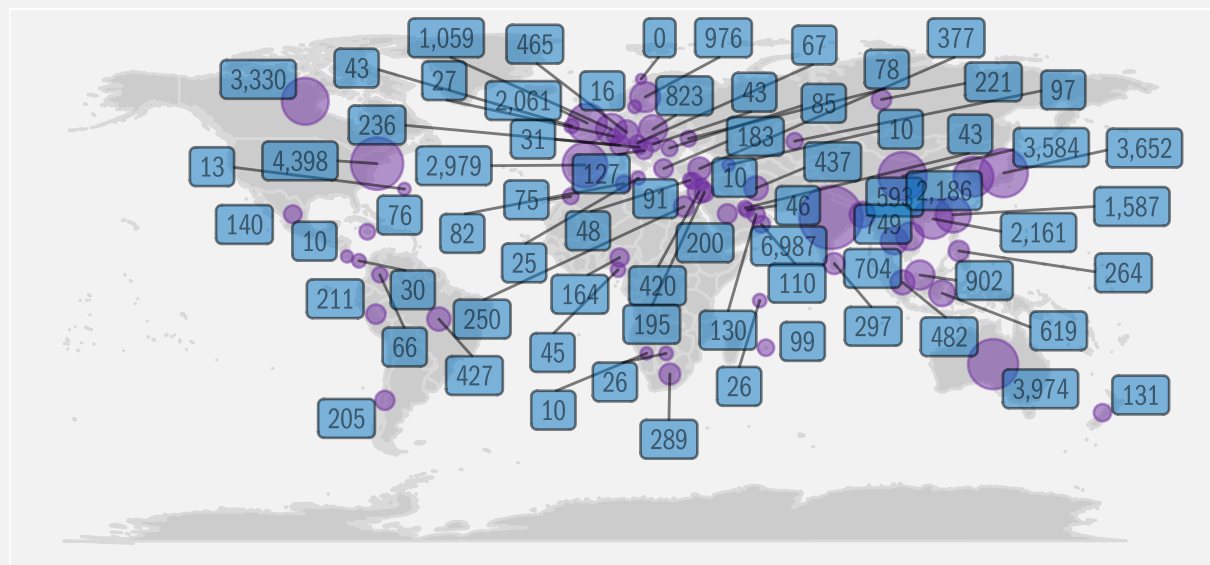
We continue to believe that, based on our experience and that of the broader industry, a focus on individual stocks and the stories they present at best has a neutral effect on portfolio performance, relative to the market in general. Stock picking, in our view, may even lead to worse-than-optimal outcomes for investors. Far more powerful, we think, is a focus on types of stocks. That is, we seek to establish favorable investment prospects based on commonalities across stocks, rather than the idiosyncrasies of each. Such statements often lead to a bit of head-scratching, so we thought we'd dive a bit deeper in this month's commentary.

Stock Picking's Senseless Energy

A debate rages on within investment circles regarding the value of investment smarts. That question boils down to, "Does it matter which stocks I buy?" We think the answer is a yes, but with a qualification. To us, "which" is less meaningful than "how" one chooses among the stocks to buy. Our preferred method is to tap into the same thinking that seems to drive interest in individual stocks—the belief that owning a particular company's shares will allow the portfolio to beat the market—without incorporating the corollary potential for disappointment when our estimations about the future prove widely off mark. Instead of attempting to divine which specific companies will "win" over time, our approach focuses on characteristics of stocks that, as a group, can be seen to have been the basis for better-than-benchmark performance.

Figure 1: Number of Domestic Stocks Traded on Exchanges by Country

There are at least 50,603 domestic stocks traded on various exchanges around the world.



Domestic Stocks ● 250 ● 500 ● 750 ● 1000

As of 12.31.18. Tallies represent listings of domestic stocks for each respective country. SOURCE: SRCM using data from The World Federation of Exchanges

Forest >= Trees

But first, why not pick individual stocks? Isn't it important to have an opinion on how well Apple's new services will fare in the video market? Or whether its News+ service will hammer another nail in the publishing industry's coffin? How about whether upcoming electric vehicles from Volkswagen Group will lead to even leaner times for Tesla? Do brick-and-mortar retailers stand a chance against Amazon.com over the long term? With certainty we believe the answers to all those questions are impossible to know in advance.

Of course, we have thoughts on them all. Apple's video services may well prove interesting enough to a sufficient number of viewers that the service gains traction. And News+ may further commodify print publishing. Volkswagen's upcoming offerings, in particular those from its Audi and Porsche divisions, are likely to more than just dent buyer attraction to the Tesla's already aging platform, as may the offerings from other domestic and European car builders. And we figure that while some retailers will continue to fall away due to increased competition from online retailers, a great many of those companies that so far have managed to stay in business may continue to live on, may perhaps even thrive.

So that's what we think. But, to take those ideas and fashion buys and sells against the various players would miss by far the more important aspect of investing: the price at which we are to buy and sell the respective shares of those companies. See, we might think that Apple's subscription services could gain substantial traction. But with more than \$260 billion in trailing 12-month revenue across all its businesses, we have a hard time believing even grand acceptance will greatly alter Apple's sales. And building out those services is likely to cost a great deal of money...perhaps far more than the revenue they'll generate in the near and medium terms. The net impact on earnings is what we're looking for here, because that potential future earnings generation is the primary reason we'd be buying or selling those shares, which essentially represent a claim on the company's assets and the future earnings potential those assets represent.

We're already now far down a rabbit hole, though. Think back to all the required estimates we just established. First, we have to guess what services Apple eventually will offer. We also must guess what they'll cost to provide and how much revenue they'll generate. Then we must estimate the competitive response. And that's just for the as-of-yet only imagined video services. Throw into the mix a range of assumptions regarding the company's hardware offerings (computers, monitors, phones watches, speakers, etc.), as well as its other service offerings (music, both downloads and streaming services). We then must iterate such estimates far into the future. We then must decide whether the \$195 or so per share we would be required to pay for those shares as we were writing this commentary are more or less appropriate for the future we just predicted.

But, wait! We would be remiss only to perform such calculations for Apple. How about all the competitors for each of those devices and services? Certainly, that list is rather long. Now do we think that the \$195 is appropriate? And, yet, there's still more! There are lots of other technologies to review. And non-technologies to review. We can't simply look at Apple's rather narrow slice of technology in a vacuum. How about, well, vacuums? And refrigerators, the auto industry, paper making, toys and games, home and building construction, retailers for construction materials, consulting firms, airlines...we could go on... Let's be sure,

too, to look not only at companies here in the U.S., but all around the world. Note the total number of stocks traded around the world in Figure 1. Better get to work...

To be fair, perhaps with a large-enough team we could devise all such assumptions. In fact, we think that team already exists in the form of the market itself. The world of investors—everyone, like us, making investment decisions—already has voted. And they’ll vote again. Those votes already are incorporated into the respective prices of all companies presently traded on equity markets around the world. They reflect estimations regarding private companies, too. And the influence of existing and potential government action and inaction. Stocks prices, then, are the best estimation of what the future might bring.

May be Smart, But Not Smarter

The upshot is that our thoughts about the future, if we may be so candid, may not ultimately overlap much with the future as it arrives. Of course, we are happy to offer our thoughts where we have them. But we’d rather be honest in acknowledging crystal balls yet do not exist, and that our opinions are only just that.

Let’s then accept that we cannot know which and to what extent individuals companies will succeed and fail. Even so, since we’d rather catch as many of the winners as we can, while understanding that their benefits to our portfolios likely will outweigh the detriments from any of the failures (from Diversification 101, one only can lose 100% of an investment in a stock; gains, theoretically speaking, are potentially infinite), we frankly would rather own just about all the stocks out there. That leaves how much to own of each as the primary question to be answered.

Many in the investment world believe that one should buy all stocks in proportion to their existing size as measured by market capitalization (number of shares outstanding times the market price of those shares) relative to all other stocks. If the market value of Stock X is 1% of the market value of all stocks in the world, 1% of the fund’s allocation to stocks in a portfolio should be allocated to Stock X. This approach can be defined as “passive” in that the methodology accepts that the market perfectly reflects the thoughts of all investors and that the investment decisions of all investors, as a group, are the best ones. Related investment approaches therefore seek to passively replicate the performance of the broader equity market.

Still Room for a Faster Run

We think such an approach is a great place to start. As we note in the first bit of our investment philosophy, “Capital market prices reflect collective investor expectations for the potential risks and returns inherent to all investments. This crowd-sourced wisdom leaves little room for incremental gain over the aggregate performance of similar securities.”

Again, we think that’s a great place to start. But we also believe there’s potential additional gain to be found, expressed in the second part of our investment philosophy: “Nonetheless, certain investment characteristics have shown to support greater-than-average returns over time. We believe portfolios built to favor these characteristics, while emphasizing portfolio diversification within and among a diverse range of asset classes, have the potential to create the optimal experience for our clients and partners.”

These investment characteristics include: smaller companies, less-expensive companies and more profitable companies. Importantly, though, we do not invest in such companies to the exclusion of other sorts. And that’s because, despite having proved an observable source of incremental total return in the historical data across equity markets here and abroad, those characteristics don’t always provide outperformance over the short term (please see our 2018 year-end Market Review for more details). Instead, we “tilt” our portfolio to emphasize those characteristics. In Figure 2, we show just what such tilts look like in one of the funds we utilize to provide exposure to U.S. stocks in our portfolios.

Figure 2: Fund Composition, Versus Broader Market, by Exposure to Size and Value

We think expanded exposure to smaller and less expensive stocks taps into many reasons folks often cite for thinking individual stocks might outperform, without the potential greater downside risk individual companies may present.

DFA US Core Equity 1 Portfolio				iShares Russell 3000 ETF			
	Value	Blend	Growth		Value	Blend	Growth
Large	20%	20%	20%	Large	24%	24%	28%
Mid	9%	9%	8%	Mid	6%	6%	6%
Small	5%	5%	4%	Small	2%	2%	2%

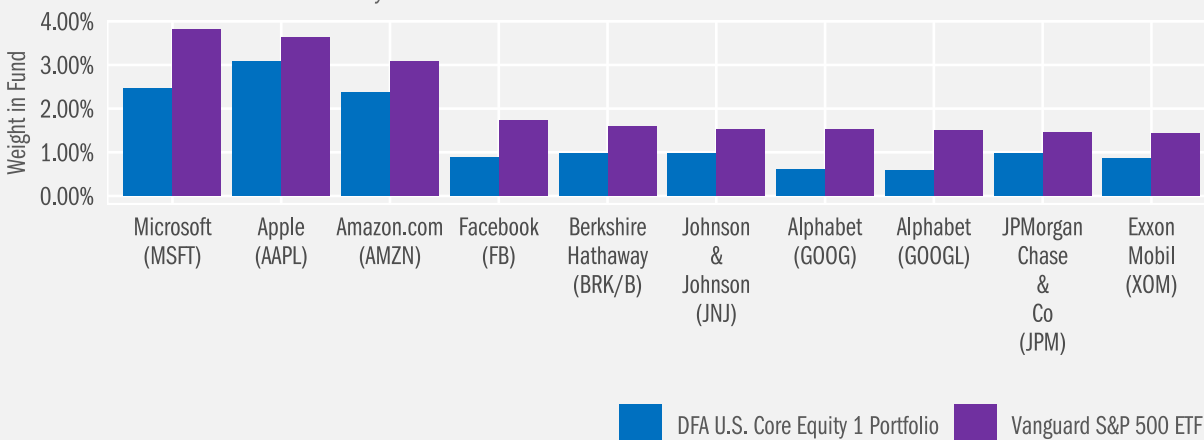
As of 12.31.18. Blue (Grey) denotes over- (under-) weight vs. the index in that particular style segment. Index data derived from holdings of exchange traded fund that tracks the index: iShares Russell 3000 ETF. SOURCE: SRCM using data from Morningstar

Readers should note, though, that the fact that we tilt exposures, overweighting small, cheap and more profitable, while underweighting large, expensive and less profitable, means that we likely have some manner of exposure to stock ideas making the rounds on financial TV, at the office water cooler and on cab rides to the airport. Apple? It’s there. Amazon? Check. We just do not own as much of those companies as one might were one just to buy them in a passive portfolio. To give a sense of those underweights, Figure 3 shows the top ten holdings as of the end of February for the S&P 500 (using a fund that seeks to track the performance of that index as a proxy for the index weights), compared to the weights of those same stocks in a fund we use as one of several for domestic equity exposure.

Readily apparent even in that mix of weights is that some stocks are much more underweight than the others. Since they all are large-cap stocks (being the 10 largest by market capitalization companies traded in the U.S.), they all would be underweight, given a tilt toward smaller-cap stocks. Differences within that group in their relative underweights then can be further attributed to the respective relative values each represents across all stocks, as well as their respective relative profitability.

Figure 3: Top 10 Holdings of S&P 500 and Corresponding Weights in Comparison Fund

While the S&P 500 can be seen as a passive exposure to the broader large-cap U.S. equity market, here represented by a fund that seeks to mimic the performance of that index, we prefer funds that tilt exposures to smaller, less-expensive and more profitable stocks. Still, we generally maintain some level of exposure to all companies within the S&P 500 and many more.



As of 02.28.19. Funds shown are for demonstrations purposes only. They are not presented as a recommendation to purchase or sell. Mutual fund holdings are subject to change. The DFA U.S. Core Equity 1 Portfolio is an open-end fund incorporated in the USA. The Fund seeks long-term capital appreciation. The Fund invests in a diverse group of common stocks of U.S. companies with an increased exposure to small capitalization and value companies relative to the U.S. universe. The Vanguard S&P 500 ETF is an exchange-traded fund incorporated in the USA. The ETF tracks the performance of the S&P 500 Index. It invests in all 500 stocks that comprise the index. SOURCE: SRCM using data from Bloomberg

“It’s in There!”

We like the idea that we can point to our portfolios and suggest just about every stock someone might name has some level of representation. We like even more that we can say our portfolios evolve to emphasize the relative greater expected return that certain types of stocks within the portfolios represent, versus the market as a whole. And finally, we like to point out that we can offer such sophistication at a level of cost that we find puts our portfolios in a highly competitive position with most similar investment solutions.

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The S&P 500 Index measures the performance of the large-cap segment of the U.S. equity market.

One cannot invest directly in an index. Index performance does not reflect the expenses associated with the management of an actual portfolio.

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