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Spotlight Focus

Smart Beta vs. Smart Investing

One fashionable investment strategy today is "smart beta." Combing through as much data as possible, smart beta funds look for financial metrics which indicate stocks' likelihood of outperforming other stocks. While the quantitative studies don't always agree (WSJ, 5/11/17), many studies have shown that value, price momentum, market capitalization, and level of capital spending are factors associated with outperformance. We, too, can and do consider these attributes, among others, when constructing and adjusting client portfolios.

The way we see it, however, quantitative investing has some shortcomings. These quantitative studies are compiled over a large number of stocks. Virtually uninvestable penny stocks account for 3% of stock market value but 60% by number of listings (WSJ, op. cit.), rendering many of the quantitative studies moot. Even after screening for minimum levels of liquidity, the favored attributes give investors only a slight statistical edge over stocks without the attributes. To reap the benefit of the strategy overall therefore, an investor must play a numbers game, buying a large number of stocks. Because the stocks which screen attractively for a particular factor are continually changing, smart beta funds are continually turning over their portfolios, generating high transaction costs and significant capital gains taxes.

As you know, we believe investors are best served by buying high quality stocks benefitting from secular growth trends and holding them for long investment horizons. Quality as a stock attribute has greater durability than value or momentum. A long investment horizon means holding stocks regardless of popularity. We are also mindful that the popularity of smart beta funds can drive up the prices of stocks with sought-after quantitative attributes, making them more attractive at times than others. Only by following a company's unique fundamentals is it possible to determine when is a good time to buy or sell that particular stock. We may only make changes when valuations become extreme or when other changes to an account necessitate trading.

Finally, we look for fundamental factors which don't necessarily show up in quantitative screens. We look for companies with competitive advantages, differentiated growth opportunities, and savvy management teams. We narrow the number of stocks we follow so that we remain focused on the stocks you own and know them well. It is a disciplined approach to assure that your portfolios appreciate over the long term.

We know that you are the most valuable business development tool that we have. Your referral of a friend, colleague or family member to us is the most important way that we grow.

We thank you for your support and want you to know that we are dedicated to serving your best interests.

William H. Darling, Chairman & President
Adrian G. Davies, Executive Vice President

The Death of Inflation

Adrian G. Davies

The US stock market had a robust first half. Following on the rally which ensued after the Presidential election, the S&P 500 Index returned 9.3% for the first six months this year. Stocks rallied even though Trump Administration agenda items of health care and tax reform have been pushed out. The Administration has been more successful deregulating. First quarter S&P 500 Index constituent earnings surprised with 14% year-on-year growth,[1] at least partially due to depressed earnings in the year-ago period. We expect earnings growth to continue to be healthy for the rest of the year, albeit at a lower rate than 14%.

Since the financial crisis ended eight years ago, the US economy has seen mostly steady if modest growth, about 2% per year. Many economists expect GDP growth to continue in the 2% range with low inflation. Fiscal and regulatory policy changes could accelerate growth, but these have been slow in coming. Against this backdrop, the Federal Reserve is continuing its efforts to normalize interest rates. Having first raised the Federal Funds rate by 25 basis points (0.25 percentage points) in December 2015, the Fed has followed on with additional 25 basis point increases in December 2016, March, and June. The Federal Funds rate stands between 1.00% and 1.25%. The Fed is guiding to one more rate hike this year, followed by additional hikes next year. Furthermore, the Fed has proposed reducing the size of its balance sheet, an endeavor which could have a comparable effect to raising interest rates.

Through the various quantitative easing programs the Fed employed in the wake of the financial crisis, the central bank has added more than $3.6 trillion in bonds to its balance sheet since 2008. As these bonds have matured, the Fed has been reinvesting the proceeds into new bonds so as to keep the newly issued money available for circulation. The Fed is currently proposing to trim the nation's money supply by allowing the bonds on its balance sheet to mature without replacing them. Beginning in September, the Fed is proposing to allow up to $10 billion worth of bonds to mature per month without rolling the proceeds into new bonds. The Fed would subsequently ratchet up its bond run-off program every three months by $10 billion per month, allowing up to $50 billion bonds to mature per month. The Fed has not specified how long it anticipates the program to run, or by how much it expects to reduce its balance sheet. Fed Governors are trying to set a course which allows for appropriate tightening of monetary policy without tightening too quickly. Since our monetary policy is in uncharted waters, it is doubtful that there is much scientific rigor which can be applied to the process. By comparison, QE3, the longest of the Fed's quantitative easing programs, bought $85 billion of bonds per month.

The Fed didn't feel comfortable raising rates more than 25 basis points in either 2015 or 2016. Why is the Fed pursuing more aggressive monetary policy this year? The global economy has largely recovered from the financial crisis and Great Recession of 2007-2009, but interest rates haven't. In fact, real short term interest rates in the US are negative, calculated by subtracting the rate of inflation from nominal interest rates. Inflation hasn't recovered to what it was before the downturn either. Rates elsewhere in the world are negative in absolute terms, although this is not a new development in 2017.

Because interest rate changes can take up to 18 months to affect the economy, Fed Governors feel the need to anticipate changes to the economic outlook and to set rates accordingly. We don't know yet what the full economic impact of the last three rates hikes will be. In the context of modest economic growth and inconsequential inflation, the Fed's communicated intention to continue raising rates seems aggressive. Long term interest rates have actually declined, with the 10-year US Treasury yield falling from 2.44% at the start of the year to 2.30% by mid-year. Lower long term rates suggest that bond investors don't see the inflation or economic acceleration implied by the Fed's actions. The US Dollar has also been weakening since the beginning of the year, falling 5.5% against a basket of currencies, seemingly suggesting weaker economic growth relative to the rest of the world.

A majority of the Federal Open Market Committee members seem to believe the low level of unemployment in the US – 4.4% in June – suggests that inflation will rise.

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Economists refer to the relationship between employment and inflation, and their tendency to rise and fall together, as the Phillips curve. The Federal Reserve Act of 1977 effectively codified the Phillips curve into the Fed's charter, providing the central bank with a dual mandate of using monetary policy both to stabilize the general price level and to maximize employment.

Recent unemployment and inflation data have fallen out of the range explained by the Phillips curve. Despite the low unemployment rate, the core Personal Consumption Expenditure Price Index (PCE) excluding Food and Energy, which is the Fed's preferred measure of inflation, remains below the Fed's 2% target, coming in at 1.4% in June, having fallen over the last few months. Wage inflation of 2.3% has also disappointed, remaining below where it's been whenever unemployment has reached these levels in the past.

There's no clear reason why the relationship between employment and inflation has broken down, or if the divergence is merely temporary. Federal Reserve Chairwoman Janet Yellen's assertion that the factors suppressing inflation are transitory speaks to the notion that employment and inflation will find some new correlation. In July, she acknowledged that low inflation may persist for longer than the Fed has been forecasting. The Fed's own forecasts for economic growth and inflation have overshot in recent years, suggesting there may be additional factors keeping inflation low this cycle.

Inflation may be tracking more in-line with modest economic growth than with the rate of unemployment. Weaker productivity has allowed employment to strengthen in the face of modest economic growth. A more ominous theory is that globalization and automation are long term deflationary forces on wages. There's a place for this theory, but these forces aren't new, and they don't explain the more recent deterioration in productivity. Another possible factor deferring the realization of the Phillips curve is that the number of low wage jobs is growing at a faster rate than the number of high wage jobs. Low wages for incremental hires may be bringing down the averages, and thus keeping a lid on wage inflation.

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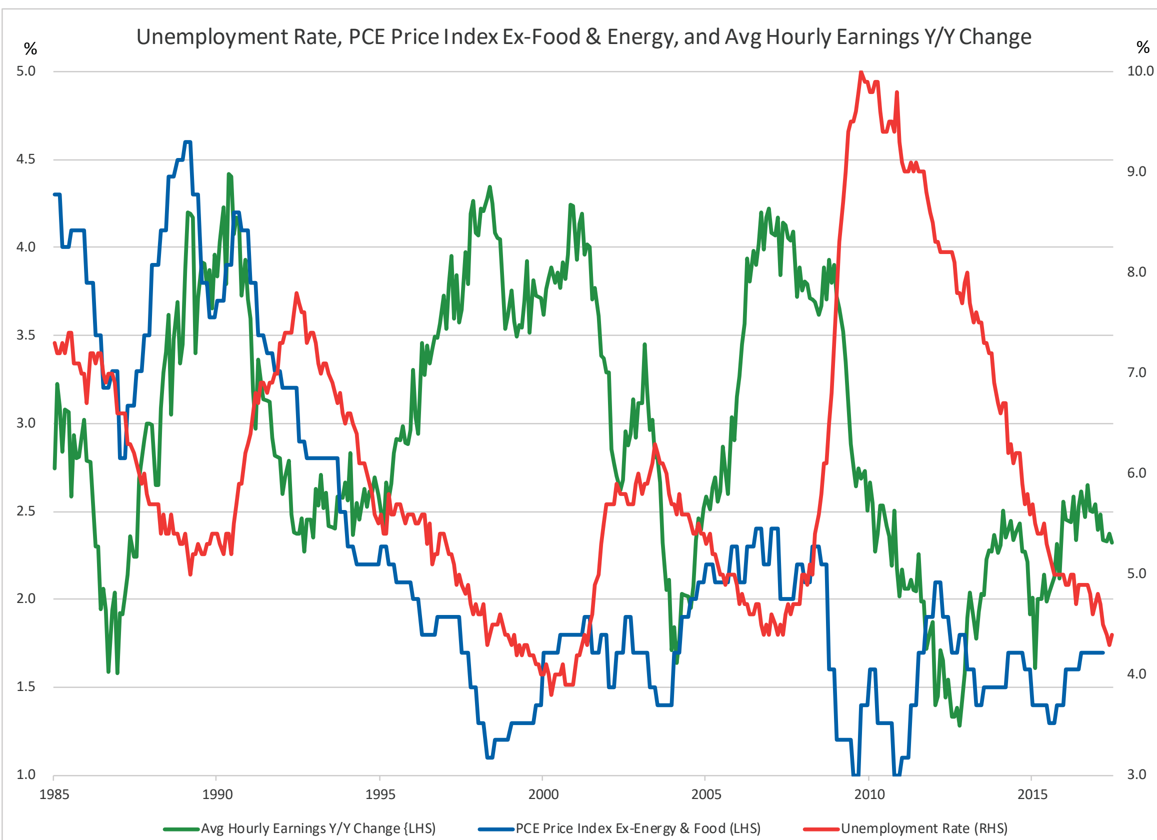

Source: St. Louis Federal Reserve (FRED)

When employment growth inevitably slows, wage pressures will become more visible. The most likely case seems to be that wage pressures and inflation eventually pick up.

Will the Fed actions hurt stock prices? The Federal Reserve's quantitative easing programs, particularly QE1, helped the stock market. It may stand to reason then that letting its bond portfolio run-off would provide a headwind for stocks. Further, both stock and bond prices have risen since the Great Recession, despite sending opposing signals. Stocks tend to rise when the economic outlook is strong. Bond prices tend to rise (yields fall) when the economic outlook is weak. Both rising in unison could be explained by quantitative easing having an effect on the general level of asset prices.

Fed Governors and those outside the Fed debate a third implied mandate for the central bank, which is to prevent asset price bubbles. Stock prices don't appear to be in a bubble, but valuations are above their historical averages. By raising interest rates now, the Fed may be trying to prevent a bubble from forming. More conservative asset prices now would reduce the possibility of a more calamitous outcome later. In a recent speech, Fed Vice Chair Stanley Fischer commented, "Elevated asset valuation pressures today may be indicative of rising vulnerabilities tomorrow."[2] But in Chairwoman Yellen's most recent testimony, she did not express any concern about elevated asset prices.

It is important to bear in mind that the Fed's rhetoric has typically been more aggressive than its actions. In part, Fed Governors test the market reaction to their ideas before moving ahead. Recall that at the outset of 2016, Fed governors indicated they intended to raise rates four times that year. After the stock market tumbled into February, they chose to raise rates only once, in December. While they may be somewhat concerned about the level of asset prices today, they remain mindful that raising rates too aggressively could upset what precious economic growth we have. We strongly suspect they are looking to the markets for guidance: they will pursue monetary tightening until they see a response from the markets.

Although the Fed's QE programs had a noticeable impact on financial markets, the direct impact on the economy has been less clear. Announcements of the programs boosted investor confidence at a time when confidence was plummeting. The turnaround in confidence probably helped to turn GDP growth positive, but the banking reserves created as a result of QE remained largely at the Federal Reserve in the form of excess reserves. Commercial bank excess reserves currently comprise \$2.1 trillion in liabilities of the Fed's \$4.5 trillion balance sheet.[3] To the extent that these reserves didn't go into the economy, the act of withdrawing them may have only a limited effect on the economy. And the impact on confidence is not linear. If the economy remains strong, the gradual withdrawal of QE could have an inconsequential impact on the economy.

Central banks around the world have embraced quantitative easing even more aggressively than the US Federal Reserve. The Fed's balance sheet is relatively modest, at 24% of US GDP, compared to the European Central Bank's (ECB's) balance sheet, which is 38% of European GDP; the Bank of Japan's balance sheet, which is 91% of Japanese GDP; and The People's Bank of China's balance sheet, 42% of Chinese GDP. The European Central Bank is still buying €60 billion of bonds per month, down from €80 billion last year. The ECB's quantitative easing program is currently due to end in December, although the program will likely be extended on a reduced basis in order to avoid a monetary cliff. The Bank of Japan has planned to purchase ¥80 trillion (\$700 billion) in bonds per year, and pledged to keep the Japanese Government 10-Year Bond at a yield of 0%-0.10% by buying bonds trading below that price level. The Japanese central bank already owns 40% of the country's government bonds.[4] Despite all this aggressive easing, Europe and Japan both remain below the inflation levels targeted by their central bankers.

Interest rates among the major developed nations tend to move together, so changes in monetary policy in one region affect the others. When taken together, it is important to note that the world's central banks are still easing on a net basis. If other central banks stop buying sovereign

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bonds, it would reduce the downward pressure on US Treasury yields.

Another important factor for the development of monetary policy is that President Trump will reshape the US Federal Reserve's Board of Governors. Three of the seven seats on the Fed's Board of Governors are currently vacant. President Trump has nominated one candidate, Randal Quarles, and may also nominate Gary Cohn, current head of the President's National Economic Council. Janet Yellen, whose term as Chairwoman expires in February, Stanley Fischer, and Lael Brainard are three Fed Governors who may choose not to stay under a different Federal Reserve regime. Fed Governor Jerome Powell, a Republican, is the most likely to stay. As of now, we know little about what President Trump's monetary agenda might be, although he has said he is in favor of low rates.[5]

We should be encouraged that the current Fed has enough confidence in the country's economic outlook to raise interest rates and start winding down its balance sheet.

There are two scenarios under which inflation could rise: either if economic growth reaccelerates, or if employment growth of low wage workers slows. Faster inflation could warrant additional rate hikes. The Fed is leading other central banks, which will likely stop easing gradually and eventually start tightening.

The withdrawal of monetary support could also mean market volatility picks up from its current low level. We are confident not only that Woodstock's investment management team will help clients to navigate the market's volatility adroitly, but that the high quality management teams of your investment holdings will also take advantage of changing market conditions to improve shareholder returns. The title of this article references a BusinessWeek Magazine front page article, "The Death of Equities," which ran on August 13, 1979. It would be another three years before equities bottomed and then embarked on an eighteen-year bull market run. Such changes are epochal. Feel free to discuss with your portfolio manager how your portfolio(s) can be best positioned to outperform under different economic conditions.♦

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1 FactSet

2 https://www.federalreserve.gov/newsevents/speech/files/fischer20170627a.pdf

3 https://www.federalreserve.gov/releases/h3/20170629/

4 Bhattacharya, Suryatapa, "Bank of Japan Punches Down Bond Yields," Wall Street Journal, 7/7/17.

5 Davidson, Kate, "Cohn and Yellen Are Among Trump's Contenders to Lead Fed," Wall Street Journal, 7/25/17.

Spotlight Focus: Sewpportive Friends

Maureen J. Murphy

While many of us spent our summer vacation recharging our batteries at the beach or lake, or sightseeing in Europe or the United States, our colleague Julie Phippen, Executive Assistant at our sister company Agawam Trust and Management, had something else in mind. Julie, along with a group of eight, headed to rural areas in Zimbabwe to continue to spread the good works of Sewpportive Friends, a 501(c)(3) non-profit and grassroots organization Julie founded in May 2016. Sewpportive Friends is an organization dedicated to health, education and gender equality for young women in rural Zimbabwe who do not have access to feminine hygiene products. Spotlight Focus (SF) recently sat down with Julie, just back from a two-week mission trip to Zimbabwe, to talk about the Sewpportive Friends organization she founded and how addressing this simple, basic human issue allows young women to get the education they need, giving them promise of a brighter future.

Spotlight Focus: How did you come up with the idea for creating Sewpportive Friends?
Julie: My first trip to Africa in 2013 was magical. As a young girl, my grandfather, who was a missionary that traveled to Africa often, would tell me stories of a land far away, filled with special people, unusual animals and amazing landscapes. That first trip to a continent I had only read about, seen pictures in National Geographic and dreamt about someday visiting, changed my outlook on life. I had packed supplies for remote schools in rural Zimbabwe, that didn't

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have enough funding for basics such as pens, pencils, notebooks and erasers. It was during subsequent trips that I learned young girls not properly equipped for their menstrual cycle aren't allowed to attend school. Buying manufactured products is not an option for them. Without proper hygiene, these girls miss significant amounts of school, most often are forced to repeat grades, and many drop out of school altogether. My eyes were opened. I thought I was helping supply school basics that we all take for granted in the USA. But, it turns out that in rural Zimbabwe, there is a more primal need. Helping the young, to be able to even attend school.

SF: So this is what inspired you to create Sewpportive Friends?
Julie: Yes. I could not imagine my daughters not being able to attend school because of the lack of availability, or not being able to afford feminine hygiene products. Also, learning that the dropout rate was so high due to this crisis, was heavy in heart and motivated me to help. I researched the healthiest and most absorbent fabric to use for this purpose, created a pattern, and ordered a sewing machine.

With the support, compassion, talent and the generosity of wonderful family and friends, Sewpportive Friends was created in May 2016 and within three months, we produced and delivered 108 Wash-Pad kits (handmade, washable feminine hygiene products) for our first mission trip in August, 2016. We were able to provide hope and help for a significant number of girls in two villages in rural Zimbabwe.

SF: What kind of a reception did your 2016 Zimbabwe visits receive from the villages and girls you helped and what impact did it have on you?
Julie: With our first Sewpportive Friends trip to Zimbabwe last year, upon our arrival at the first school we visited, we were welcomed not only by the headmaster, and teachers, but also students dressed in their uniforms, and the elder men and women of the local village – this was a great honor! Our meeting began with a prayer, which was followed by kind introductions and speeches. The children then performed songs and danced for nearly two hours! The mothers and grandmothers sang and danced to end the gathering. We were presented with beautiful handmade baskets. Our second visit to another school was another truly remarkable experience. Really life changing. The celebrations of gratitude were extraordinary and will forever be in our hearts. I believe we have the ability to give back, and it is our purpose, our gift to help others no matter where they live.

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SF: And your Zimbabwe 2017 project?
Julie: After returning from our Zimbabwe 2016 mission trip, Sewpportive Friends volunteers worked harder than ever to produce over 300 Wash-Pad Kits for our Zimbabwe 2017 project. We worked hard, pushing forward to provide for these beautiful young women and their communities; they were in our thoughts and woven in every stitch we made. From Massachusetts, Vermont, New Hampshire, California, Bermuda and many places in between, we have seen compassion from dedicated volunteers and generosity of contributors, reaching out to help raise awareness for the lack of feminine hygiene products in poorer regions of the world, with the current focus on Zimbabwe.

SF: And you just returned from your second Sewpportive Friends trip to Zimbabwe?
Julie: Yes, myself and eight caring volunteers. Our 2017 summer project included not only distributing the reusable feminine hygiene products, but also all the sewing supplies needed for them to learn and sew their own feminine products, creating a self-sustainable resource and addressing this basic human need within their community. We were very excited to see the students, teachers and parents again at both of the schools we visited last year.

SF: Was the 2017 Sewpportive Friends trip to Zimbabwe all that you hoped it would be? And what's next on your journey?
Julie: The trip was an incredible success and such an emotional experience. We were welcomed with open arms and many hands that wanted to learn how to sew Sewpportive Friends items. We also had a last-minute addition to our schedule. A Zimbabwean non-profit organization reached out and asked us if we would visit a school they sponsor and teach a Sewpportive Friends sewing class to the girls and teachers. Every one that attended each of our sewing classes was full of energy, enthusiasm, and gratitude! Each gathering finished with a performance of songs of thanks and dancing.

Our goal is to continue to produce and deliver our Sewpportive Friends kits, teach sewing classes, and find more communities that are in need. We are an all-volunteer community. All directors, officers and producers are loving volunteers. No compensation is provided for their services. Any organizational expenses are provided by contributors who specifically request their donation be allocated for this administrative purpose. Knowing that 100% of donations is used to benefit those in need is an important policy for me.

Our next mission trips will be this November, and then another in July 2018. This gives time to fundraise for supplies, produce, and research other communities in need. In addition, we would love to be able to source our fabric/material for our sewing classes from suppliers in Zimbabwe and/or South Africa. I am so grateful for the support of individuals, companies and publications like the Christian Science Monitor which featured us in an article earlier this year. Raising awareness is the first step in making a change. Thank you, Maureen and Woodstock Corporation, for your kindness, interest and support of our organization.

SF: Julie, thank you very much for sharing the story of Sewpportive Friends with us. It is extremely humbling and inspiring.

"The meaning of life is to find your gift. The purpose of life is to give it away." These are the words of Pablo Picasso, which are so appropriately included on the website for SEWPPORTIVE FRIENDS. Clearly, Julie Phippen appears to have found her gift and she tirelessly channels her heart and energy in giving back. We at Woodstock are extremely proud of Julie, and also of her volunteers! To learn more about SEWPPORTIVE FRIENDS, or to see how you may help, we invite you to visit the organization's website: www.sewpportivefriends.org.

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