

INVESTMENT UPDATE

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Saltmarsh

Financial Advisors, LLC

AN AFFILIATE OF SALTMARSH, CLEVELAND & GUND

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Return Not Done Yet?

Due dates for filing
extended tax returns are
10/2 for trusts and 10/15
for individuals.

Please contact your tax
advisor with any questions.

Getting What You Don't Pay For

Costs matter. Whether you're buying a car or selecting an investment strategy, the costs you expect to pay are likely to be an important factor in making any major financial decision. People rely on a lot of different information about costs to help inform these decisions. When you buy a car, for example, the sticker price tells you approximately how much you can expect to pay for the car itself. But the sticker price is only one part of the overall cost of owning a car. Other things like sales tax, the cost of insurance, expected routine maintenance costs, and the potential cost of unexpected repairs are also important to understand. Some of these costs are easily observed, and others are more difficult to assess. Similarly, when investing in mutual funds, different variables need to be considered to evaluate how cost-effective a strategy may be for a particular investor.

EXPENSE RATIOS

Many types of costs lower the net return available to investors. One important cost is the expense ratio. Similar to the sticker price of a car, the expense ratio tells you a lot about what you can expect to pay for an investment strategy. **Exhibit 1** on the following page helps illustrate why

expense ratios are important and shows how hefty expense ratios can impact performance. This data shows that funds with higher average expense ratios had lower rates of outperformance. For the 15-year period through 2016, only 9% of the highest-cost equity funds outperformed their benchmarks. This data indicates that a high expense ratio is often a challenging hurdle for funds to overcome, especially over longer horizons. From the investor's point of view, an expense ratio of 0.25% vs. 0.75% means savings of \$5,000 per year on a \$1 million account. As **Exhibit 2** helps to illustrate, those dollars can really add up over longer periods. While the expense ratio is an important piece of information for an investor to evaluate, what matters most when gauging the true cost-effectiveness of an investment strategy is the "total cost of ownership." Similar to the car example, total cost of ownership is more holistic than any one figure. It looks at things that are readily observable, like expense ratios, but also at things that are more difficult to assess, like trading costs and tax impact. It is important for investors to be aware of these and other costs and to realize that an expense ratio, while useful, is not an all-inclusive metric for total cost of ownership.

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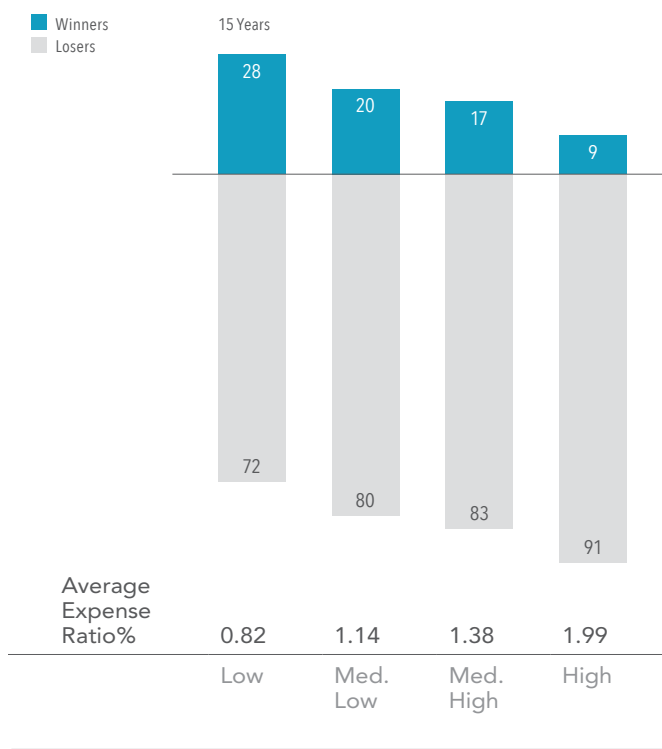


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Getting What You Don't Pay For (Continued)

Exhibit 1: High Costs Can Reduce Performance, Equity Fund Winners and Losers Based on Expense Ratios (%)



TRADING COSTS

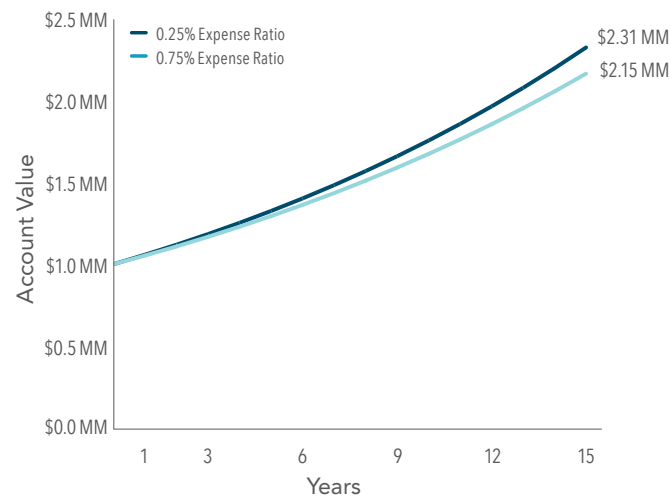
For example, while an expense ratio includes the fund's investment management fee and expenses for fund accounting and shareholder reporting (among other items), it doesn't include the potentially substantial cost of trading securities within the fund. Overall trading costs are a function of the amount of trading, or turnover, and the cost of each trade. If a manager trades excessively, costs like commissions and the price impact from trading can eat away at returns. Viewed through the lens of our car analogy, this impact is similar to excessively jamming your brakes or accelerating quickly. By regularly demanding immediacy like this when it may not be necessary, the more wear and tear your car is likely to experience and the more fuel you will end up using. These actions can increase

your total cost of ownership. Additionally, excessive trading can also lead to negative tax consequences for the fund, which can increase the cost of ownership for investors holding funds in taxable accounts. The best way to try to decrease the impact of trading costs is for funds to avoid trading excessively and pay close attention to effectively minimizing cost per trade. Employing a flexible investment approach that reduces the need for immediacy, thereby enabling opportunistic execution, is one way to potentially help accomplish this goal. Keeping turnover low, remaining flexible, and transacting only when the potential benefits of a trade outweigh the costs can help keep overall trading costs down and help reduce the total cost of ownership.

CONCLUSION

The total cost of ownership of a mutual fund can be difficult to assess and requires a thorough understanding of costs beyond what an expense ratio can tell investors on its own. A good advisor can help investors look beyond any one cost metric and instead evaluate the total cost of ownership of an investment program—and ultimately help clients decide if a given strategy is right for them.

Exhibit 2: Hypothetical Growth of \$1 Million at 6%, Less Expenses



There is no guarantee investment strategies will be successful. Diversification does not eliminate the risk of market loss. Mutual fund investment values will fluctuate and shares, when redeemed, may be worth more or less than original cost. The types of fees and expenses will vary based on investment vehicle. Investments are subject to risk including possible loss of principal. All expressions of opinion are subject to change. This article is distributed for informational purposes, and it is not to be construed as an offer, solicitation, recommendation, or endorsement of any particular security, products, or services. Dimensional Fund Advisors LP is an investment advisor registered with the Securities and Exchange Commission.

Exhibit 1: The sample includes funds at the beginning of the 15-year period ending December 31, 2016. Funds are sorted into quartiles within their category based on average expense ratio over the sample period. The chart shows the percentage of winner and loser funds by expense ratio quartile; winners are funds that survived and outperformed their respective Morningstar category benchmark, and losers are funds that either did not survive or did not outperform their respective Morningstar category benchmark. US-domiciled open-end mutual fund data is from Morningstar and Center for Research in Security Prices (CRSP) from the University of Chicago. Equity fund sample includes the Morningstar historical categories: Diversified Emerging Markets, Europe Stock, Foreign Large Blend, Foreign Large Growth, Foreign Large Value, Foreign Small/Mid Blend, Foreign Small/Mid Growth, Foreign Small/Mid Value, Japan Stock, Large Blend, Large Growth, Large Value, Mid-Cap Blend, Mid-Cap Value, Miscellaneous Region, Pacific/Asia ex-Japan Stock, Small Blend, Small Growth, Small Value, and World Stock. For additional information regarding the Morningstar historical categories, please see "The Morningstar Category Classifications" at morningstardirect.morningstar.com/clientcomm/Morningstar_Categories_US_April_2016.pdf. Index funds and fund-of-funds are excluded from the sample. The return, expense ratio, and turnover for funds with multiple share classes are taken as the asset-weighted average of the individual share class observations. For additional methodology, please refer to Dimensional Fund Advisor's brochure, The 2017 Mutual Fund Landscape. Past performance is no guarantee of future results.

Exhibit 2: For illustrative purposes only and not representative of an actual investment. This hypothetical illustration is intended to show the potential impact of higher expense ratios and does not represent any investor's actual experience. Assumes a starting account balance of \$1,000,000 and a 6% compound annual growth rate less expense ratios of 0.25% and 0.75% applied over a 15-year time horizon. Taxes and other potential costs are not reflected. Actual results may vary significantly. Changing the assumptions would result in different outcomes. For example, the savings and difference between the ending account balances would be lower if the starting investment amount was lower.

Quit Monkeying Around!

In the world of investment management there is an oft discussed idea that blindfolded monkeys throwing darts at pages of stock listings can select portfolios that will do just as well, if not better, than both the market and the average portfolio constructed by professional money managers. If this is true, why might it be the case?

THE DART BOARD

Exhibit 1 shows the components of the Russell 3000 Index (regarded as a good proxy for the US stock market) as of December 31, 2016. Each stock in the index is represented by a box, and the size of each box represents the stock's market capitalization (share price multiplied by shares outstanding) or "market cap" in the index. For example, Apple (AAPL) is the largest box since it has the largest market cap in the index. The boxes get smaller as you move from the top to the bottom of the exhibit, from larger stocks to smaller stocks. The boxes are also color coded based on their market cap and whether they are value or growth stocks. Value stocks have lower relative prices (as measured by, for instance the price-to-book ratio) and growth stocks tend to have higher relative prices. In the exhibit, blue represents large cap value stocks (LV), green is large cap growth stocks (LG), gray is small cap value stocks (SV), and yellow is small cap growth stocks (SG). For the purposes of this analogy you can think of Exhibit 1 as a proxy for the overall stock market and therefore similar to a portfolio that, in aggregate, professional money managers hold in their competition with their simian challengers. Because for every investor holding an overweight to a stock (relative to its market cap weighting) there must also be an investor underweight that same stock, this means that, in aggregate, the average dollar invested holds a portfolio that looks like the overall market.¹

Exhibit 2, on the other hand, represents the dart board the monkeys are using to play their game. Here, the boxes represent the same stocks shown in Exhibit 1, but instead of weighting each company by market cap, the companies are weighted equally. For example, in this case, Apple's box is the same size

as every other company in the index regardless of its market cap. If one were to pin up pages of newspaper stock listings to throw darts at, Exhibit 2 would be much more representative of what the target would look like. When looking at Exhibits 1 and 2, the significant differences between the two are clear. In Exhibit 1, the surface area is dominated by large value and large growth (blue and green) stocks. In Exhibit 2, however, small cap value stocks dominate (gray). Why does this matter? Research has shown that, historically over time, small company stocks have had excess returns relative to large company stocks. Research has also shown that, historically over time, value (or low relative price) stocks have had excess returns relative to growth (or high relative price) stocks. Because Exhibit 2 has a greater proportion of its surface area dedicated to small cap value stocks, it is more likely that a portfolio of stocks selected at random by throwing darts would end up being tilted towards stocks which research has shown to have had higher returns when compared to the market.

SO...THROW AWAY?

This does not mean, however, that haphazardly selecting stocks by the toss of a dart is an efficient or reliable way to invest. For one thing, it ignores the complexities that arise in competitive markets. Consider as an example something seemingly as straightforward as a strategy that holds every stock in the Russell 3000 Index at an equal weight (the equivalent of buying the whole dart board in Exhibit 2). In order to maintain an equal weight in all 3,000 securities, an investor would have to rebalance frequently, buying shares of companies that have gone down in price and selling shares that have gone up. This is because as prices change, so will each individual holding's respective weight in the portfolio. By not considering whether or not these frequent trades add value over and above the costs they generate, investors are opening themselves up to a potentially less than desirable outcome. Instead, if there are well-known relationships that explain differences in expected returns across stocks, using a systematic and purposeful

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Exhibit 1: US Stocks Sized by Market Capitalization

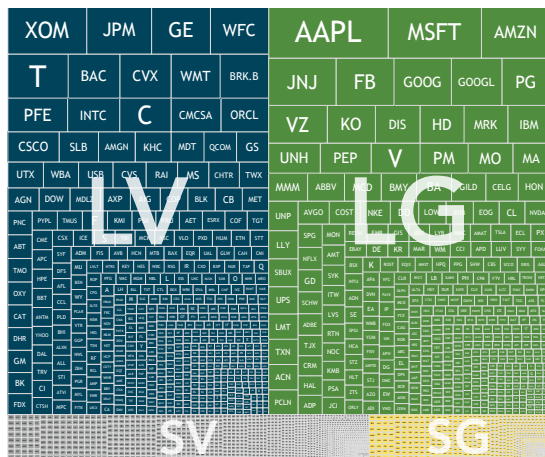
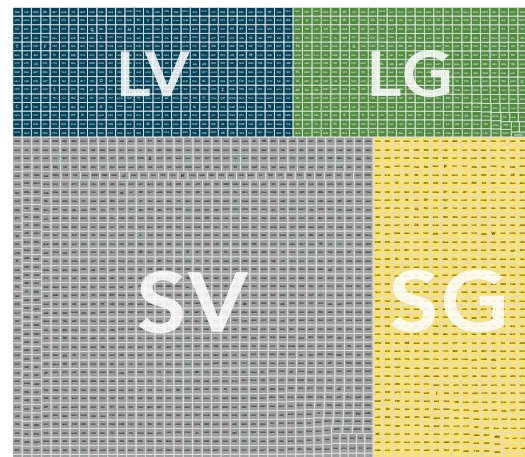


Exhibit 2: US Stocks Sized Equally



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Quit Monkeying Around! (Continued)

approach that takes into consideration real-world constraints is more likely to increase your chances for investment success. Considerations for such an approach include things like: understanding the drivers of returns and how to best design a portfolio to capture them, what a sufficient level of diversification is, how to appropriately rebalance, and last but not least, how to manage the costs associated with pursuing such a strategy.

THE LONG GAME

Finally, the importance of having an asset allocation well-suited for your objectives and risk tolerance, as well as being able to remain focused on the long term, cannot be overemphasized. Even well-constructed portfolios pursuing higher expected returns will have periods of disappointing results. A financial advisor can help an investor decide on an appropriate asset allocation, stay the course during periods of disappointing results, and carefully weigh the considerations mentioned above to help investors decide if a given investment strategy is the right one for them.

CONCLUSION

So what insights can investors glean from this analysis? First, by tilting a portfolio towards sources of higher expected returns, investors can potentially outperform the market without needing to outguess market prices. Second, implementation and patience are paramount. If one is going to pursue higher expected returns, it is important to do so in a cost-effective manner and to stay focused on the long term.

APPENDIX

Large cap is defined as the top 90% of market cap (small cap is the bottom 10%), while value is defined as the 50% of market cap of the lowest relative price stocks (growth is the 50% of market cap of the highest relative price stocks). For educational and informational purposes only and does not constitute a recommendation of any security. The determinations of Large Value, Large Growth, Small Value, and Small Growth do not represent any determinations Dimensional may make in assessing any of the securities shown.

1. For more on this concept, please see “*The Arithmetic of Active Management*” by William Sharpe.

There is no guarantee investment strategies will be successful. Investing involves risks including possible loss of principal. Diversification does not eliminate the risk of market loss. All expressions of opinion are subject to change. This article is distributed for informational purposes, and it is not to be construed as an offer, solicitation, recommendation, or endorsement of any particular security, products, or services. Dimensional Fund Advisors LP is an investment advisor registered with the Securities and Exchange Commission.

Exhibit 1: For illustrative purposes only. Illustration includes constituents of the Russell 3000 Index as of December 31, 2016, on a market-cap weighted basis segmented into Large Value, Large Growth, Small Value, and Small Growth. Source: Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. Please see Appendix for additional information.

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