"The fact is that markets behave in ways, sometimes for a very long stretch, that are not linked to value. Sooner or later, though, value counts." – Warren Buffett

The U.S. equity markets continued to grind higher in the 2nd quarter of 2017, with the Russell 1000 large cap index rising 3.06% and the Russell 2000 small cap index rising 2.46%. Since the bottom of the bear market that ended in 2009, the Russell 1000 has seen positive returns in 29 of the 34 calendar quarters while the Russell 2000 has been positive in 25 of them.

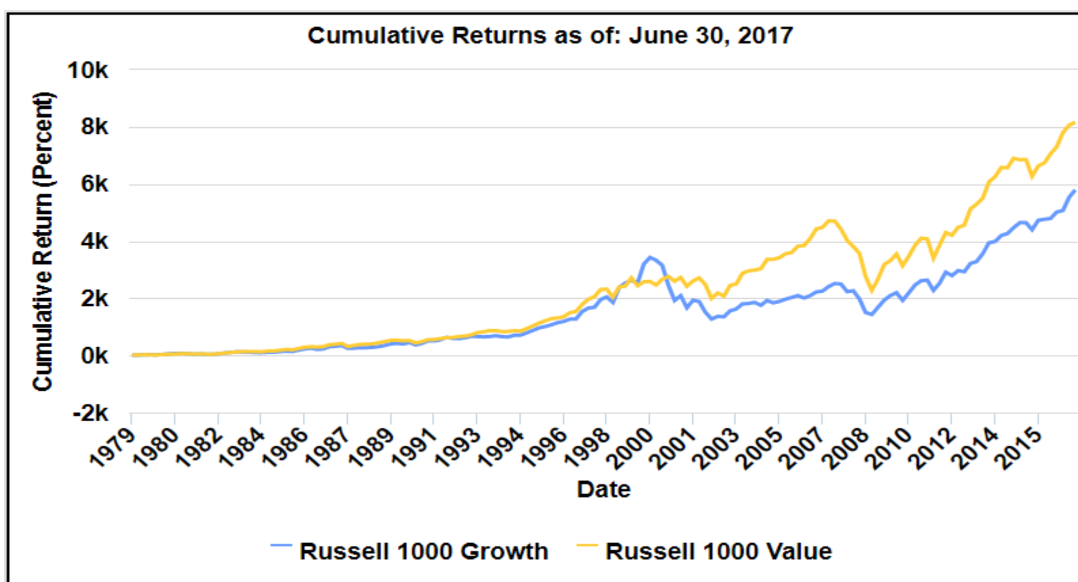
While Bowling's Small Cap Value portfolio performed well in the first half of 2017, it was a challenging environment for our Large Cap Equity and Small Cap Equity portfolios relative to the broad market benchmarks (Russell 1000 and 2000 respectively). The cause of the underperformance for these 2 portfolios is very simple: we are a value manager and growth stocks have outperformed value stocks by a historically large measure thus far in 2017. To put this into numbers, the Russell 1000 Growth index returned 14.0% for the first six months of the year while the Russell 1000 Value index returned only 4.66%! Meanwhile, the Russell 2000 Growth Index returned 9.97% in the first six months of 2017 compared to 0.54% for the Russell 2000 Value. Given the value metrics of our portfolios, it would be expected that we would underperform the broad market indices in an environment such as this. We will discuss this in much more detail later in the letter.

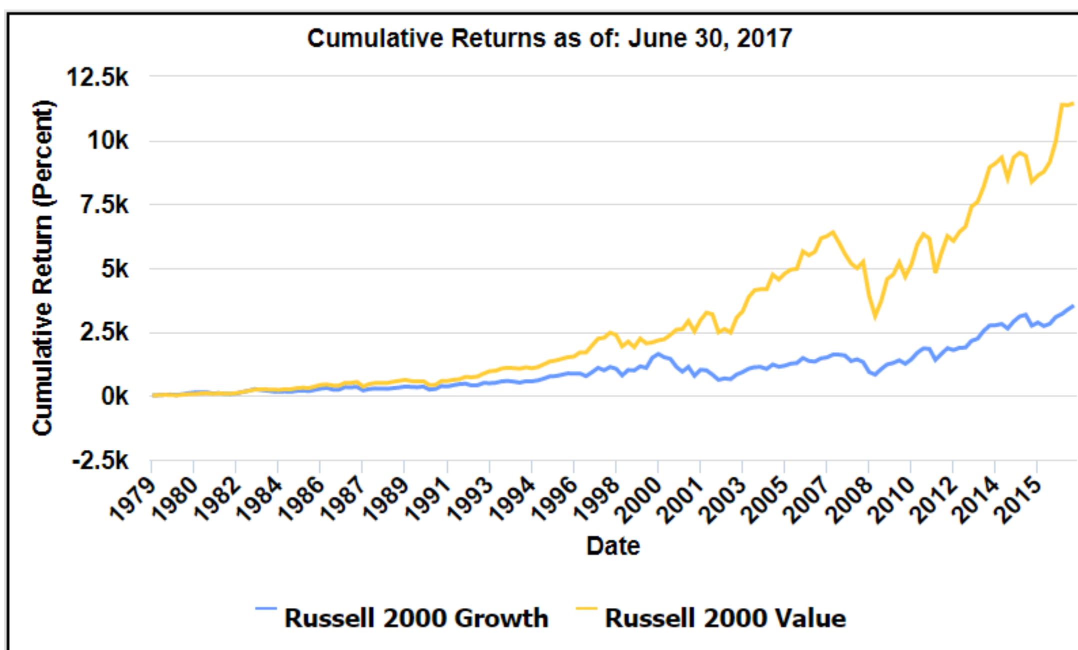
The current environment is not the first time we have seen growth stocks outperform value and it won't be the last. We saw a similar phenomenon in the late 90's which was a difficult comparison period for us, but that eventually ran its course and stock valuations began to matter again in the early 2000s. At that point our Large Cap Equity portfolio began a lengthy streak of significant outperformance versus the broad market benchmarks. We have every reason to believe that the current strength in growth stocks will run its course and valuations will begin to matter again.

As of the writing of this letter, U.S. equity markets continued to hit new highs in early July, driven by the Fed's dovish comments on inflation. The Fed is now saying that the current federal funds rate of 1-1.25% is close to what they perceive as a neutral rate, which the Fed defines as the interest rate that is neither stimulating nor restraining the economy. As little as 10 years ago the neutral rate was thought to be closer to 4%. This is a significant development for the U.S. financial markets due to the fact that all financial assets, including stocks, are priced relative to short term interest rates. If interest rates are expected to be low for a long period of time, investors are willing to pay more for other financials assets (like stocks).

Value vs. Growth

The value-based approach was first documented by Benjamin Graham in The Intelligent Investor back in 1949, a book that Warren Buffett credits as having changed the course of his life. The concept posited in The Intelligent Investor is that buying stocks that trade at a discount to the market on measures such as price/earnings and price/book (so-called Value Investing) tends to lead to outperformance over time. Both Russell and Standard & Poor's began tracking Growth and Value Indexes in 1979, with the indexes essentially being subsets of the Russell 1000 and S&P 500 respectively. The following chart shows the performance of the growth and value indexes for both the Russell 1000 and Russell 2000 going back to their inception in 1979.





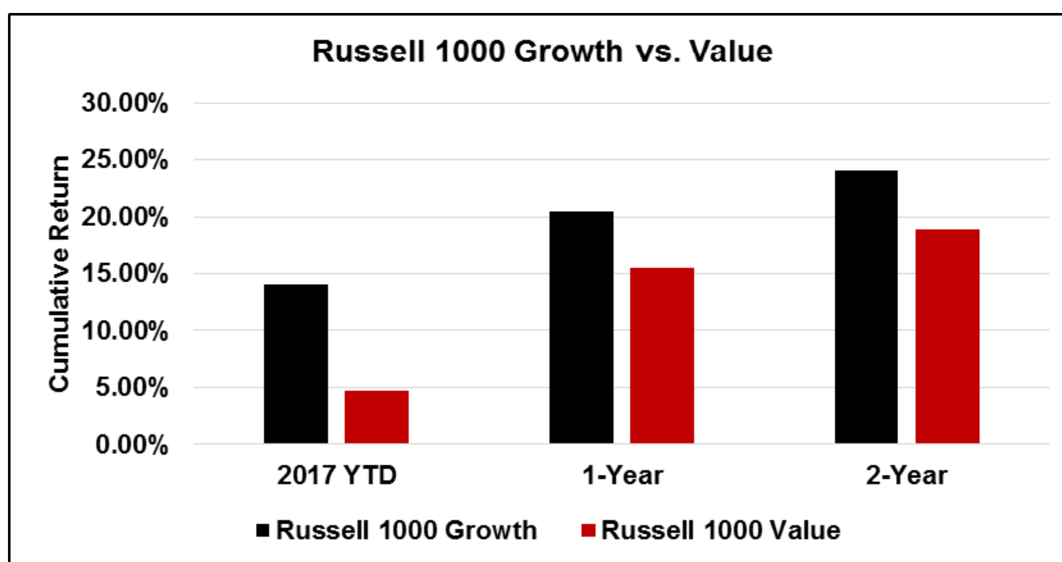
As you can see in these charts, since inception in 1979 the value indices for both the Russell 1000 (Large Cap) and Russell 2000 (Small Cap) have significantly outperformed their growth stock counterparts. For this reason, long time readers of this newsletter know that Bowling's approach to investing is rooted in value investing. The following chart shows the fundamentals of our Large Cap Equity and Small Cap Equity portfolios relative to their respective benchmarks.

	Price/Earnings	Price/Cash Flow	Price/Sales
Bowling Large Cap Equity	14.0	12.7	1.0
Russell 1000	18.2	15.0	2.0
Russell 1000 Value	16.4	10.7	1.6

	Price/Earnings	Price/Cash Flow	Price/Sales
Bowling Small Cap Equity	13.5	11.8	0.9
Russell 2000	26.1	16.3	1.3
Russell 2000 Value	21.0	11.8	1.0

Each of these portfolios is trading at a significant discount to their broad market benchmarks (Russell 1000 and Russell 2000), and have valuation metrics that are more in line with the value subsets of the indices. With respect to price/earnings ratios, both of these portfolios are actually well below the value subsets.

Unfortunately, despite having outperformed over the last 39 years, the value approach to investing does not outperform over every time period. The following charts shows the performance of the Russell 1000 growth and value indices over the last two years.



The growth subset of the Russell 1000 has outperformed the value subset substantially over the last two years. Given the value foundation of our Large Cap Equity and Small Cap Equity portfolios, this has hurt our relative performance versus the broad market indices. As stated previously, while growth stocks are having their day in the sun this is not a permanent phenomenon. We fully believe that stock valuations will begin to matter again at some point, which would be a good development for our portfolios.

Market Volatility and the Gambler's Fallacy

The second quarter (and really all of 2017 to date), saw a shockingly low number of market-moving headlines. The Chicago Board Option Exchange's S&P 500 volatility index, the VIX, hit its lowest level since 1993 on May 8th. At one point during the first half of the year, the stock market had gone 110 days without a drop of 1%, and 54 days without a 1% move in either direction. To put that in perspective, since 1962 the previous record for number of days without a 1% move was 34, and even a streak of 15 days would have put the market in the top 20 longest streaks over the last 55 years.

All of this has led to some calls that the low stock market volatility is simply the calm before the storm, and a sign of investor complacency. However an analysis of the data shows otherwise. Following the 20 longest daily streaks without a 1% market move since 1962, the market generated positive returns over the following month 65% of the time (about in line with historical averages). Over the subsequent 6 months returns were positive 83% of the time, and over the subsequent year returns were positive 100% of the time with an average return of 10.5% (slightly above the long-term average). Three years later the market was positive 92% of the time with an average cumulative return of 47%, and five years later the market was positive 82% of the time with an average cumulative return of a whopping 107%! While there are always many things to fret about in the stock market (which is why stock holders get paid more than bondholders in the long run), low volatility clearly isn't one of them.

The false perception that streaks like the ones mentioned above must have an equal and opposite reaction in the universe is what's known as the gambler's fallacy. This is one of many behavioral biases investors must overcome to be successful in the long run. The gambler's fallacy means that people tend to believe that random events must "average out", when in fact they don't. If we were to flip a coin ten times and it miraculously came up heads each time, most people would bet on tails for the 11th clip of the coin. After all, what are the odds of heads coming up 11 times in a row? In reality, the next flip of the coin would have a 50% chance of being either heads or tails. Similarly, periods of low volatility are not predictive of higher volatility in the future.

This report is provided for informational purposes only and should not be construed as a recommendation for the purchase or sale of any security nor should it be construed as a recommendation of any investment strategy. There is no guarantee that any opinion, forecast, estimate or objective will be achieved. Certain information has been obtained from sources that we believe to be reliable: however, we do not guarantee the accuracy or completeness of such information. Opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions.

PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS.

Bowling Portfolio Management LLC ("Firm") is an investment management firm serving both tax-exempt and taxable clients, offering a variety of investment management strategies. The Firm is an SEC-registered investment adviser and is dedicated to the practice of professional investment management. Bowling Portfolio Management LLC claims compliance with the Global Investment Performance Standards (GIPS®). If you would like to receive a complete GIPS compliant presentation and/or the firm's list of composite descriptions please contact Kathy Wayner at Wayner@bowlingpm.com or 513-871-7776. Performance is expressed in U.S. Dollars.

The Large Cap Equity Composite includes all discretionary, tax -exempt accounts investing primarily in large cap value equities, with account market values above $50,000. Effective January 1, 2006, closed end funds are no longer utilized in the strategy. Effective January 1, 2012, taxable accounts are no longer included in the composite. The benchmark for the firm's Large Cap Equity strategy is the Russell 1000 Index, which is an asset-weighted index of U.S. based companies that includes income but does not have any expenses.

The Small Cap Equity Composite includes all discretionary accounts investing primarily in small cap equities. The benchmark for the firm's Small Cap Equity strategy is the Russell 2000 Index, which is an asset-weighted index of U.S. based companies that includes income but does not have any expenses.

The Small Cap Value Composite includes all discretionary accounts investing primarily in small cap value equities. The benchmark for the firm's Small Cap Value strategy is the Russell 2000 Value Index, which is an asset-weighted index of U.S. based companies that includes income but does not have any expenses.