SEGALL BRYANT & HAMILL

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SBH NEWSLETTER

Thoughts on the Current Environment

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"Real learning is the ability to acquire new ideas from experience and retain them as memories. Acquiring knowledge is not real learning. It's just the first easy step in the process. Formal learning can only give us 10 percent of our learning and feedback. Coaching and sharing—learning from others—can only give us 20 percent. The other 70 percent comes from experience."

-Dr. Eric Kandel, Columbia University

A persistent theme in investment discussions remains what a reasonable expectation of long-term returns might be after eight years of rising stock prices and 35 years of falling interest rates. This is not an academic exercise. Trustees of public or private pension funds, trustees of endowment funds and parents trying to save either for college education or retirement all have to contend with this issue. As clients and long-time readers of this newsletter are aware, our bottom-up, fundamental approach to investing does not require that we have a formal opinion on top-down questions such as these. And for many clients, primarily our institutional ones, our assignment of providing a specific investment strategy rather than managing an overall portfolio does not oblige us to provide an asset allocation solution. Nonetheless, one cannot help but be aware of the waters in which one swims, and in that vein, we have some observations to share that we hope will be additive to the debate.

In this era of vast computing power, the standard approach to developing a framework for setting asset allocation is to start—as one should expect—with historical data. One compiles all the historical return series considered appropriate and runs a series of calculations designed to identify which mix of assets would have produced the highest returns and the lowest risk profile (usually measured as the standard deviation of a return series, which is a proxy for volatility). The output describes what Modern Portfolio Theory (MPT) calls the Efficient Frontier, which is the set of investments that has produced the best combination of risk and reward for a given target return.

There is no single efficient frontier that works for all portfolios. All portfolios share the attribute that they are created to produce a flow of distributions over some time horizon. No one would save, or deny themselves the opportunity to currently consume wealth, if that were not the case. One foregoes today in order to have funds to spend tomorrow. This is equally true of a pension fund, an endowment or the fund a parent saves for a child's college education. After that, of course, the differences become as varied as the colors in a rainbow (or maybe today we should say, "as varied as the colors on an iPhone"), but this underlying principle is always true. Beyond that starting point, of course, any number of constraints, investment-oriented or otherwise, can be imposed, all dependent on the unique needs of the portfolio at hand, leading to varying optimal portfolio mixes.

The conventional approach in creating efficient frontier ranges or looking at asset class returns is to sort them by decade and to group decades to generate longer-term time horizons. We have found, however, that there is insight to be gained by letting the actions of the markets define the range of time to be considered. Grouping by common periods of economic circumstance (e.g., periods of rising or falling interest rates) rather than arbitrary and uniform cuts of time (e.g., decades) allows us to see how returns vary within the range of a common regime. We have applied this concept in analyzing equity returns and have found that viewing results over market cycles can make the interpretation of a return profile clearer. In this instance, we propose looking at asset returns and efficient frontiers over interest rate cycles.

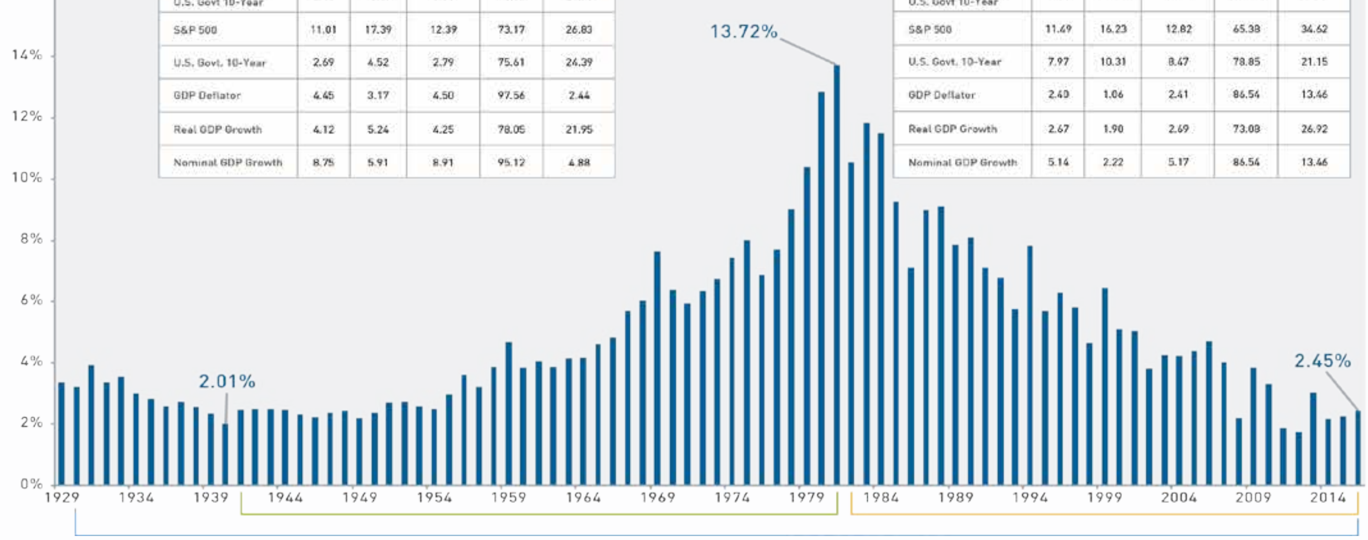
Trends in interest rates persist on almost a generational basis. In the 20th century, interest rates fell until 1941, when they began an upturn that did not end until 1981. From 1982 on, rates have been falling steadily. The exhibit below charts the year-end yield of 10-year U.S. Treasury notes and shows the history of stock and bond returns from 1928 through 2016, both in aggregate and in two sub-periods, 1941 to 1981 and 1982 to 2016. The two sub-periods represent, first, the peak-to-peak move in interest rates occurring between 1930[1] and 1981, and second, the peak-to-decline from 1982 to the present. Over the entire period, 1930 to 2016, a diversified portfolio (as expressed by a static 60/40 allocation of stocks and bonds) earned 8.14%/year nominally, more than keeping pace with the economy as nominal GDP grew 6.13%/year. Thus, financial assets kept their holders' wealth intact relative to the overall economy. Perhaps the key insight (to us) was that in the era of rising interest rates, which should have been a difficult environment for stocks and bonds, the diversified portfolio's returns essentially matched the growth rate of the overall economy (6.5%/year vs 6.8% /year for GDP). In the current era of falling interest rates, the outperformance has been striking; the return of the diversified portfolio has been more than twice the growth rate of the economy (10.58%/year vs. 5.14%/year). In the current era, it has been a relatively straightforward proposition for fiduciaries or trustees—or households—to earn a 5% real return with a diversified portfolio.

ASSET RETURNS AND ECONOMIC GROWTH — LONG-TERM HISTORY

Entire Period: 1930—2016					
Asset	Return	Std. Dev.	Avg. CY Ret.	% Pos. CY	% Neg. CY
60% S&P 500/40% U.S. Govt 10-Year	8.14	11.97	8.83	79.31	20.69
S&P 500	9.37	19.33	11.22	73.56	26.44
U.S. Govt. 10-Year	4.96	7.79	5.24	81.61	18.39
GDP Deflator	2.82	3.54	2.88	91.95	8.05
Real GDP Growth	3.22	4.91	3.34	79.31	20.69
Nominal GDP Growth	6.13	6.87	6.37	90.80	9.20

Period of Rising Rates: 1941—1981					
Asset	Return	Std. Dev.	Avg. CY Ret.	% Pos. CY	% Neg. CY
60% S&P 500/40% U.S. Govt 10-Year	8.05	10.37	8.55	78.05	21.95
S&P 500	11.01	17.39	12.39	73.17	26.83
U.S. Govt. 10-Year	2.69	4.52	2.79	75.61	24.39
GDP Deflator	4.45	3.17	4.50	97.56	2.44
Real GDP Growth	4.12	5.24	4.25	78.05	21.95
Nominal GDP Growth	8.75	5.91	8.91	95.12	4.88

Period of Falling Rates 1982—2016					
Asset	Return	Std. Dev.	Avg. CY Ret.	% Pos. CY	% Neg. CY
60% S&P 500/40% U.S. Govt 10-Year	10.58	10.44	11.08	73.08	26.92
S&P 500	11.49	16.23	12.82	65.38	34.62
U.S. Govt. 10-Year	7.97	10.31	8.47	78.85	21.15
GDP Deflator	2.40	1.06	2.41	86.54	13.46
Real GDP Growth	2.67	1.90	2.69	73.08	26.92
Nominal GDP Growth	5.14	2.22	5.17	86.54	13.46



Note: Chart represents the yield on the U.S. 10-Year Treasury note at calendar year (CY) end.
Sources: FactSet, Bloomberg, MSCI, S&P, St. Louis Federal Reserve, NYU Stern, U.S. Bureau of Labor Statistics

[1] We used 1930 as the starting point because it is when the U.S. government began reporting on Gross National Product (now Gross Domestic Product) and inflation. For simplicity, we use "GDP" in the text to represent growth rates.

Undergirding the forecast of almost everyone who has ventured into analysis of interest rates is the idea that rates can only go so low before they can't go any lower. And yet since the downturn in 2009, the central banks of the world have attempted to hold rates down at levels many analysts estimate would not have prevailed in the absence of intervention. Indeed, in 2015–16, central banks engineered a descent below zero, producing negative interest rates, a condition which prevailed over much of the developed economies in Europe and in Japan for a prolonged period. In order not to get too far into the weeds on that point, we will simply assert that negative interest rates cannot exist on a permanent basis. At some point, a new cycle of rising interest rates will commence.

Similarly, corporate profit margins, which have gone far higher than any forecaster might have imagined, will fall under the inexorable force field that is called mean-reversion. One well-known bear on the stock market, Jeremy Grantham, threw in the towel this spring, saying that he had become bullish because he thought profit margins at their currently exalted levels could remain there indefinitely and would not have to fall back to more "normal" levels, in terms of historical experience. Whether his arguments are correct or not don't matter for our purposes. With capitalization rates on earnings so low, the risk of any slip in profit margins, which would lead to slower-than-expected profit growth, could put pressure on stock prices. Meanwhile, the impact of higher interest rates would put pressure on both bonds and stocks. We believe the negative consequences of an adverse development are likely to be much more severe than the favorable consequences of the status quo being maintained. Even if the likelihood of lower or unchanged-to-higher interest rates is a 50/50 proposition, it is not hard to conclude that the consequences of the negative outcome are likely to be more intensely adverse than the favorable alternative would be positive.

There is another dynamic that is revealed in viewing asset returns in this cycle context rather than in decades marching past one by one. Consider that the current interest rate cycle is now 35 years old. We wondered how many professional investors have worked in a rising interest rate regime. As a proxy for the professional investment community, we used data for chartered financial analyst (CFA) charterholders. A CFA charter is considered to be the gold standard of professional designations in the investment realm. To earn one requires an undergraduate college degree or four years of professional work experience in the field and passing three levels of examinations over several years. Despite an overall passage rate on the exams of around 40%, more than 175,000 charters have been awarded globally to date (of which 142,000 are currently active) since the first was earned in the late 1960s.[2] There are enough CFA charterholders that the designation can be considered as indicative of the broader investment community.

We inquired of the CFA Institute and received census data (self-reported) on CFA charterholders. Only 4% of CFAs were engaged in the field while interest rates were rising. Of more concern is that 35% of CFAs have been professional investors for eight years or less, which means that their entire professional career to date has been during the highly unusual period of quantitative easing, in which short-term interest rates have been held at zero percent by the global central banks. We have long contended that fixing the most important price in the world—the rate of interest on the 10-year U.S. Treasury note—has distorted pricing across all capital markets. For more than a third of those people who labor in the investment management vineyard, a price-administered environment is all they know. They have yet to operate under the greater uncertainty that results when markets move freely about as they try to circle in on equilibrium. Experience is not necessarily a requirement for success in investing, but it doesn't hurt. As Mark Twain wisely observed, good judgment is the result of experience and experience is the result of bad judgment.

We know that being prepared for the eventuality of the end of this golden era in investing is the first step to take in the protection of clients' capital. The historical tendency of our strategies has been to protect on the downside. That means our strategies go down, but generally by less than their broad index. Just to be clear, though, while we may say we are striving to achieve this result, there can be no assurance this will happen in the next (or any future) downturn. And being true to the Financial Forecasters Primary Rule, which says that one can forecast an event or its timing but never both at the same time, we are not suggesting when this will happen. But we are watching the horizon looking for the signs of storm clouds. The conditions for a storm are building.

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[2] According to the CFA Institute data, the average 10-year passage rate for CFA exams for the 2007–2016 time period was 42%. SBH employs 25 CFA charterholders, which represents more than 70% of our total investment professionals. Those 25 charterholders have an average experience level of more than 20 years in the investment industry as of December 31, 2016.

MARKET BAROMETERS
AS OF JUNE 30, 2017

	Dec 31, 2016	1Q17	2Q17	June 30, 2017	Low	High
Dow Jones Industrial Index	19,762.60			21,349.63	19,732.40	21,528.99
S&P 500 Index	2,236.20			2,420.90	2,236.20	2,447.50
Russell 3000 Stock Index	1,331.72			1,436.82	1,331.72	1,452.82
Russell 2000 Stock Index	1,357.13			1,415.36	1,345.24	1,425.99
Russell Midcap Growth Index	782.97			867.37	782.97	880.01
Barclays Cap Aggregate Index	1,967.23			2,011.96	1,957.61	2,025.20
Barclays Cap Muni Bond Index	1,139.51			1,180.14	1,139.51	1,187.92
Gold (Price/Oz) London AM Fix	1,159.10			1,243.25	1,148.65	1,292.70
Goldman Commodity Index	2,417.31			2,169.81	2,053.66	2,428.42

Source: Bloomberg

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