

SIGNATUREFD

SUMMER 2015

## MARKET SENSE: Notable Activity Remains Below the Surface



As the old saying goes, only true sports fans can appreciate a pitchers' duel in baseball, a 0-0 tie in soccer or hockey, or a defensive battle in football. In today's fast-paced world, everyone craves offensive scoring, action and something to talk about. Carrying that analogy over to the capital markets, 2015 has been a disappointing year for most market spectators.

While notable activity is going on under the surface, the progress of broad indexes has been modest. The Dow Jones Industrials are effectively unchanged, and the S&P 500 closed the second quarter up around 1% since the beginning of the year. The second quarter was the first down quarter out of the last 10. Markets outside the U.S. were mixed, but on average they fared better. Japan, Europe, Russia and China were the best performers. Fixed-income markets had periods of volatility but also ended up closing the quarter near start-of-the-year levels.

The table below contains key data on several benchmarks. In the rest of this note, we will provide our views for the balance of 2015 and the longer term, and wrap up with some key thoughts on current portfolio positioning.

	2nd Quarter	52 Weeks
S&P 500	0.28	7.42
Dow Jones Industrials	-0.29	7.21
MSCI EAFE (International)	0.62	-4.22
MSCI EM (Emerging Markets)	0.69	-5.12
Bloomberg Commodity	4.66	-23.71
Barclays Global Bond (Global Bonds)	-1.18	-7.09
Barclays U.S. Aggregate (Taxable Bond)	-1.68	1.86
Barclays 5-Year Muni (Tax-Free Bonds)	-0.17	1.48
HFRI Fund of Funds Composite Index	2.10	6.32



INVESTORS HAVE BEEN GENERALLY EMBRACING RISK FOR THE PAST FEW YEARS, AS RATES ON SAVINGS HAVE BEEN NEGLIGIBLE.

### “WEIGHT OF THE EVIDENCE” APPROACH TO INVESTING

There is never a shortage of things to worry about, and this is certainly true at present. We constantly field questions about each pending crisis: Greece, China, the dollar, Ukraine, Puerto Rico, Washington dysfunction, interest rates, etc. These issues are all relevant, but one must take a “weight of the evidence” approach to investing. Risk and opportunity must both be assessed. It is not just external events that move markets but also investor attitudes, money flow, valuation and economic fundamentals. When analyzing a broad set of these factors today, one walks away with an outlook that remains slightly bullish. In our case, we think the evidence for bullishness is even stronger outside the U.S., but this doesn’t leave us significantly negative on the U.S.

Ned Davis, an experienced and oft-quoted market strategist, often says, “Don’t fight the Fed or the tape.” What he means is that over the shorter term, market direction can be driven by Federal Reserve policy and by the general direction of the market, aka “tape” (some of you may remember the old ticker tape that provided investors with price updates). Over the longer term, however, economic and company performance are more important to focus on, even if they are not predictive of shorter-term direction.

It is these exact indicators that are providing a positive message now, though admittedly things aren’t as convincing as they were a few years ago. Domestically, the Federal Reserve has held interest rates at zero for a remarkable seven years. Even with the coming first rate increase, the Fed will remain highly supportive of the economy for the foreseeable future. Investors have been generally embracing risk for the past few years, as rates on savings have been negligible. When confronted with poor alternatives, investors feel they have to move into riskier assets to earn something on their money. Plentiful amounts of cash from investors and companies themselves have consistently flowed into the market and have been the basis for recent gains.

It is important to reiterate that while these forces remain relatively accommodative, they are not as positive as they have been over the past five years. With the Fed winding down asset purchase programs and moving toward rate increases, the amount of liquidity in the markets is beginning to wane. Corporate profit margins appear to have peaked last summer, and a slower rate of growth in corporate cash flow could constrain increases in stock buybacks and dividends. When these factors are combined with a relatively highly valued market and a sense of complacency among investors, it does require one to stay on heightened alert. But our base case is not for large declines in U.S. stocks but a market characterized by below-historical rates of return.

We believe this same weight-of-the-evidence approach pinpoints some more attractive opportunities outside the U.S. With central banks in China, Japan and Europe continuing with extremely stimulative policy, liquidity trends are more favorable. Additionally, sources of new money are coming into these markets, as investors have been largely underweight these regions over the past few years. In some cases, especially in Japan, official sectors such as government pensions are also increasing allocations to equities, which provide fresh money flows. Finally, these regions, generally speaking, have more attractive equity valuations and additional room for margin expansion. Global markets are linked, so major moves in either direction tend to impact all regions. But, in our opinion, this weight-of-the-evidence approach indicates that equities outside the U.S. can provide upside vis-à-vis domestic equities.

## INVESTING VS. SPECULATING

As mentioned, our base case remains constructive over the near term. However, after seven years of extreme central bank policies, we believe it is important for investors to monitor the longer-term health of the markets. There are increasing signs of what we would term speculative behavior at the expense of investing based on fundamentals. It is important to define these terms. The investing website Investopedia provides, “It may sometimes be difficult to distinguish between speculation and investment, and whether an activity qualifies as speculative or investing depends on a number of factors, including the nature of the asset, the expected duration of the holding period, and the amount of leverage.”<sup>1</sup> Importantly, speculating is not gambling, as the speculator is making a calculated decision and would not likely do so if outcomes were truly random. However, if too many speculators are taking the same calculated risks, then markets can become fragile if those speculators simultaneously change positions.

In his highly admired book, *Margin of Safety*, famed investor Seth A. Klarman uses a valuable parable to differentiate between investors and speculators:

“There is an old story about the market craze in sardine trading when the sardines disappeared from their traditional waters in Monterey, California. The commodity traders bid them up and the price of a can of sardines soared. One day a buyer decided to treat himself to an expensive meal and actually opened a can and started eating. He immediately became ill and told the seller the sardines were no good. The teller said, ‘You don’t understand. These are not eating sardines, they are trading sardines.’”<sup>2</sup>

To understand why this concept is important, one needs only to remember the purpose of the capital markets. At their essence, markets are designed to provide capital to businesses and projects that will deliver the highest risk-adjusted returns, presumably based on the overall utility they provide to society in general. In a recent piece defending the noble work of financial professionals, Jason Trennert, of Strategas, writes, “The genius of modern [finance], while imperfect and subject at times to excess, has been the single greatest contributor to human progress ... allowing businesses to take on more risks in their efforts to grow. Prudent risks can lead to faster economic growth, more jobs, and greater innovation in all fields of human endeavor.”<sup>3</sup>



## THE INCENTIVES OF THE SYSTEM FROM THE HIGHEST LEVELS MOTIVATE PROFESSIONALS AND AMATEURS ALIKE TO SPECULATE RATHER THAN INVEST.

This is the objective of finance, but it is clear that much of the industry has failed to live up to these ideals. Moreover, the incentives of the system from the highest levels motivate professionals and amateurs alike to speculate rather than invest. We could fill several pages of text with examples, but we believe that some of the more important signals in today's markets are the following:

- The investor time horizon has continued to shorten. According to a paper by the Brookings Institution, the average holding period of U.S. investors was seven years in 1960, dropping to two years in 1992 and to less than seven months today.<sup>4</sup> We would suggest that the *average* buyer of stocks is thus a speculator. Corporate fundamentals do not change enough over a seven-month period to suggest that anyone buying for that period of time is investing on fundamentals. For that to occur, a holding period of at least three to five years is needed.
- A growing percentage of investments is tied to index tracking strategies. These index-oriented strategies have many positive attributes, and we strategically use them to pick up general market exposure for some asset classes. However, by definition, they are allocated based on index composition and do not take a fundamental view of underlying investments. This could be a factor in future downturns as they can be pro-cyclical in nature—pushing the markets up during up trends and accelerating declines in down trends.
- We have written about corporate buybacks and increasing dividends recently. These have clearly been positive for the market and reflect an underlying strength in corporate cash flows during the past several years. But it remains important to remember that these are also pro-cyclical flows, and it is likely that the majority of companies will be compelled to slow or even reduce share buybacks at the same time. It is possible that companies will pay out a record \$1 trillion in the form of dividends and buybacks in 2015. Capital spending by companies tends to be a better indicator of long-term, sustainable opportunities, and we would rather see more growth in this area than buybacks. This is a question of misallocation of capital. Can a portion of those trillion dollars be used for long-term growth as opposed to the companies purchasing their own stock after the market has more than doubled in six years?
- With central banks holding short-term rates near zero and buying back longer-term bonds, it is possible that interest rates are being impacted and forcing market participants to buy other assets—higher-risk bonds or yield-oriented stocks—to meet their income needs. Compounding this risk, many investors may be utilizing low-cost leverage to add to these positions. The Federal Reserve has been trying to communicate proactively with the market about its intentions to raise rates before year-end. The idea is captured well in a phrase the team at Strategas coined a few years ago: T.I.N.A.—There Is No Alternative. That is the case now, but when another alternative does arise, many speculators are likely to shift all at once, putting pressure on some assets.

- The previous crisis was triggered by weaknesses in the banking sector and was specifically related to the products created around housing finance. Banks have been broadly strengthened over the past few years, both by their own efforts and the demands from regulators. However, a consequence of some of those regulatory changes has been to create other areas of market fragility. One key area is the availability of liquidity during market volatility, especially in the fixed-income space. Banks and other finance companies have historically been a source of liquidity during downturns, but the portion of the market they now control is down by more than 50% since before the financial crisis. This reduced inventory, coupled with the fact that bank regulators will be less willing for them to add to risk during a decline, will likely increase volatility but is potentially an opportunity for prepared investors.
- Finally, if the past 30 years have taught us anything, it is to look for the source of the next crisis in the area that has seen the largest increase in credit creation during a bull cycle. Over the past few years, debt has accumulated fastest in emerging-market economies. According to a recent report by the Bank for International Settlements (BIS), the combined debt of governments and nonfinancial private sectors has grown by 50% of gross domestic product since 1997 and now stands at 120% of GDP.<sup>5</sup>

We raise these issues not to provide any near-term predictions. But after several years of robust markets, we feel it is important to look for market weaknesses to try to appreciate when it will be time to play defense again. The experience of the last 20 years—first the technology and telecom bust and then the housing finance crisis—teaches us that misallocation of capital eventually leads to distortion and, ultimately, a correction. When and how this will happen again, we don't yet know. But given that most don't appear to have learned lessons from the previous two cycles, we feel it is important to be prepared.

## PORTFOLIO POSITIONING

In closing, we will review portfolio positioning in light of the above competing near-term and longer-term factors.

Our long-term success will be driven by the decisions we make regarding two components of the portfolio management process—asset allocation and fund selection (including both active and index strategies). Broadly speaking, asset allocation has been helpful in 2015, reversing the difficult trends of last year. Equity markets outside the U.S. exceeded those in the U.S. during the past six months, which has helped portfolio performance. Our decision to allocate to alternative strategies has not yet meaningfully added returns to the portfolio. However, we sourced the majority of these funds from fixed-income-related investments (which are basically flat so far this year), so the opportunity cost of holding these hedged investments is still quite low and should be accretive as interest rates continue to climb.

With regard to fund selection, the first half of the year was a mixture of positives and negatives. Within the U.S. portion of portfolios, managers trailed slightly, as our focus on companies that pay stable, growing dividends lagged the overall market. We continue to believe that having a meaningful weight to companies with strong cash flow and dependable dividend policies is a prudent way to invest, especially at this point in the equity and interest rate cycle. In the international and real asset categories, our managers generally did well. Across the fixed-income space, our underweight to core holdings was positive and our active managers have added value year-to-date.

During the quarter we shifted capital within the U.S. market by reducing exposures to value-oriented managers and increasing to growth managers that specifically focus on the health care, consumer and technology sectors. We retain some exposure to smaller-cap stocks but have the majority of domestic capital in strategies that are focused on companies with solid growth and growing dividends. These companies should be rewarded as growth in earnings becomes ever more difficult to find.

In the international markets we shifted exposure to Japan and away from emerging markets based on some of the fundamentals we discussed in this letter. The portfolio now includes broad exposure to developed markets—especially Europe and Japan—and selective positions in emerging markets. Certain markets in Asia have been the strongest portions of emerging markets, and our managers generally remain overweight these locations. Our long-term conviction in frontier economies remains, though holdings in this space have lagged so far in 2015.

Across the balance of the portfolio, we did further reduce exposure to commodities and natural resources, broadly shifting capital toward real estate companies outside the U.S. Within fixed-income portfolios we made slight tactical shifts, reducing slightly the already low weighting to longer-term holdings as the rate-rising cycle gets closer.

Please remember that client portfolios are designed and built with individual circumstances in mind, so the above comments do not necessarily apply in all cases. We have been working to increase communication regarding our views on the markets and portfolios in order to provide you with additional transparency. We appreciate your support and confidence. Please don't hesitate to reach out to anyone on our team with questions or comments.

## SOURCES

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