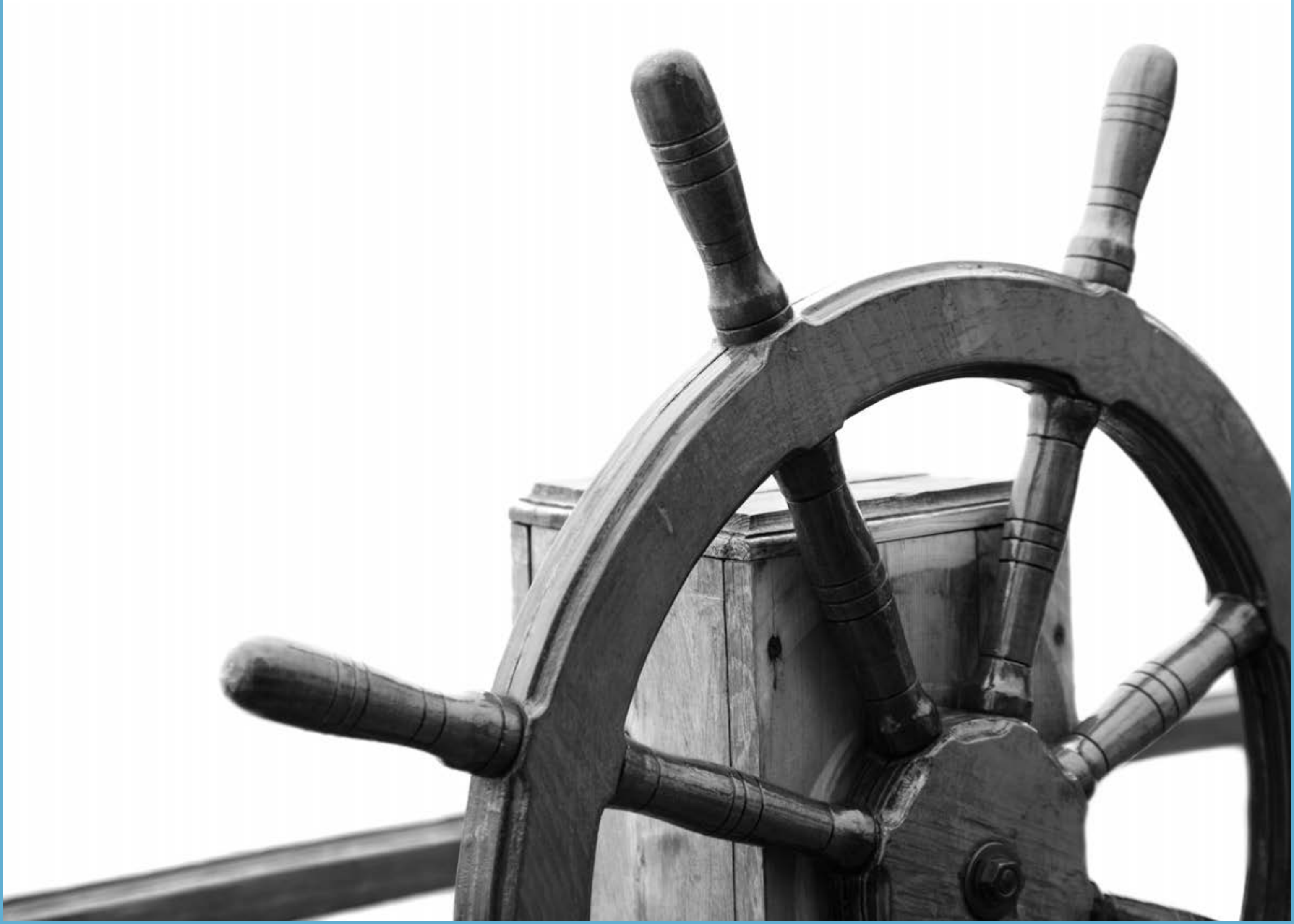
ABBOT DOWNING

NAVIGATING IN A LOW RETURN ENVIRONMENT



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Navigating in a Low Return Environment

Tom Peters, business management guru, has left an indelible mark on the field of business management and leadership. Curiously enough, despite decades of research, consulting, and authoring several books on the subject, a mere two words might just be his most enduring contribution. Peters is often credited with the quotation "Underpromise; overdeliver." It's succinct, straightforward, sensible, and omnipresent in Corporate America. It is also a fitting mantra for many investment practitioners as they survey the global opportunity set today.

In a nutshell, outsized performance in the near term looks increasingly elusive. Like others, we see certain equity markets near all-time highs, interest rates at head-scratching lows, and some asset classes about to encounter the laws of financial gravity. Returns may not moderate tomorrow or even a year from now, but portfolio management in today's investing environment still seems more like advanced calculus than entry-level algebra. Therefore, we feel a dash of pragmatism is in order, and Tom Peters might just agree.

A low return environment is not guaranteed in the near term, as markets have an indecisive quality. However, we can say quite confidently that, over long stretches, they follow a rhythmic ebb and flow, just not in a way you can set your watch to. Further, the market's myriad of parts don't move entirely in unison. Each asset class has a different narrative with an eclectic mix of characters that should be analyzed accordingly.

For instance, sometimes the hand we get dealt contains bonds with a negative yield and it's fair to say these bonds will deliver a low return for the foreseeable future. Yet, that doesn't mean we should automatically fold. There may be other assets, such as municipal bonds or emerging market stocks, with more appeal and corresponding upside. In other words, specific assets might flow a little longer or prove more resilient during the ebb. This report will look at several asset classes and, in essence, provide a map and a compass to help navigate what may lie ahead.

Underpromising, or assuming future returns will fall below historic averages, may appear unduly pessimistic. Yet, adversity is best confronted when it is expected. Therefore, we feel we have a better chance to overdeliver when planning for a broader range of outcomes and operating with assumptions that aren't all rosy-colored. Navigating a low return environment requires proper planning just in case there are obstacles in view, as is commonly the case with any journey. We begin by examining the two most mainstream asset classes: equities and fixed income.

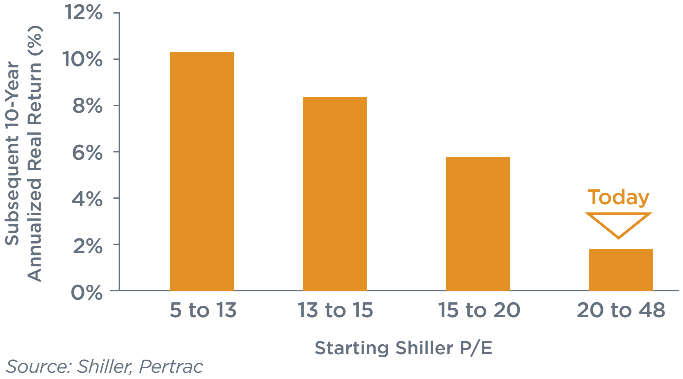
Equities

As E.F. Schumacher alluded, our future is molded out of present day conditions, with the stock market being no exception. In particular, there is a telling inverse relationship between current valuations and future stock market long-term results. The spirit of this is really no different than the buy low-sell high mantra, which is rarely in dispute. However, there isn't strict adherence to this simple and intuitive investment maxim. Time and again we see cheap stocks get cheaper and expensive ones become even more so. While the long-term trajectory for stocks is fairly predictable, the short-term can be subject to some theatrics. The irrationality of the short-term is a function of investors trying to process an unrelenting barrage of information, coupled with human fallibility and counter-productive instincts.

> *"The future is always in the making, but it is being made largely out of existing material, about which a great deal can be known. The future, therefore, is largely predictable."*
>
> E.F. Schumacher, *Small is Beautiful* (1973)

Eventually, the blue light special ends for inexpensive stocks and the false hype in overbought markets becomes better understood. The short-term will eventually converge with the market's long-term master plan, but the larger question looms: "When?" Frankly, it's hard to precisely determine what the trigger will be. Yet we do know that the further markets move away from fair value, the nearer the course correction gets and the sooner we approach the moment when valuations invariably start to impose their will.

S&P 500 Index (1925 – 2014)



Source: Shiller, Pertrac

The Shiller P/E multiple (also referred to as the cyclically adjusted price-to-earnings ratio) uses ten years of inflation adjusted average earnings in its denominator. It has good long-term predictive power, but can be of lesser utility as a guide for nearer-term market movements.

That leads us to today where several years of good equity market performance have created some rich market valuations. For instance, the Price/Earnings (P/E) multiple for the S&P 500, a bellwether valuation metric, is above its historic averages. That's not the only cautionary signal. Tobin's Q resides at a point last seen in the bubble forming years of the late 1990s. For good measure, there are more colloquial considerations, such as the S&P 500 having appreciated for six straight calendar years with no precedent for a seven-year streak.

Tobin's Q measures the price of the stock market relative to its underlying replacement costs. A measure above 1.0 implies an overextended market (S&P) is currently at 1.1). The measure is not perfect. It may not be as accurate of a predictor in a service-oriented economy.

The question is really not if the S&P is expensive, but to what degree. Is the S&P at a state of hope-induced, sky-high valuations such that it sits on the edge of a precipice a la tech stocks in 1999? Not really. Could monetary stimulus, sheer greed, or some other factor take the S&P to such a point? You bet. It's also conceivable the "E" outpaces the "P" and the S&P grows into its valuation on the back of positive fundamental change. Yet, there still exists these intractable, but difficult to time, forces that intimate years of good performance will be followed by years of not-so-great ones. In other words, the odds tell us it may be time to underpromise.

Did we learn from history? The late 1990s tech bubble is a vivid, albeit extremist, tale of the importance of valuations from a risk management lens. The tech-heavy NASDAQ had an average return of 41.9% per year from 1995 through 1999 resulting in a stratospheric P/E multiple of 71x at its peak. These outsized returns effectively cannibalized future performance as the index punishingly fell on average 30.6% annually from 2000 to 2002.

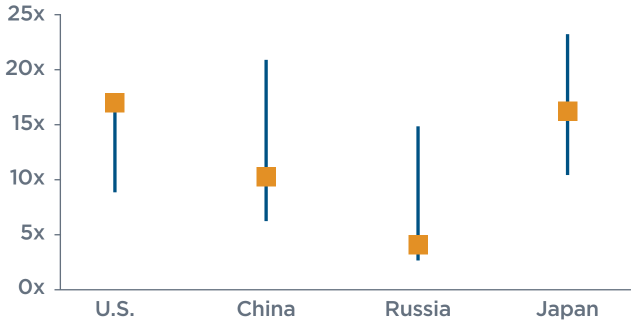
Not all is lost, as there are alternatives and tactics to employ if equities shift onto a lower return path. For starters, the preceding comments have been quite parochial. Yes, domestic equities are richly priced, but not all stocks are created equal. In particular, there is a great deal of variation on a country and regional basis.

For instance, while the names vary at any given point of time, Russian, Chinese, and even Japanese equities were not subject to the same high valuation starting point as domestic stocks as of March 31, 2015. Yes, we know these countries have their imperfections. China has an overheated real estate market, Japan has the largest relative government debt on the planet, and the Russian economy is hampered by the drop in price of oil. These provide convenient, comforting excuses to avoid these rather terrifying undervalued assets, but you sacrifice upside by abstaining.

It's our natural instinct to extrapolate current conditions into the future, a behavioral finance shortcoming called the recency bias. When valuations are low, we think they'll stay chronically low, despite their innate investment upside. The reality is these widely publicized flaws are more often than not captured in the price and there is an investor-friendly asymmetry of outcomes in place.

In these instances, investors don't need great news to deliver above-average results. Rather, they're really just counting on a whiff of okay news and, critically, increased self-awareness and the emotional prowess to capitalize on such opportunities. This tactic may not deliver instant results. It could actually take months or even years to cultivate and entails a very patient, private equity-like mindset. A low return environment will be trying at times, but for the dispassionate, open-minded, and disciplined, these undervalued assets should help you overdeliver.

Forward P/Es Relative to 10-yr range



Source: Hexavest, Bloomberg, China Russia & Japan are estimated by applying the discount of the US between trailing and forward earnings.

Lastly, there are other options to augment your equity allocation, literally. In particular, covered call writing, an options program, may help enhance returns, along with offering some risk management benefits. This strategy essentially sells away upside participation above a certain threshold for a given security in exchange for current cash flow. The strategy increases portfolio yield and smooth returns with the added income mitigating some of the financial loss and corresponding anguish when stocks fall.

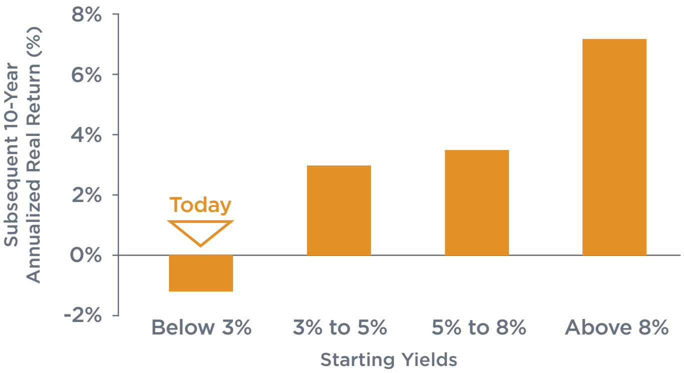
The Achilles' heel of this strategy is a runaway bull market for the underlying security. This strategy is fully collateralized, but there will be opportunity cost if the market starts to get ahead of itself. There are other blemishes, such as covered call premiums being typically characterized at the less favorable short-term capital gains tax rates. Further, some options are rather illiquid with high bid-ask spreads, which makes it more difficult to actively manage. A covered call program has various sensitivities, but it still seems like a sensible alternative in a low return environment.

Fixed Income

"Predictable" is a fitting descriptor for bonds. Future performance is pretty much a known quantity at the time of acquisition, at least more so than for stocks. For instance, if the U.S. 10-Year Treasury bond has a 2% yield, then over the next 10 years those who own it and hold until maturity assuredly will have a 2% nominal return per year on average. It will not be straight line results and there may even be some dizzying periods, but your investment fate is largely predetermined.

So we'll be blunt–we expect lower returns from bonds. Yields are currently at perhaps previously unimaginable lows. If rates do rise, there will be pedestrian returns at best, and negative returns may be in the cards during some stretches. Even if rates stay put, the market yield you earn is quite low. The only way bonds can be strong performers is if yields fall further still, which is mathematically limited. Yet, we wouldn't suggest hitting the cancel button with fixed income. Their predictability can, perhaps curiously, be a valuable asset in a low return environment.

U.S. Treasuries (1819 – 2014)



Source: Shiller, Pertrac

Certainty is a highly coveted asset in the investment realm as in many walks of life. For instance, we buy insurance for the peace of mind that comes with it. Unlike insurance, which may never deliver a financial gain, bonds have positive cash flow and no recurring premium payments. Like insurance, we tend to underappreciate the worth of bonds until times of adversity, such as a low return environment.

The future could bring an emotionally taxing stretch and many investment programs may be undermined by irrational instincts. The predictability element inherent in bonds can be the invaluable ballast in a portfolio during those gut check times when markets aren't cooperating. Therefore, they remain essential for capital preservation and portfolio stability, however poor their earnings potential. Not to mention, bonds tend to be low cost and are typically liquid. These features can be liberating by allowing you to use your illiquidity and fee budget in less trafficked, less efficient investment areas to bolster overall results. Fixed income may lack some sizzle in this paltry rate environment, but its total package can put a governor on emotions and at the same time make a portfolio's sum greater than its parts.

You don't want any surprises with your fixed income nor do you want to leave basis points on the table in a low return environment. Therefore, don't forget the basic blocking and tackling, such as tax considerations. Municipal bonds ("munis") have a decided advantage in this department as their coupon is exempt from federal taxation, the Medicare surtax, and possibly state and local taxes. For instance, on May 20, 2015, the 10-Year U.S. Treasury bonds yielded 2.25% (Federally taxable), and a high quality 10-Year muni index was at 2.48% (Federally tax free). Granted, munis have credit risks that Treasuries don't, but that's still a very large edge for munis, especially in an environment where every increment of yield matters.

The yield pick-up with munis doesn't come with commensurate risk, which might be inconsistent with popular perception. Despite the recent drama in Detroit and Puerto Rico, municipals are pretty sleepy with a microscopic historic default rate and relatively high recovery rates.[1] Consider that there was an average of just seven defaults per year out of a universe of over 12,000 rated issues during the choppy economic period of 2008 through 2014.

This translates into lower volatility for municipals as compared to many taxable bonds, even “safe haven” Treasuries. Also, given the upward sloping shape of the municipal curve there is a relatively larger rolldown benefit, the phenomenon that as time passes and a bond gets shorter, its price is further supported by its being valued to a shorter, lower-yielding point on the yield curve. Munis offer quite a nice bang for your buck on an after-tax and risk-adjusted basis, and that shouldn’t be overlooked in a low return environment.

Despite the previously extolled virtues, we aren’t naive about the state of fixed income as the low yield starting point for new capital into the asset class income isn’t exactly ideal. However, while much conjecture is devoted to when rates will rise, we think the more pertinent question is how they rise. Fortunately, the U.S. Federal Reserve wants to engineer an orderly rise in interest rates, with as little disruption to the markets as possible. Rising yields will stress bond prices, but disorder and panic selling would make things worse, at least in the short run. Further, bond market liquidity could dry up, a natural tendency during turbulent periods. We like certain parts of fixed income more than others, but that certainly doesn’t mean complacency is in order.

Execution will be critical with fixed income. Therefore, try to avoid using bond funds. These commingled solutions don’t naturally amortize and tend to have a rather inelastic portfolio maturity. Their structure invites more volatility and uncertainty when rates rise, as compared to holding an individual bond to maturity. Also, make sure your bond portfolio maturity is properly calibrated with your time horizon to avoid an asset-liability mismatch. For instance, if you know you will have a material liquidity event in three years, then have your bonds mature at or before that time. A bond portfolio that matures after a known need for cash in the future will be unnecessarily more sensitive to rising rates and, importantly, an avoidable peril. Risk management will be vitally important in all asset classes in a low return environment, even in boring old bonds.

The Tax Loss Harvesting process starts by selling a security with an unrealized loss and simultaneously purchasing a proxy security, that’s not substantially similar, then holding it over the ensuing 30 days. The trade is then reversed after the Wash Sale period expires. If well executed, pre-tax returns remain largely unaltered and after-tax performance is improved.

An Action Plan for Investors

We want to invest in the right asset classes during a low return environment, but we also want to be invested in them the right way. When performance begins to moderate, fees and taxes can prove painfully corrosive. Over-extended investors might face some difficult realities, and emotions will be tested for many others. In today’s environment, it’s incumbent upon all investors to be increasingly disciplined and more judicious with every dollar in their portfolio.

Active Share measures the amount of a portfolio that differs from its respective index. Empirical research shows that if a fund’s active share exceeds 80%, then it has the foundation for benchmark out-performance.

Taxes, Fees, and Inflation

Taxes are an unavoidable truth and should always be part of the investment decision-making mosaic. Yet, they should be viewed through a different prism in a low return environment. For starters, leaner pre-tax returns mean less room for error on the after-tax front.

Fortunately, there are mitigating factors that start with investors implementing a thoughtful financial plan, inclusive of asset location tactics. A tax optimized balance sheet, which, among other things, places tax-unfriendly investments (for example, high yield debt) into tax-friendly entities (for example, an IRA), and vice versa, will help enhance after-tax results. Also, a low return environment might just be accompanied by more tax loss harvesting opportunities. This technique can help improve portfolio efficiency by decreasing gain recognition.[2] It's a tactic that is part art and part science, but we would suggest, at a minimum, considering a more expansive menu for these opportunities. All told, while the quantity of pre-tax returns may be on the low side, there may be more opportunities to improve the quality of results on an after-tax basis.

Fees, much like taxes, have an inverse relationship with performance and also can be controlled by investors. Fees and costs should always be rationalized, but these tend to be pretty inelastic numbers and arguably deserve more scrutiny in a low return environment. In other words, a 1% fee stings a little bit more when your gross return is 4% as compared to 6%. For starters, one could consider cutting some active managers for cheaper, comparable passive solutions. Some decisions might be easier than others, with varying degrees of opportunity cost being the trade-off when eliminating an active manager. We don't make investment decisions on a single factor, but active share is a metric that can make this vetting process a bit easier by ushering in an objective way to identify active managers that are really passive solutions in disguise.[3]

This might feel like thinly veiled advocacy for passive investing. It's not. For starters, passive funds have to own the index, both the good and bad parts. You don't. Neither do active managers who can avoid some seemingly ill-fated investments, such as government bonds with a negative yield. Further, there are good managers out there that earn their premium compensation by delivering strong performance without inordinate amounts of risk. These skilled managers will be of increasing value in a low return environment and shouldn't be ideologically dismissed.

Fees are always a sensitive matter, but think of yourself as a general manager for a major league baseball team. Maybe you want to stock your team with borderline major league players, thin out your payroll, and accept a rather mediocre fate. Or you could splurge on some perennial all-stars and try to spend your way to a championship. A convincing case could be made for either strategy, as long as they are approached thoughtfully. Just remember, markets can be a bit unpredictable, but fees are always a known quantity.

Finally, factor in the impact of inflation. Fortunately, this type of return environment might not be so painstakingly low if you think in real terms, as opposed to nominal. We have a tendency to think in a non-inflation adjusted way, a concept called money illusion. For instance, consider the following two portfolios in Table A. A knee-jerk reaction is to think that Portfolio A did better. It did, but only in nominal terms. Both portfolios have roughly the same purchasing power at the end of the day due to inflation being tamer for Portfolio B.[4] It is certainly conceivable that a low return environment be accompanied by lower levels of inflation.[5] Many investment-related matters will need to be reevaluated before entering a low return environment, including the yardstick used to measure results.

Table A

	Portfolio A	Portfolio B
Nominal Return	6.0%	4.0%
Inflation	3.0%	1.0%
Real Return	3.0%	3.0%

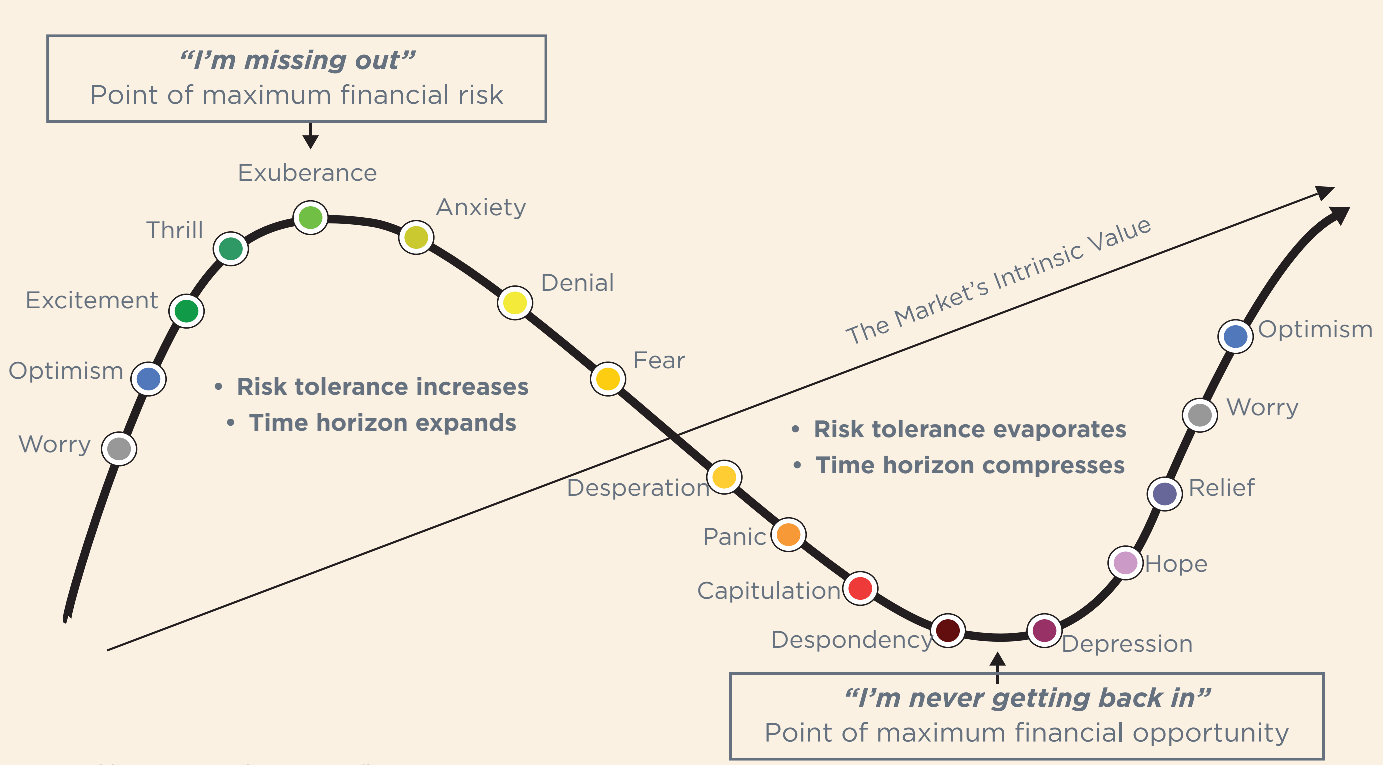
Portfolio Construction

Arguably, the most critical and difficult item to review will be austerity measures. As Ernest Hemingway once wrote, "First you borrow. Then you beg."[6] A highly levered portfolio might collapse upon its own weight if robust returns aren't there to support it. Therefore, take a closer look at a portfolio's debt/assets ratio and stress test it. Make any resulting adjustments now, before you are forced to, and limit any distressed selling.

Similarly, the strong markets of recent years may have resulted in a portfolio distribution policy that was aggressively underwritten. Reining in any corresponding spending will not feel great. However, continued draws on a portfolio when markets aren't cooperating is really a permutation of a margin call. Spending and debt conservatism are never fun conversations, but they are decidedly more difficult when they are compulsory.

It's not just the over-worked, highly indebted portfolios that will need reflection. Investors will need to process the notion that the returns they thought their strategic asset mix would deliver may not be achieved in the near-term. Without forethought, frustration and impatience could result, and emotion-laden investing rarely ends well. A typical reaction is to counter-productively sell low, which recency bias suggests may occur with great frequency if returns are lower than expected. Dispassionate investors will be best served in this type of environment with underpromising helping to quell emotions flaring at less than ideal times.

The Cycle of Investor Emotions



"I'm missing out"
Point of maximum financial risk
Exuberance
Thrill
Anxiety
Excitement
Denial
Optimism
Fear
Worry
• Risk tolerance increases
• Time horizon expands
The Market's Intrinsic Value
Optimism
Worry
• Risk tolerance evaporates
• Time horizon compresses
Desperation
Relief
Panic
Hope
Capitulation
Despondency
Depression
"I'm never getting back in"
Point of maximum financial opportunity

Source: Abbot Downing (then Lowry Hill), January 2010.

For portfolios with fixed rate, required distributions (such as a Unitrust or foundation) the daunting math, coupled with the emotional quotient, will pose a challenge. Consider that a foundation basically needs a seven to eight percent return to break even after accounting for fees, inflation, and mandated charitable distributions. That's a steep hurdle, particularly when observing the earnings capacity of mainstream asset classes. The temptation will be to increase risk in the portfolio to achieve performance goals. That could make sense, but a more innately volatile portfolio has it vulnerabilities. In particular, this type of portfolio would conceptually be more sensitive to rising and, importantly, falling markets. Distributions could be required with greater regularity when the markets and your portfolio are in a temporary oversold state.

Be sure to have a drawdown policy in place or a way to manage portfolio outflows to avoid making a bad situation worse via forced selling. For instance, consider delaying distributions or perhaps using a bridge financing facility. There are other mitigating factors for fixed rate distribution portfolios, such as rightsizing fees or embracing more exotic asset classes and investment solutions. While there are no easy, comfortable answers, being proactive and creative is a good place to start.

You don't necessarily have to throw your hands up if low returns are on the menu for mainstream asset classes. Rather, while remaining true to your strategic asset allocation you can still expand your boundaries by taking a closer look at the less trafficked corners of the market. Yes, playing defense will be vital, as related to those more surefire fixed income investments. But don't be afraid to go on the offensive as well by venturing outside your conventional boundaries.

Whether its option strategies, illiquid investments, or just something with a quirky name you've never heard, don't automatically dismiss new ideas. For instance, John Paulson rose to somewhat revered status in the investment world after he defied orthodoxy and shorted the housing market before the throes of the global credit crisis. It was a lonesome trade, but he reaped billions due to his unconventional thinking at a time when the markets were in a state of panic. Paulson put in place a once-in-a-generation type of trade, but the spirit of that example is important. Effectively navigating a low return environment will require a, perhaps unnerving, level of versatility. Otherwise, your fate may be sealed and mediocrity awaits you.

A low return environment implies several lean years on the horizon, which is a half-truth. On average, returns may moderate, but that does not rule out a few pockets of frothy results along the way. Yet, don't automatically treat these as false positives. More than anything, a disciplined investment decision approach is needed. For instance, adopting a more aggressive, innately volatile strategic asset mix solely due to encountering a performance oasis will be a chancy tactic. This might be better thought of as overpromising and not the most prudent path forward.

The interest rate environment has remained remarkably low. This, combined with a Federal Reserve mindset to ideally engineer an orderly rise in interest rates, provides ongoing opportunities for judicious deployment of leverage to enhance returns. We do not believe a modestly increasing interest rate environment alone should preclude the prudent utilization of debt to augment returns in alternative asset classes (e.g., commercial real estate).

Conclusion

Markets and economies move in cycles with the pendulum swinging back and forth between extreme forms of fear and greed. This perspective is often lost, as we have an innate tendency to focus on the here and now, and assume the status quo will persist. Sadly, this can give rise to complacency, along with being an ingredient for a toxic cocktail if mixed with excessive leverage or spending patterns predicated upon the good times continuing to roar. This is preventable, but surely easier said than done. It's also an objective of this report–to look up and remind oneself of the bigger picture. This ebb is an unavoidable part of the typical investing journey, but it should be less debilitating and sting less for those who have underpromised. Nobody knows precisely when we will enter into a low return environment, but with prudent expectations and some of the aforementioned guidance, your portfolio will have a foundation to overdeliver when the pendulum changes course.

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Endnotes

[1] *2014 Annual U.S. Public Finance Default Study and Rating Transitions,* Standard and Poor's, May 5, 2015.

[2] Note *U.S. Code § 1091 - Loss from wash sales of stock or securities.* Tax benefit secured assuming substantially similar security not held during 30 day wash sale period that commences after loss is realized.

[3] Antti Petajisto, *Active Share and Mutual Fund Performance,* Financial Analysts Journal, Volume 69, Number 4 (2013).

[4] The formula for the Real Return is [(1 + Nominal Return) / (1 + Inflation Rate)] – 1.

[5] *Inflation and the Stock Market: Understanding the "Fed Model,"* NBER Working Paper No. 15024 (June 2009).

[6] Ernest Hemingway, *The Old Man and the Sea* (1952).

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