SEEING THE FOREST IN SPITE OF THE TREES

April 21, 2017

One of the most important things in investing is to step back and see the forest, not just the trees. If you are studying a particular company for investments, for example, it is critical to understand that company's industry and the company's place in its industry. Only then can one begin to paint an accurate picture of any individual investment. To illustrate, traditional pharmaceutical companies are likely in the second half of maturity within the standard five-stage industry lifecycle. If this ends up being the case, then there are broad implications for organic revenue growth in the sector, which has ramifications for expected total return and potential long-term investment returns.

R. Anthony Jasinski, Jr., CFA
Portfolio Manager
Trustmark Investment Advisors, Inc.

The difficulty in stepping back is that we are bombarded with numerous media outlets, from television, to radio, to newspapers, to the internet, all of which guide our thought process to the path of least resistance. Recently, that path of least resistance has led most of us to believe several things might not work out over the next 7-10 years. The goal of this short article is to highlight where our focus may be stuck (the trees), and then to hopefully pull readers' thought process back to focus on the larger investment landscape (the forest).

THE TREES

Put your equity exposure into an S&P 500 index fund and don't even think about active management.
All we seem to hear in the press is that passive investing trumps active investing. This has not been my experience over the past 25+ years. Notwithstanding my experience, over the past eight years passive index funds have taken in an unbelievable amount of assets at the expense of actively managed stock funds. As of Mid-2016, 28.0% of the U.S. investment industry's $17 trillion in assets were in passive funds, more than double the 13.0% allocation in 2008 (Source: Morningstar data as highlighted in October 20, 2016 article on CNN Money).

A 60.0% Equity/40.0% Bond portfolio has been the sweet spot in investing, and it will be going forward. From 1926-2013, an account of 60.0% U.S. stocks and 40.0% U.S. 5-year Treasury Notes returned approximately 8.5% per year with approximately 11.5% annual volatility (Source: DFA Returns database). This has caused many financial advisors, stock brokers and pension advisors to use expected return numbers for a 60/40 portfolio of 6.0%-7.0% and higher when advertising their services to clients.

The real risks in investment accounts are potential volatility and political events. Let's face it, stocks can be volatile investments, and that volatility can scare people into doing foolish things with their financial assets. From 1926-2013, a portfolio of 100.0% U.S. stocks had an annual volatility of approximately 18.5%. (Source: DFA Returns Database). This implies that every 5-10 years, a 20.0% move down in one's stock portfolio is likely to happen. Often times this volatility is tied to events started by politicians and government officials (for example, the Federal Reserve raising interest rates and putting the U.S. into a recession). So, it is understandable how investors see the connection between politics and market volatility.

Four to five percent yield on my account is needed to meet my withdrawal/income needs. Over the past 40 years, investors have grown accustom to simply chasing yield, both in stocks and in bonds. The 30+ year bull market in bond yields has afforded investors the opportunity to match their withdrawal rate with the net yield in their portfolio. In a world of 4.0% and higher bond and stock yields, this strategy made a lot of sense.

Now that we have look at the trees, let's pull back and look at things in a slightly different light:

THE FOREST

Active investment management has more benefits than the media would have you believe. According to DALBAR, over the past 30 years, the average U.S. stock fund has earned 9.0% per year. The average investor in those U.S. stock funds has only earned a 3.0% annual return. Assuming a 50.0% allocation to stocks, this would imply that the average investor in U.S. stock funds has earned 3.0% less than they should every year over the past 30 years. After taxes, this is more than 2x investors' money over the 30-year timeframe. By simply using a high-quality, registered investment advisor that keeps clients at a fixed acceptable asset allocation, investors would have only paid about 0.5% to 1.0% per year to earn that 3.0% per year on their whole investment account.

In addition, active investment allocation allows clients to be in the highest returning asset classes as opposed to just accepting average returns in an S&P 500 index fund. This is not to say that some index funds do not make sense for the average client. However using a one size fits all approach is unlikely to work well over the next 7-10 years, as highlighted in the next paragraph.

A diversified investment portfolio with several asset classes is increasingly likely to outperform a traditional 60/40 approach. Clients should think outside of the box with their advisors if they intend to earn an acceptable level of return over the next 7-10 years. This entails looking at certain foreign stock markets, foreign bond markets, commodities, and other alternative assets. Remember that true returns are rarely sustainable if one is constantly chasing what is hot, and what others have been buying.

A recent research piece by Ned Davis Research, showed that in the U.S, the proportion of stocks in investors' portfolio had a high negative correlation with future 10-year stock returns. In other words, the more investors were committed to stocks, the worse stocks performed over time. This analysis looked at 56 consecutive rolling 10-year periods. If one were to attempt to forecast using this research, and what it has been reflecting recently, the expected return from the S&P 500 over the next 7-10 years is in the low to mid-single digits, including dividends. When combined with 1.0% to 2.0% bond yields, this is not likely to be sufficient for most clients in terms of their distribution needs. Therefore we are at a very important point in time where active asset allocation might result in returns necessary for client income/withdrawal needs (over passive-only investing).

Focusing on total return instead of simply yield is often a safer and more successful strategy. The effect of retirees on yields in the bond and stock market is unprecedented. The sheer number of folks retiring is driving down yields to artificially low levels in many cases. Our high-dividend strategy, for example, has partially reflected this, having outperformed the S&P 500 benchmark by approximately 4.0% per year for the past 10 years. As another example, the 10-year U.S. Treasury note has recently hit all-time low yields, around the 1.3-1.5% level. This is the same 10-year note that yielded 15.5% in 1981! Because they have been in such demand, these high-yielding asset classes are most likely over-priced. That being said, I see many folks reaching for yield in a world where there isn't any. In many cases, the total return of these investments will be decently below their current yield. The question all investors need to ask themselves is this: Would I rather earn an 8.0% total return from a safe equity investment that yields 2.0%, or a 3.5% total return from a safe equity investment that yields 6.0%? As I analyze many investments in the marketplace, this is increasingly the question I am asking myself for clients. For those looking to retire, the former investment will likely get them where they need to be. The latter will only feel like it is working on paper, however, as the dividend returns will in fact likely be a partial return of principal.

The real risk in many investment portfolios going forward may be not earning an appropriate return. Investments can be volatile as they are reevaluated on a daily basis in the marketplace. While many consider this a risk, it is only a risk if it causes one to act foolishly and sell at the bottom and buy at the top. To offset this volatility, clients need to work with their financial advisor to structure an asset allocation that delivers a return and a volatility parameter that is acceptable over the long-term. This should mostly eliminate volatility as a risk consideration. As far as political risk is concerned, a properly diversified and allocated portfolio will also reduce most normal political risk.

The only real other manageable risk looking forward over the next 7-10 years is the one mentioned earlier – that is because of the large proportion of folks retiring versus the number of folks working in the U.S., future returns may not be what they once were. This is not to say that clients cannot earn a handsome return in their portfolios. It is saying that it may take some active allocation and management to get there.

To conclude, if investors want to have decent real returns over the next 7-10 years, there is a high probability that they will have to look in places not being touted by the media. In short, they need to avoid asset classes that have been overbought and potentially overvalued due primarily to active global yield and return seekers. Focusing on these asset classes would be to only focus on the trees. What clients need to instead focus on with their advisors, is the entire forest of investment opportunities. This may include asset classes that don't initially look like they will solve client investment needs. However, in practice, these investments may indeed be the only thing that will provide clients with sustainable real returns for years to come.