Investment Commentary: 5/2015

Global equities delivered positive returns in April, with foreign and emerging market stocks leading the way. In the U.S., the start of earnings season was not as bad as the market had come to expect. Despite worries about a resurgent dollar and profit warnings the S&P 500 finished the month up close to 1%. In the face of generally poor macroeconomic data small and midcap stocks sold off (2.55%) in April. Foreign stocks performed well and continue to lead global performance on a year-to-date basis. Developed international markets gained a little over 4% and emerging markets soared over 7%. The 10-year Treasury yield rose during the month, while intermediate-term bond returns dipped a slight 0.4%. High-yield bonds gained 1.2% and floating-rate loans returned 0.9%.

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The U.S. economy—the relative standout among its global developed peers—posted disappointing first quarter GDP growth in April (coming in at a 0.2% annualized rate), though harsh winter weather likely bears some responsibility. Consumer confidence also fell in April. Meanwhile, hopes abound that Europe's economy is on firmer footing as measures such as availability of credit improved. And finally, oil prices have been in a dramatic downward trend but reversed sharply upward in April. The extent to which any of these trends will persist over the near term is not predictable, which underscores the importance of investing with a disciplined, fundamental, long-term approach.

Research Q&A

We regularly use a question-and-answer format to address questions from clients about our investment views and current strategy. This format permits us to address a range of different topics and allows readers to focus on individual areas of interest.

Investment Environment

How do fluctuations in the U.S. dollar and oil impact your outlook for economic growth and the financial markets?

Both the dollar and the price of oil have been extremely volatile and spent a lot of time in the headlines the past year. In the short run, these two variables have moved financial markets and added to volatility. However, there are a multitude of factors and variables that impact economic conditions and financial markets, so focusing too much on these two would be a mistake. In other words, an investor might make a longer-term forecast about the dollar or oil and actually get it right (although whether that's due to skill or luck is a different question), but unexpected changes in other macro variables could swamp or neutralize the impact of their dollar or oil bet.

With respect to the dollar, over the longer term we believe fundamental valuation measures like purchasing power parity (PPP) have some validity. So from that perspective we are comfortable taking on some additional non-dollar exposure by increasing our exposure to foreign assets, particularly equities. From a long-term perspective, we like the overall portfolio diversification benefits from having non-dollar exposure.

With respect to oil, falling prices have varying impact on different parts of the U.S. and global economy. But we view falling oil prices, driven by strong supply growth, as a net benefit to the economy via its positive effect on consumer purchasing power. However, over the medium to longer term, the forces of supply and demand are also likely to put upward pressure on oil prices (as demand grows and supply is curtailed). Or there could be a technology breakthrough that renders oil less essential to the economy, counteracting that upward price pressure. Given the uncertainty we do not believe it is time to make large directional bets on oil prices, our best guess is that oil prices will stay contained due to excess supply that currently exists and can be turned back on if prices rise. Which is likely to suppress the earnings of energy related companies.

In January you recommended increasing the allocation to international stocks, can you comment on that decision and the risks to hedging currency versus being unhedged?

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In general, we believed that many of the known risks had been adequately priced into foreign stock valuations. Giving us confidence that potential returns justified an increased allocation to foreign stocks. Reviewing earnings trends and valuations for foreign (primarily Europe) stocks relative to the U.S. it was clear they were at historically attractive valuation levels versus their U.S. counterparts. We also believed aggressive monetary policy in Europe, Japan and China would create favorable conditions for risk assets to rally, similar to the QE experience in the United States. In regards to currency, strategically (long-term) we prefer an unhedged stance. Tactically speaking, there are risks to both.

Our view is that currencies are notoriously hard to value and can be vulnerable to wild fluctuations and overshoots based on sentiment. Therefore, it is unlikely we will make short-term bets on the direction of currencies. We have always approached currency from the point of view that it can be a tailwind or a headwind to excess returns in the short-run but over the long-term it tends to even out. Presently, the weight of the evidence points to the euro possibly being a tailwind. Comparing the results of some dollar- and local-currency-based models suggests the euro may now be attractive versus the U.S. dollar. When looking at the PPP-based metrics the conclusion is similar.

But we are mindful of the extraordinary policies currently being enacted by the ECB. This has been a key driver of the decline in the euro over the past year. It would be reasonable to think that much of the effect from the ECB's QE has already been priced into the euro (after all, the ECB, just like the Federal Reserve, has been pretty transparent about what it plans to do with its QE and for how long). However, we see there is general consensus in the market that the euro will continue to decline versus the U.S. dollar and could possibly go well past parity. While normally that would call for a contrarian approach (being fully unhedged), we also know currencies tend to exhibit momentum and can be significantly out of whack with valuation measures like PPP for a long time. So, there is a risk that being long the euro can be a headwind to returns. As a result, having some portion of your foreign investments hedged against currency risk may make sense in this environment.

Is the median price/earnings ratio a better measure of stock valuation than the more traditional market-cap-weighted P/E measure?

The median P/E ratio is just one of many valuation metrics we look at, including the Shiller P/E, price/sales, price/book, price/cash flow, market cap to GDP, dividend yield, and others. We think the median P/E is useful because it eliminates the possible skewing of data compared with the traditional market-cap-weighted P/E measures, which are driven primarily by the companies in the index with the biggest market cap. These traditional P/E measures may therefore not provide a full picture of the market since they are influenced most by larger-cap stocks. We'd also note that the median P/E may also better represent the valuation of the opportunity set for active large cap managers that are not tied to the index's company weightings.

The key point here is that no single valuation measure is perfect or determinative, which is why we look at multiple metrics when assessing valuations. We use a "weight of the evidence" approach and we certainly do not base our investment decisions on any single valuation metric like the median P/E.

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As it relates to the difference between the current median P/E and market-cap-weighted P/E measures, the first thing to point out is that the actual values are pretty close to each other. The median P/E is approximately 21.5x and the market-cap-weighted trailing P/E is 20.3x (as of 4/30/15). But there is a big difference relative to their own histories: the median P/E is around 30% above its 50-year median value, whereas the market-cap P/E is only about 5% above its 50-year median. So relative to history, the market looks much more expensive on a median P/E basis than on a market-cap P/E basis.

This data tells us that relative to history, the valuation of the median stock in the market is much higher than it has typically been. And just to be clear, the median P/E is where half the stocks in the index have a higher P/E, and half a lower P/E. So the "typical" stock in the index looks expensive or overvalued based on this simple trailing 12-month P/E metric. But the market-cap-weighted P/E suggests the biggest market-cap stocks are not so overvalued relative to their history, certainly not close to where they were in the market bubble of the late 1990s.

While the median P/E tells us that the median, or typical, stock in the index looks expensive, there is an additional important piece of information it does not tell us. And that is the dispersion or distribution of valuations across all stocks in the index. We could have an expensive median (and market-cap) P/E) but still have a wide "tail" of stocks in the market that are very cheap. That might still indicate an attractive opportunity set for active managers and stock pickers (e.g., this was the case during the 2000 market bubble in areas other than growth/tech stocks). Unfortunately, the valuation dispersion in the current market is relatively narrow. So, broadly speaking, the broad stock market looks to be somewhat overvalued.

Alternative Strategies

Why are you recommending alternative strategies and are there any new strategies you are evaluating?

The primary reason to own alternative investment strategies is for diversification and risk management. Owning alternative strategies that have a relatively low correlation to traditional assets (stocks and bonds) can reduce volatility and improve risk-adjusted returns. The performance of alternative strategies has been mixed over the past couple of years, as is often the case during strong bull markets. A good example is the diversified arbitrage category (merger, convertible, relative value, etc.) which lagged last year. The largest part of that disappointment came in the last four months of the year, as many funds were tightly hedged with the intention of capturing the "alternative risk premia" of merger spreads (e.g., convertible bond cheapness, etc.) while taking out most or all market beta. This approach was not richly rewarded over the last several years, while beta was. At the end of last year, the alt risk premia experienced negative performance (e.g., merger spreads widened), as tends to happen from time to time, leading to poor performance for alt-focused exposure without corresponding market beta to participate in the continued upward trend for equities. Some of this should reverse, and some is permanent loss (from deals that fell apart). While deal spreads in the merger space have tightened, they are not back to the tightest levels, and the nature of these conservative funds doesn't lend itself to making up the losses in a quarter or two, so we don't

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view the short-term meager performance as cause for alarm. That said, we are continuously evaluating our existing funds, as well as researching new funds in a variety of alternative strategies, including long-short equity, alternative credit, multi-strategy arbitrage, event-driven arbitrage, and others, with the intention of potentially adding to our lineup when we find funds in which we have a high level of confidence.

Managed futures is an area that we continue to review and believe may add positive attributes to client portfolios. We are currently evaluating the category and whether there are any managers and funds that warrant an investment. Since managed futures (or trend-following strategies to be more precise) are "Sharpe Ratio strategies" rather than definitive expected-return strategies, we can estimate the returns and downside by knowing what level of volatility a given manager is targeting in their particular fund. Targeting a specific volatility is relatively easy for good managers in strategies of this nature. While, of course, it is nearly impossible to say what returns will be over any given short-term period, we should have a reasonably good idea over medium- to long-term periods.

To clarify the Sharpe Ratio point, while there is no "valuation" to managed futures as there is in equities (e.g., P/E, P/CF, etc.) or fixed-income (yield to maturity, yield to worst), there is fairly extensive data from real-world practitioners (commodity trading advisors) as well as academic literature using data created from simple models on out-of-sample historical prices across a variety of asset classes. Our review of the research leads us to believe the expected Sharpe Ratio for managed futures is in the same range as equities over the long term (0.3–0.4), although several pieces of literature find Sharpe Ratios for trend following significantly higher than that. Thus, the expected level of long-term returns (and the potential for upside or downside around that level) depends on what level of volatility the manager targets. We will update our research as we come closer to making a final determination on allocations and positions.

Fixed-Income

Considering the expectations for rising interest rates, does it still make sense to have dedicated allocation to intermediate core bonds or munis, rather than holding cash or shorter-term securities?

The primary role of core bonds in our portfolios has never been to generate strong returns. Rather, the role of core bonds is as a risk reducer, or the ballast to lower the portfolio's overall volatility and provide shorter-term protection in the event of a macroeconomic shock, recession, or bear market for stocks and other riskier asset classes. Core bonds have historically performed well in these scenarios, and we expect that to be the case going forward. So for risk-management purposes, particularly in more conservative accounts, we maintain a meaningful allocations to core bonds.

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While we own core bonds in portfolios, we are underweight relative to our strategic allocation (or benchmark). We have very low expected returns for core bonds over the next five-years, a function of their currently low yields combined with the loss potential they face from rising interest rates. Accordingly, we have moved some of our core bond allocation to where we think are more attractive options in the bond arena. We own active funds that have significant flexibility to manage their interest-rate risk (i.e., their duration) as well as other risk exposures. These flexible and unconstrained bond funds we are using look very attractive relative to the core bond index along two important dimensions—yield and duration (which is a measure of interest-rate sensitivity). The funds' much lower duration means they face less of a negative price impact from rising interest rates. One example is floating-rate debt which benefit from rising rates, while their higher yields give them a big head start in terms of their multiyear total return potential. Floating-rate debt is an asset class that some of our managers are currently using and we are evaluating whether to add direct positions.

The biggest trade-off is some of the flexible/unconstrained funds come with some risks that core bond funds typically do not; specifically, credit or default risk and, to a more limited extent, non-dollar currency risk. However, we have a great deal of confidence in the manager's ability to assess and navigate these risks—incurring such risks only when the expected return is sufficiently high. More importantly, our allocation to "non-core" fixed-income funds shouldn't be viewed in isolation relative to just core bonds, but rather in the context of the overall portfolio risk exposure. When viewed in this total portfolio context, we believe we have offset the risks presented by flexible bond funds and constructed a portfolio with a more attractive return profile.

We expect volatility to increase as markets adjust to attempts to normalize monetary policy in the coming year(s). In this environment we expect our fixed income decisions to add value relative to the traditional bond benchmarks over the full market cycle.

—AWM Investment Team