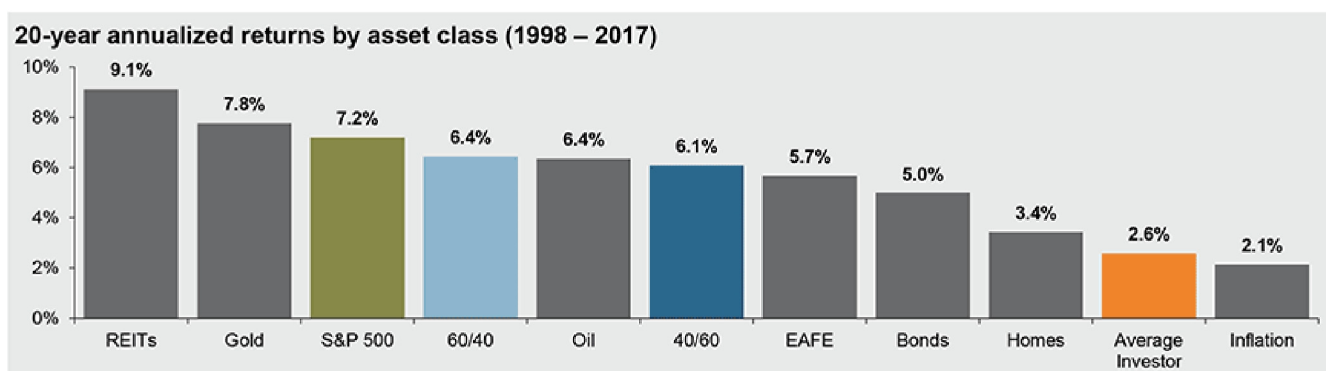
NOTES FROM THE NORTH: MARKET OUTLOOK

March, 2019

Buy low, sell high. Such a simple concept in theory and yet so *vexingly* difficult in practice. The chart below, featuring data from Dalbar Associates, demonstrates just how difficult it is to execute for the "average investor."

The colorful bars highlight the 20-year annualized return (ending 12/31/2017) for a variety of assets classes and for two "balanced" portfolios (the 60/40 and the 40/60 mix). Notice, however, the second bar from the right, representing the 20-year results for the average investor. Assuming Dalbar's calculations are correct, the typical U.S. individual has achieved an annual return of just 2.6%, well below each of the asset classes and barely staying ahead of inflation. The message we take from the chart below is that this average investor has underperformed even a conservatively balanced portfolio (40% allocation to stocks), by 3 and 1/2 percentage points of annual return due to a combination of factors, one of which is *selling low and buying high*.



Emotional investing decisions can be very expensive! Unfortunately, there is no straightforward method of determining whether it's time to be buying low or a time to be selling high.

One reliable approach is to "set it and forget it"; determine an asset allocation you can live with through thick and thin and rebalance when the allocations move away from your target. This is reliable, but not foolproof. The process doesn't prevent losses. Judgment is required to determine what asset classes to include, how to weight them, and when to rebalance them. It can also leave long-term return on the table if the "stick with it through thick and thin" metric causes you to have a lower equity exposure than is appropriate. (This is especially true for younger investors who are, on balance, *adding* to their investments.)

We typically modify the "set it and forget it" method by adding in thoughtful consideration of whether it is more likely a time to be emphasizing portfolio offense or portfolio defense, i.e. a time to be buying low or a time to be selling high. Recognizing that we are never entirely sure, we use the results of this exercise to fine-tune a client's equity target rather than to be "all in" or "all out." Adjustments are made within the equity portion of the portfolio, as well, to shift towards more or less market exposure ("beta" to those of you who enjoy financial jargon).

Presently, there are enough anomalies in the capital markets that we lean towards playing defense. For instance, over the last five years:

- The S&P 500 Index (domestic stocks) has outperformed the MSCI Europe and Far East Index (international developed market stocks) by over 50 percentage points (that's a total return of +49.9% compared to –1.8%, by the way).
- In the US, growth-style stocks have outperformed value-style stocks by a similar amount (+70% versus +28%).
- Inflation has been remarkably subdued, allowing central banks to leave interest rates extraordinarily low.

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Furthermore, on any number of metrics, valuations are high, and history has proven that the valuation starting point has a significant impact on long-term returns. The table below, from Ned Davis Research, shows how a low P/E (Price/Earnings) ratio starting point produces strong 10-year gains. Each quintile of higher valuation at the start results in a lower long-term return (although note that each level remains robustly positive).

If equity returns are likely to be lower than we've become accustomed to, perhaps portfolios should be shifted to bonds? Unfortunately, bonds today are also starting from a position of poor prospective returns. The 20-year return for bonds in the first chart (page 1) was 5%. Today, however, a 20-year Treasury bond guarantees just 2.8%. While we can use corporates to generate a yield to maturity of 3.5% (or so) with maturities no longer than 10 years, that's still a far cry from 5%. If we manage maturities adeptly and rates rise gradually, it is possible that bonds could produce a 5% return between now and 2039, but it's not likely between now and 2024.

Returns by P/E Quintile

P/E Ratio Quintile (1= Lowest, 5= Highest)	**Return** (Median Annualized Total Return Subsequent 10 Years)
1	15.7%
2	12.9%
3	9.9%
4	7.8%
5	4.3%

Source: Ned Davis Research

If we were writing for the internet, at this point we'd bait the trap for your clicks with a large font and an alarming headline. Since we're actually managing portfolios, not writing for clicks, our answer to the question "What is an investor to do?!?" is rather prosaic. Stay the course, but be prepared for lower returns in the next ten years than in the ten years just passed.

Tactically, BCA (whose tactical advice has been reasonably good in the last several years) does not expect this bull market to end until we enter a recession. Given the Federal Reserve's decision to at least temporarily stop raising interest rates, BCA thinks the timing of the next recession has been pushed back to the second half of 2020 at the earliest. However, after suggesting increasing stock exposure in December, BCA now recommends waiting for a pullback before committing more funds to the stock market.

Strategically, for a client building wealth, lower returns might require more savings in order to meet goals. For those drawing on their portfolios, lower prospective returns call for careful cash flow planning to preserve capital in the short-term, and giving some thought to a Plan B for the long-term, just in case. If we haven't had this conversation with you yet, please call!

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