

## October 2015

We had occasion to attend a luncheon and meet former Federal Reserve Chairman Ben Bernanke who was the featured speaker. The luncheon was held in Boston on a recent Friday, shortly after the September announcement that the Fed would keep rates unchanged. There were about 80 financial professionals in attendance from both the wealth management and institutional money management communities, and the format was a “fireside chat”; a moderated conversation with Dr. Bernanke, after which followed a question and answer session.

This was an opportune time to glean the inner-workings of the Fed Open Market Committee, which is the body within the Federal Reserve which votes on monetary policy. It was also an opportunity to pick the brain of Dr. Bernanke, who for better or for worse, charted the course of US and even global markets from near-collapse to our current status over the last eight years. Of course interest rates and the Fed have been very much in the news over the last several weeks, and much of the recent volatility we have experienced has been directly attributed to the “will they or won’t they” drama surrounding near-term monetary policy, as well as the timing of the inevitable first interest rate hike in 9 ½ years. The irony here, in our view, is that the Fed as a policy-making body has taken considerable pain over the preceding seven or so years to appear transparent and to telegraph intentions far in advance of any action to minimize market-rocking “surprises”.

Yet, on the eve of the September 24<sup>th</sup> policy announcement, we noted a *significant lack of consensus* among forecasters regarding the Fed’s pending decision.

We’ve been in numerous conversations in recent weeks with clients revolving around the topic of interest rates. The topic of interest rates itself reaches far into the depths of many market and financial planning concerns, thereby subdividing the “interest rates” topic into many sub-themes which affect the lives of most Americans and all investors in numerous ways. We’ll highlight two in particular that affect our clients:

- 1) Low interest rates = low savings returns. Seems like an obvious conundrum—and it is. But many investors who were perhaps just beginning to think about retirement 8 years ago are now living with the practical conundrum of low interest rates being paid on their life savings. The Fed’s actions over this period of time have forced investors into “riskier assets” in order to obtain a positive return on their money above the 0%-1% they can expect out of the “safe investments” most retirees would prefer.

Rising interest rates will *eventually* make available higher yields of course, but as we discuss below, rates can have a value destroying effect on financial assets *while they're rising*.

- 2) Market price volatility: Why does the openly discussed topic of rising interest rates engender so much volatility in the market? This is a more complex issue, but one we believe we will be living with for some time. Perhaps you've heard the term "inflated asset prices" as it relates to various discussions of rising stock (and bond) prices over the seven years that have passed since the Fed's first foray into "quantitative easing".

**Market volatility is directly connected to interest rates because interest rates are directly incorporated into the theoretical value of all financial assets.** John Burr Williams is widely recognized as a founder of

Flow"  
of  
asset

$$PV = \frac{FV}{(1 + i)^n}$$

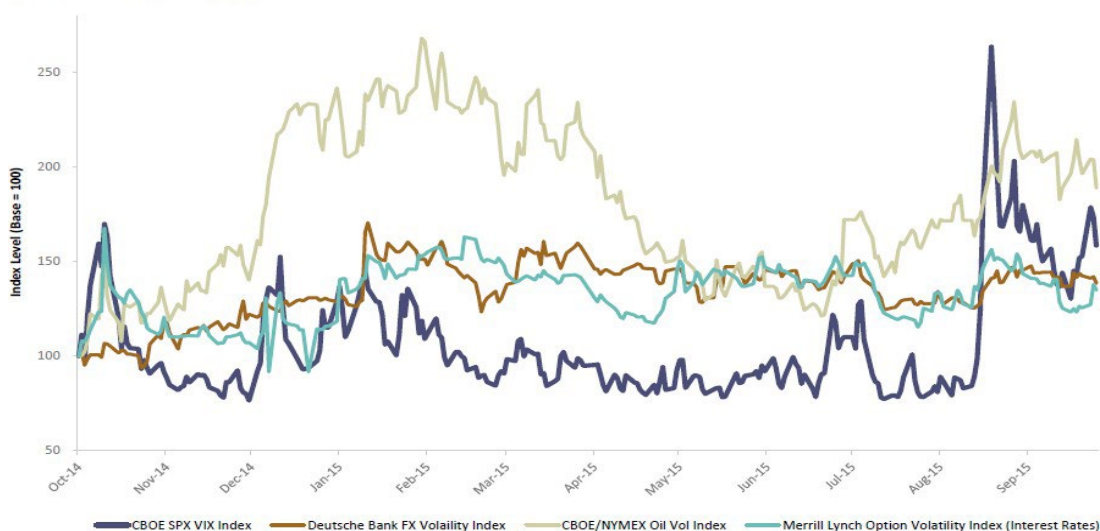
fundamental analysis in the early 20<sup>th</sup> century. The concept of "Discounted Cash analysis was outlined in his text *"The Theory Investment Value"* in 1938. It is the the bedrock principle behind almost all financial pricing models, including stocks, bonds, and commercial real estate, and even currencies. **Stated simply: the value of any**

**asset is the present value of all the asset's discounted future cash flows.** There are many discounted cash flow models which measure cash flows differently, for different applications. However the commonality among all the models is that they can generally be simplified into a complicated-looking fraction, with the sum of future cash flows in the numerator, and the discount rate in the denominator. The *discount rate in all these formulas is a direct derivative of the Fed Funds Rate*, most often termed the "risk free rate" in fundamental analysis.

As we all recall from our elementary school math curricula, if the denominator in the fraction (i.e. interest rates) rises, the value of the fraction (the Present Value of the Asset in question) gets smaller. The opposite also applies. The Federal Reserve has spent the last eight years driving down the denominator's most basic form (the Risk Free Rate) to zero, and has kept it there. So the fraction (Present Value of our stocks, bonds and commercial real estate) has risen virtually unmolested by a discount rate! Hence the term "inflated asset pricing".

## Market Volatility — Across Asset Classes — From Currency to Rates to Equities to Commodities — Markets Remained in a Heightened Volatility Environment

### Measures of Market Volatility



Source: Bloomberg LP. As of September 30, 2015.  
Past performance is not a guarantee of future results.

Fast forward to today's market gyrations and we see two important forces at play which have called into question the PV (present value) of today's assets, *which is the very source of volatility*. The numerator (FV: future value of cash flows) is dependent on economic growth. The denominator (derived directly

from the Fed Funds Rate) is understood by all to eventually rise. The forces affecting the numerator include domestic, "organic" economic considerations, but are also influenced from as far away as China. Again—5<sup>th</sup> grade math holds that even if the denominator remains constant (interest rates hold steady), a potentially shrinking numerator also results in a lower number (i.e., the present value of your portfolio). In short, volatility is back in the markets after a prolonged absence. Economic setbacks and uncertainty were easier for market participants to digest when they could be assured (as they were for the last 8 years) that the denominator was not going to rise. But this assurance was removed earlier this year as the current Fed Chairman Janet Yellen openly discussed the time table for an eventual increase in the Fed Funds Rate. We now have a situation where the numerator, economically driven, *must advance at a rate greater than the rate of interest rate increases* in order for current values to remain stable. Thus, the market becomes hypersensitive to economic turmoil and uncertainty.

**Volatility** in the capital markets tends to be a roving phenomenon, like a virus attacking different cells in an organism systematically. When concerns of slowing global growth merge with fears of higher interest rates, we see money quickly flow out of stocks and into short term bonds. Pockets of strength may remain, but not for long. We've seen this most recently with healthcare and biotech stocks, which have corrected 13% and 24% respectively from their recent summer highs, having defied the downturn inflicted on the rest of the equity markets to that point. The portfolio's comprised largely of Apple, Amgen or Netflix lost as much as 30% of their value during the last quarter (about as much as the S&P 500 lost in 2008). When concerns dissipate, as they generally always have over time, we see money flow back into stocks—thereby suppressing *bond returns*. The important take-away, in our view, is that there is no lasting “silver bullet” which will propel portfolio returns (for long) above the long-term, prorated allocation return we discussed in our July Outlook. As we pointed out, these expected returns are considerably lower than the historic returns many of our clients have experienced over most of their investing lifetimes.

To the extent that we foresaw the pending volatility and return challenges wrought by low and rising interest rates two years ago, we introduced the concept of non-traded REITs as an asset class into our model portfolios. We continue to feel investors can make *incremental adjustments* to at least temper the volatility of lower average returns. Our suite of model portfolios has been expanded to include strategies that have

Asset class returns GTM – U.S. | 55

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	YTD	15-yrs '00-'14	
																Ann.	Vol.	IT
Comdty.	REITs	Comdty.	EM Equity	REITs	EM Equity	REITs	EM Equity	Fixed Income	EM Equity	REITs	REITs	REITs	REITs	Small Cap	REITs	Fixed Income	REITs	REITs
31.8%	13.9%	25.9%	56.3%	31.6%	34.5%	35.1%	39.8%	5.2%	79.0%	27.8%	8.3%	19.7%	38.8%	28.0%	1.3%	12.7%	22.3%	
REITs	Fixed Income	Fixed Income	Small Cap	EM Equity	Comdty.	EM Equity	Comdty.	Cash	High Yield	Small Cap	Fixed Income	High Yield	Large Cap	Large Cap	Cash	High Yield	Small Cap	Small Cap
26.4%	8.4%	10.3%	47.3%	26.0%	21.4%	32.6%	16.2%	1.8%	59.4%	26.9%	7.8%	19.6%	32.4%	13.7%	0.0%	8.7%	21.8%	
Fixed Income	Cash	High Yield	DM Equity	DM Equity	DM Equity	DM Equity	DM Equity	Asset Alloc.	DM Equity	EM Equity	High Yield	EM Equity	DM Equity	Fixed Income	High Yield	Small Cap	EM Equity	EM Equity
11.6%	4.1%	4.1%	39.2%	20.7%	14.0%	26.9%	11.6%	25.4%	32.5%	19.2%	3.1%	18.6%	23.3%	6.0%	-1.9%	7.4%	21.5%	
Cash	Small Cap	REITs	REITs	Small Cap	REITs	Small Cap	Asset Alloc.	High Yield	REITs	Comdty.	Large Cap	DM Equity	Asset Alloc.	Asset Alloc.	Asset Alloc.	EM Equity	Comdty.	Comdty.
6.1%	2.5%	3.8%	37.1%	18.8%	12.2%	18.4%	7.1%	-26.9%	28.0%	16.8%	2.3%	17.9%	4.9%	5.2%	-4.4%	7.4%	18.4%	
High Yield	High Yield	Cash	High Yield	High Yield	Asset Alloc.	Large Cap	Fixed Income	Small Cap	Small Cap	Large Cap	Cash	Small Cap	High Yield	Small Cap	REITs	Fixed Income	DM Equity	DM Equity
1.0%	2.3%	1.7%	32.4%	19.2%	8.1%	15.8%	7.0%	-33.8%	27.2%	15.1%	0.1%	16.3%	7.3%	4.9%	-4.5%	5.7%	17.6%	
Asset Alloc.	EM Equity	Asset Alloc.	Large Cap	Asset Alloc.	Large Cap	Asset Alloc.	Large Cap	Comdty.	Large Cap	High Yield	Asset Alloc.	Large Cap	REITs	Cash	DM Equity	Asset Alloc.	Large Cap	Large Cap
0.0%	-2.4%	5.9%	28.7%	22.8%	4.9%	15.3%	5.5%	-35.6%	26.5%	14.8%	0.7%	16.0%	2.9%	0.0%	-4.9%	5.3%	17.2%	
Small Cap	Asset Alloc.	EM Equity	Asset Alloc.	Large Cap	Small Cap	High Yield	Cash	Large Cap	Asset Alloc.	Asset Alloc.	Small Cap	Asset Alloc.	Cash	High Yield	Large Cap	Large Cap	Asset Alloc.	Asset Alloc.
-3.0%	-3.9%	-6.0%	26.3%	10.9%	8.6%	13.7%	4.8%	-37.0%	25.0%	13.3%	-4.2%	12.2%	0.0%	0.0%	-5.3%	4.2%	13.7%	
Large Cap	Large Cap	DM Equity	Comdty.	Comdty.	High Yield	Cash	High Yield	REITs	Comdty.	DM Equity	Fixed Income	Fixed Income	Fixed Income	EM Equity	Small Cap	DM Equity	DM Equity	High Yield
-9.1%	-11.9%	-15.7%	23.9%	9.1%	3.6%	4.8%	3.2%	-37.7%	18.9%	8.2%	-11.7%	4.2%	-2.0%	-1.3%	-7.7%	3.0%	11.7%	
DM Equity	Comdty.	Small Cap	Fixed Income	Fixed Income	Cash	Fixed Income	Small Cap	DM Equity	Fixed Income	Fixed Income	Comdty.	Cash	EM Equity	DM Equity	EM Equity	Comdty.	Fixed Income	Fixed Income
-14.0%	-19.5%	-20.5%	4.1%	4.3%	3.0%	4.3%	-1.6%	-43.3%	5.9%	6.5%	-13.3%	0.1%	-2.3%	-4.5%	-15.2%	2.7%	3.4%	
EM Equity	DM Equity	Large Cap	Cash	Cash	Fixed Income	Comdty.	REITs	EM Equity	Cash	Cash	EM Equity	Comdty.	Comdty.	Comdty.	Comdty.	Cash	Cash	Cash
-30.6%	-21.2%	-22.3%	1.0%	1.2%	2.4%	2.1%	-15.7%	-53.2%	0.1%	0.1%	-18.2%	-1.1%	-9.5%	-17.0%	-15.8%	1.9%	1.0%	

historically only been availed of by endowments, pensions, foundations and other large institutional portfolios. These models include “liquid alternative” components which seek to capture both the upside and downside potential of global asset movements and replicate broad-based hedge-fund benchmarks. Importantly, the objective of these portfolio components is not to somehow produce returns which defy the muted expectations of stocks and bonds, but to provide a portfolio with a middle ground which, as a result of lower market correlations, comes with somewhat dampened overall volatility expectations. While

liquid, these strategies are not broadly appropriate for all investors. We encourage our clients to engage in a thorough due-diligence process with their advisor if there is interest in learning more.

The question we asked Dr. Bernanke directly at last month's luncheon was; *how does the Fed reconcile "full employment" in the US while we have a labor-participation rate below 65%, and akin to 1978 levels?* His answer was, not surprisingly, rather long. Parts of his answer also appear in a Wall Street Journal op-ed he authored on October 4<sup>th</sup> entitled "How the Fed Saved the Economy". Most of our clients likely don't follow US economic news or monitor monetary policy closely, so we'll explain that 5% unemployment in the US is considered "full employment", allowing for certain labor market frictions. Dr. Bernanke went on to explain changing demographics in our labor market (i.e. the aging of the Baby Boom generation) coupled with technological changes/productivity enhancements, plus the great labor force disruption that occurred seven years ago are most likely at play. In other words, no matter how low the current unemployment rate goes (currently at 5.1%, and "approaching full employment")—the population of unemployed working-age people will likely remain high for the foreseeable future. But what did surprise us about his answer was that he began it with the statement, "we really don't know, we've been studying it for some time".

In an economy that generates roughly 1/3 of its GDP growth from consumers, it is therefore not surprising that annual GDP growth has really never topped 3% since 2007 (with one very brief exception in early 2010). Recall, GDP impacts the numerator. Interest rates impact the denominator. We believe investors should acclimate themselves to continued subdued returns, and look to methods of smoothing out volatility where appropriate.

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