October 2018 Outlook

A sizeable chunk of the CFA curriculum* is made up of a combination of pension accounting and institutional portfolio management (both principles and practices). Since we can already sense your eyes glazing over, we will keep this a very high-altitude discussion. We bring it up because in years like 2018, we receive numerous questions and comments from clients which cut to the very core of what we do as wealth managers. It is also a germane discussion in an environment with such divergent asset returns.

Pension funds have similar *objectives* to that of most of our clients, which is to provide an asset base capable of producing a stream of income in the future for living expenses. Additionally, pension funds have quantified investment objectives, called a "discount rate". This is the rate of return which must be achieved over time such that the present value of assets will meet the future income requirements (which are legal *obligations*). This discount rate is, in effect, equivalent to the assumed rate of return incorporated into our clients' financial plans, and the discount rates applied to our clients' Cash Balance plans. One notable difference is that many pension funds and other institutions have a "perpetual" time horizon. We would say most of our clients have a time horizon roughly equal to their life expectancy--which is obviously finite for all of us.

Many institutional portfolios also have *risk profiles* similar to our clients. While upside is the ultimate goal, severe drawn-downs are to be avoided. Pension funds, banks, and insurance companies face significant ramifications in such circumstances (financial, or even legal)—as we witnessed in 2008. Significant drops in portfolio values inflict stress on balance sheets and income statements—which in turn negatively affect financial ratios, and ultimately a company's cost of capital.

While parallels can be drawn between the investment objectives and risk tolerances of various types of institutional portfolios, an obvious difference is the sheer size of these portfolios, which can range from *hundreds of millions*, to *hundreds of billions* of dollars. The stakes are high, and so the portfolio management and methodology must be sound, to say the least. While the asset levels differ—the importance of achieving the objective and managing the risk is identical. CCR Wealth Management has always operated under the assumption that our client's nest-eggs are sufficiently precious to them to apply equally sound management.

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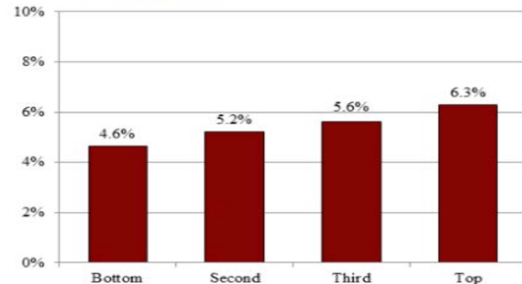
So how do institutions achieve their objectives while managing the risks?

For time immemorial, they have used the same principals used in wealth management—***diversification****—both within and among asset classes*.

To keep the conversation simple, we are primarily talking about stocks & bonds. While some "alternatives" factor into some of our portfolios, access to true private equity and hedge funds at the institutional level falls outside the scope of this discussion.

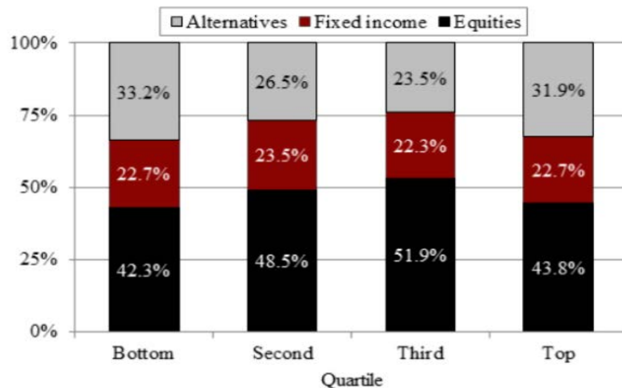
A recent report (July, 2018) from The Center for Retirement Research at Boston College outlined sources of variation of return for state and local pension funds due to asset allocation. The conclusions of the report are less interesting for this discussion than are some of the findings along the way. For the record, the report found the average annualized rate of return, net of fees, for public plans was 5.5% from 2001—2016. What struck us is the similarity among asset allocations.

Average annualized returns for public pension plans, 2001-2016, by quartile



Source: Aubry et al. (2018).

Asset allocation by quartile of returns, 2016



Source: Aubry et al. (2018).

Annualized asset class returns by quartile, 2001-2016

Asset class	Top	Third	Second	Bottom
Public equities	6.2%	5.1%	4.1%	4.1%
Fixed income	6.2	6.2	6.3	6.1
Alternatives				
Private equity	8.8	8.5	6.6	8.5
Hedge funds	5.7	4.5	6.3	5.0
Real estate	10.2	9.3	8.2	7.0
Commodities	5.0	6.6	-2.8	4.8

Source: Aubry et al. (2018).

In short, we hasten to point out that the average equity allocation in the pension plans is less than 50%. Let us now return to current market conditions. Regular readers of our Outlook will know that CCR Wealth Management has been predicting this year's lack-luster (to be kind) return in the general bond market for several years. A common question we've received throughout the year generally goes like this: "Well, if bond returns are not good, why do we own bonds?" The natural corollary to this question is, shouldn't we be all in stocks?

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There are two basic reasons for owning at least two asset classes: The first reason is that flipping back and forth between asset classes based on which one has the best recent returns virtually guarantee that you will accumulate a track record of buying high and selling low. The second reason, one that both pension and institutional investment committees are quite familiar with, is that bonds and stocks have, on average, very low correlations to one another. This relationship helps to manage the downside risk. The allocation relationship between the two is set to achieve the discount rate *over time*. We venture to say no bank, insurance company or pension portfolio managers are looking at their twelve month returns and preparing for massive redeployment of assets as a result.

Investment committees for large institutional portfolios are generally made up of savvy, sophisticated investors who understand that a required rate of return (the discount rate) must be achieved *over time*, given the variable return nature of different asset classes. That returns of 13%-15% in a diversified portfolio one year may be followed by returns of 1%-2% the next is not all that unusual. The average would generally satisfy most required returns.

																2003 - 2017	
2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD	Ann.	Vol.
EM Equity 56.3%	REITs 31.6%	EM Equity 34.5%	REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	EM Equity 37.8%	Small Cap 11.5%	EM Equity 12.7%	EM Equity 23.0%
Small Cap 47.3%	EM Equity 26.0%	Comdty. 21.4%	EM Equity 32.6%	Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	DM Equity 25.6%	Large Cap 10.6%	Small Cap 11.2%	REITs 22.3%
DM Equity 39.2%	DM Equity 20.7%	DM Equity 14.0%	DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	Large Cap 21.8%	Asset Alloc. 2.9%	REITs 11.1%	Small Cap 18.8%
REITs 37.1%	Small Cap 18.3%	REITs 12.2%	Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty. 11.8%	Small Cap 14.6%	REITs 1.8%	Large Cap 9.9%	Comdty. 18.8%
High Yield 32.4%	High Yield 13.2%	Asset Alloc. 8.1%	Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	Asset Alloc. 14.6%	Cash 1.3%	High Yield 9.6%	DM Equity 18.4%
Large Cap 28.7%	Asset Alloc. 12.8%	Large Cap 4.9%	Asset Alloc. 15.3%	Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. 0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	High Yield 10.4%	High Yield -0.6%	DM Equity 8.6%	Large Cap 14.5%
Asset Alloc. 26.3%	Large Cap 10.9%	Small Cap 4.6%	High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	REITs 8.7%	DM Equity -1.0%	Asset Alloc. 8.3%	High Yield 11.3%
Comdty. 23.9%	Comdty. 9.1%	High Yield 3.6%	Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 3.5%	Fixed Income -1.6%	Fixed Income 4.1%	Asset Alloc. 11.0%
Fixed Income 4.1%	Fixed Income 4.3%	Cash 3.0%	Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Comdty. 1.7%	Comdty. -2.0%	Cash 1.2%	Fixed Income 3.3%
Cash 1.0%	Cash 1.2%	Fixed Income 2.4%	Comdty. 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%	Cash 0.8%	EM Equity -7.4%	Comdty. -0.3%	Cash 0.8%

Source: Barclays, Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management.
Large cap: S&P 500, Small cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Comdty: Bloomberg Commodity Index, High Yield: Bloomberg Barclays Global HY Index, Fixed Income: Bloomberg Barclays US Aggregate, REITs: NAREIT Equity REIT Index. The "Asset Allocation" portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Bloomberg Barclays US Aggregate, 5% in the Bloomberg Barclays 1-3m Treasury, 5% in the Bloomberg Barclays Global High Yield Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. Annualized (Ann.) return and volatility (Vol.) represents period of 12/31/02 – 12/31/17. Please see disclosure page at end for index definitions. All data represents total return for stated period. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of September 30, 2018.

2018, while not over yet, has certainly been a year of divergent asset returns. Note the nearby chart—which we've posted in prior Outlooks. Updated through September 30, this "periodic table" shows asset returns using common benchmarks for each year, going back 15 ¾ years. Also plotted is a JP Morgan diversified portfolio "benchmark" (white boxes) comprised of these indexes. While this need not be the benchmark of any client in particular—it gives a fairly good indication of what a diversified portfolio has returned in each of the last 15 years, and year-to-date through September. It is the year-to-date through September number we found has surprised some of our clients. They read (or heard or saw on TV) that the S&P 500 was up over 10% for the year. So they should be up in that range, right?

This periodic table shows three other key pieces of information that influence a diversified portfolio, of which institutional investors are aware. The first is the disbursement of returns in any given year between asset classes and within asset classes (note that in 2007, 55.5% separated the best performing asset class from the worst, where as in 2016, this difference was only 21%). The second crucial piece of information which informs institutional asset managers is the risk embedded in their portfolios. The right-most column of the chart shows the risk of each asset class, expressed as standard deviation. Note that the diversified portfolio has the third lowest risk among the assets listed, bested only by cash and bonds. Last, this table illustrates the difficulty in doing what many individual investors tend to make a habit of *trying to do*, which is predicting where to put all their "chips" from one year to the next. We could have observed at the end of 2017 that Emerging Markets Equity (up 37.8%) was where to be. Through the end of September however, it is the worst performing asset class listed.

So why do we own bonds? Because years like 2008, 2014 and 2015 do not announce themselves in advance!

It is October, after all!

Turning our attention to the weeks that have passed since the third quarter ended, we add some bulleted thoughts on the current market.

- From October 1st to October 23rd (intra-day, as we write), the S&P 500 is down 7.56%, the Dow Jones Industrial Average is down 6.75%, and the NASDAQ Composite is down 8.92%.

  The Bloomberg Barclays Aggregate Bond index (as measured by the iShares AGG ETF) is down 0.54% over this same period.

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- October gets a bad rap as being the worse month for stocks in the calendar. This is

because several "named" famous sell-offs have happened in October, including "Black Monday" in 1987, "Black Tuesday, Thursday and Monday" in 1929, and the "Panic of 1907". However, statistically the "worse-month-for-stocks award" belongs to September. Nevertheless, there is statistical seasonality to this time of year, with October owning the title of the most *volatile* month of the year.

- LPL has done research showing that stocks tend to do very well after midterm elections. According to their research, "The average 12 month gain off midterm election lows is over 30%, and since 1946 the S&P 500 has never been down 12 months following midterm elections."

- Stocks are less expensive today than they were 12 months ago, despite higher index levels. The Large Blend boxes in the chart below represent the S&P 500.

S&P 500 9/30/2017:   2,519.36

Current P/E vs. 15-year avg. P/E*

	Value	Blend	Growth
Large	15.9 / 13.1	17.7 / 14.5	20.6 / 16.7
Mid	16.4 / 14.1	18.1 / 15.7	21.0 / 18.0
Small	19.5 / 16.8	25.2 / 20.1	34.9 / 25.2

S&P 500 9/30/2018:   2,913.98

Current P/E vs. 20-year avg. P/E

	Value	Blend	Growth
Large	14.1 / 13.8	16.8 / 15.9	21.3 / 19.7
Mid	14.5 / 14.2	16.9 / 16.2	22.2 / 21.1
Small	15.5 / 16.0	22.2 / 20.1	37.4 / 29.2

Source: FactSet, Russell Investment Group, Standard & Poor's, J.P. Morgan Asset Management.

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This is due to the rising E (earnings) in the P/E relation we spent much time talking about in the last few years. The denominator is on track to rise ~25% this year, resulting in a lower multiple.

This Outlook edition has (uncharacteristically) trod lightly on economic numbers and interest rate narratives. Suffice it so say, the numbers have remained quite strong since our last e-mail in August. We are also aware that having imagined the prospect of cooling economic growth in the coming calendar year and an eventual end to the current market cycle not too long afterward, that we leave the prospect dangling with no follow up this month. Truth is, this view is becoming popular with market watchers and practitioners. Our omission of a follow up is intentional, as importantly, we do not wish to conflate the current market volatility with a scenario we think is both at least a year away and notoriously difficult to time. Current fundamentals support opportunistic buying in equity markets today, in our view.

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