LIFE BEYOND STOCKS

- So burdensome is the narrow-minded investment news cycle, investors might be forgiven for losing sight of the broad swath of investment opportunities outside of the equity space. Or that the greatest impact of portfolio diversification can be had at the asset class level, an effort made greatly more convenient by the advancing breadth of the exchange-traded fund (ETF) universe.
- We are truly agnostic when it comes to investment exposures—we just want exposures that properly balance expected risk with potential return. To be frank, in our opinion proper portfolio diversification cannot be found within one asset class alone. Certainly not solely within the equity universe.
- No model can properly quantify the secular changes taking place throughout the global economy whether they are monetary, fiscal or geopolitical. We'll readily admit that we'd be stymied...to the point of a non-workable solution...in any attempt to incorporate even slices of that long list of potential threats to valuations in a broad-market valuation that gets us to the current levels of much of the equity space. And we're confident that anyone that claims otherwise is selling something.
- So where would an investor prefer to be instead of equities? Certainly, we'd encourage strong consideration of the risk-adjusted potential returns of corporate bonds over equities. We particularly like lower-rated investment grade and higher-rated below-investment-grade bonds. Relative to U.S. domestic equities we also prefer Treasuries, municipal bonds and even gold. Our last asset class we prefer over equities is real estate—primarily REITs and residential—as we again find the risk-adjusted return potential across the REIT market to be better than that available across most aggregate equity exposures.
- In sum, we believe that several asset classes offer risk-adjusted opportunities superior than those implied by most equity valuations. This may not be true in a few short months. The capital markets react swiftly and with such volatility come new tactical opportunities.

Cheers from Team Equities have been marginally less enthusiastic since April as the risks that define current equity-market investment opportunities have become broadly more obvious. Not that we can excuse the fact that the shift may be a matter of detail to many, rather than of substance. So set against changing their stance and further encouraged by misguided monetary policy, however, equity apologists will have us believe each small setback is another buying opportunity. Our bets are that the "buy on the dips" rationale will go down swinging. Fundamentals can't be ignored forever.

So burdensome is the narrow-minded investment news cycle, investors might be forgiven for losing sight of the broad swath of investment opportunities outside of the equity space. Or that the greatest impact of portfolio diversification can be had at the asset class level, an effort made greatly more convenient by the advancing breadth of the exchange-traded fund (ETF) universe. To be fair—by mandate, expertise or otherwise—a particular asset-manager's investment decisions may need to fall within a unique asset class. Still, that's no excuse to dismiss either the risks inherent in any specific investment opportunity or the benefits to choosing asset-class diversity over concentration within portfolios.

Our purposes here are not to be overly bearish toward equities. Rather, we want to objectify the investment decision and portfolio construction process so that readers at least consider an alternative perspective on equity valuations and arguably better risk-adjusted return exposures we see offered by other asset classes. We are truly agnostic when it comes to investment exposures—we just want exposures that properly balance expected risk with potential return.

Truer diversification

To be frank, in our opinion proper portfolio diversification cannot be found within one asset class alone. Certainly not solely within the equity universe. Were that the folks talking up "inexpensive stock valuations" in the midst of "a growing global economy" operated upon such a premise. Indeed, many in the investment profession have fixated on the return potential for U.S. domestic equities—large capitalization stocks in particular. In our view, the rationalizations sourcing most of these theses seem to ignore many of the fundamental realities driving global fundamental health. The resulting "fair" equity valuations thus likely fail to fully appreciate the evolving dynamics in equity fundamentals and the resulting risks associated with expected return computations.

Again, we suppose we can fault what was until late April a strongly-trending market for the stupor. Of course, with this past month's-worth of rising fear we might have rightly expected the clamor for stocks to have eased. Alas, there remains what seems to us a pretty obviously strong desire to see the momentum continue. Recall that equities are sold more so than they are bought. This is unique to that asset class. The recent rancor around equity market dynamics seems to be following the usual historical pattern of an acceleration of value well ahead of supporting fundamentals. Reality be damned seems to resonate. Always note the source of any investment advice. Impartiality, discipline, and asset class diversification are essential when considering advice being proffered by those incentivized differently.

Blame it on the Fed?

No surprise there, really, as risk assets—equities in particular—have benefited greatly from the profligate monetary and fiscal policies of the recent past. Monetary authorities in the U.S., in fact, have touted the successes of their policies by measure of the strong performances across the equity markets. Never mind the revisionist nature of these proclamations, their claims that the wealth effect will rejuvenate organic economic growth both domestically and abroad are in our view likely to prove ill-derived.

Please allow us a nod to a long and growing list of concerns in regard to the strength of the U.S. economy: employment participation levels dance with record lows; real wages remain on the decline; residential real estate prices continue to fall, with consequences dire not only for the homeowner, but also the financial sector; the output gap remains stubbornly large; regulatory burdens are on the rise; meaningfully slower economic growth projections are more commons...and remain more realistic. This list of domestic issues by no means exhaustive, we can add: growing acceptance of the likelihood of sovereign debt defaults in peripheral Europe (restructuring, re-profiling, etc.) and the political fallout of such actions throughout the EU, rising and sustainable inflation (both wage and commodity) throughout the emerging economies, and persistent geopolitical instability throughout most of the Middle East.

Now, please allow some 'what ifs?', none in our view too unlikely: What happens when domestic U.S. monetary and fiscal policies come to an end? What happens when a default actually takes place in peripheral Europe? What if there is another impactful disruption in the supply of oil due to more unrest in the Middle East? What if China's current restrictive policy proves too firm...too weak? What about the Japanese economy following the tsunami disaster? Minimally, we can state that the risk dimension will be dramatically altered—in fact, we'd argue that organic growth will be meaningfully constrained. In other words, the macroeconomic backdrop to earnings growth will be severely challenged. Indeed, the very same corporate balance sheets used to justify valuations are currently built for a long sideways slough through economic challenges. Growth will be hard to come by and it seems that most corporate executives realize this as fact and have built their financials to deal with it. Despite what others might want to believe, potential realities of such consequence demand more objectivity in portfolio construction.

Model that

We don't like to forecast investment returns given that forecasts are always—and we mean always—wrong. It's a silly exercise that adds no value. We've refused to participate in these approaches over the years because we realize that any investment conclusion reached is highly sensitive to the underlying assumptions and inputs. In other words, the standard errors of all the inputs are too large to establish any worthwhile conclusion. Turned around, we could reach any conclusion we wanted by tweaking the inputs accordingly. Want an ending, make up the story. Pitch...repeat.

The equity valuation modeling process has its place in that it can be a very good learning framework, but it must be used with great care. No model can properly quantify the secular changes taking place throughout the global economy whether they are monetary, fiscal or geopolitical. We'll readily admit that we'd be stymied...to the point of a non-workable solution...in any attempt to incorporate even slices of that long list of potential threats to valuations in a broad-market valuation that gets us to the current levels of much of the equity space. And we're confident that anyone that claims otherwise is selling something.

Life beyond stocks

So where would an investor prefer to be instead of equities? Certainly, we'd encourage strong consideration of the risk-adjusted potential returns of corporate bonds over equities. Sure, inflation might be the greatest strike against the class...were unexpectedly onerous inflation likely in the medium term. We strongly believe that inflation is not an issue—particularly with the tremendous output gap and as all levels of governmental munificence are reined in. We particularly like lower-rated investment grade and higher-rated below-investment-grade bonds. These bonds tend to have strong financial support, relative low duration risk and steady income. Steady real income compares well favorably, in our view, to theory that effectively boils down to "they've gone up in the past."

Relative to U.S. domestic equities we also prefer Treasuries, municipal bonds and even gold. In tune with prior comments and seemingly still the big fear at the Fed, the risk of deflation (output gap, wage stagnation, unemployment claims, etc.) has not subsided sufficiently to be ignored. As we foresee risk growing atop the equity complex we expect the demand for Treasuries to increase well beyond the draw from the current round of quantitative easing. This is particularly so as the aforementioned global issues evolve.

Due to the same interest rate dynamic we also like municipal bonds and think that good security selection in this arena will be handsomely rewarded. Municipal bonds have done very well thus far this year as a result of highly publicized scare tactics and the subsequent opportunities they presented. We'd continue to encourage investors to take advantage of any renewed bearish call-driven stampede for the exits. This has particular appeal to those interested in a buy and hold to maturity approach.

For all of the fiat currency concerns globally, we also still like the secular backdrop of gold, again, especially when compared to that of most equity spaces. We advise investors to take advantage of its oscillatory nature and continue to add exposure to the precious metal in a tactical and opportunistic manner. Indeed, being nimble...tactical, as it were...we think will pay off handsomely in the forthcoming quarters and years.

Our last asset class we prefer over equities is real estate—primarily REITs and residential—as we again find the risk-adjusted return potential across the REIT market to be better than that available across most aggregate equity exposures. Rent-driven income should realize an ever increasing premium going forward as the real estate market continues to struggle. That struggle, for cash heavy portfolios, will offer several opportunities across the residential real estate market. This last preference, obviously, does come with practical limitations. But we are confident that adding exposure to this space over the next year or so will prove over the next decade to be more impactful from both a risk and a wealth accumulation perspective than anything within the equity spaces.

In sum, we believe that several asset classes offer risk-adjusted opportunities superior than those implied by most equity valuations. This may not be true in a few short months. The capital markets react swiftly and with such volatility come new tactical opportunities. We advise investors to remain objective and to never put too much faith in numerical estimates of expected return. Instead, we'll suggest investors remain ever mindful of the potential return *and risks* inherent to any individual investment decision—keen emphasis on the latter—while contemplating the potentially bolder portfolio-level potential return/risk scenarios that can be achieved through broader asset-class diversification, as well as short- and medium-term investment flexibility.

IMPORTANT INFORMATION

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