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The Past is History

There have been many recent pronouncements warning that the lack of returns in equities over the past decade is only a taste of what is to come. These predictions purport that the opportunities for long-term equity market returns no longer exist. Therefore, they argue, the run-up in equity prices from the lows of March 9, 2009 has given investors the perfect opportunity to exit stocks for good.

The current argument against holding equities rests on an extrapolation of the past ten years, contending that equities will continue to wander along a wayward path of limited upside and unlimited volatility. To be successful as an equity investor in such an environment, one must be able to accurately "play the trading range" by buying on dips and subsequently selling when stocks rebound. The concept is fairly straightforward on paper for a market that oscillates in a predictable range for a prolonged period of time. However, after layering in short-term capital gains taxes and trading costs this becomes decidedly more challenging. For those who are unwilling to play the trading range, buying bonds becomes the strategy of choice.

Insanity is often described as performing the same action repeatedly, getting the same results, and each time expecting a different outcome. It is no wonder then that maintaining a long-term strategic allocation to an asset class (equities) that has performed so poorly over the past decade is thought by some to be nothing short of insane. This has caused investors to flock to strategies that have worked well in the recent past, which has most commonly been an increased allocation to bonds. Instead, one should look to understand the fundamentals that will drive investment returns going forward and adhere to a well thought out, non-emotional strategy.

There is no question that the market events of the past three years have driven investors to reexamine their risk tolerance. Some who thought they could handle equity market volatility were proven wrong in 2008 and early 2009. Their realization of a lower risk tolerance surfaced at the precise time that the markets bottomed. Poorly timed reallocations meant the subsequent upside was missed. These investors accepted all of the downside while foregoing any future benefit of a recovery in equities.

Admittedly, extrapolating the returns of the past 10 years provides a compelling argument for bonds over equities. However, history can serve as a painful reminder of what happens when investors chase yesterday's news. Ten years ago the mainstream argument was flip-flopped, with U.S. stocks having outperformed bonds by a wide margin for much of the previous two decades. It was argued that traditional equity valuation measures no longer applied, as many technology and internet stocks traded at more than 100 times earnings. The flow of funds out of bonds and into equities was unprecedented. The result was disastrous, with the NASDAQ composite eventually falling more than 75% over 3 years from its peak in 2000.

While complacency sent investors piling into internet stocks at their peak in 2000, capitulation caused a mass exodus out of stocks in March of 2009. The

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Investment Company Institute has cited that from January 2008 through June 2010, outflows from equity funds amounted to $232 billion while $559 billion found its way into bond funds. We believe that the recent flow of funds out of equities and into bonds highlights an overly pessimistic view of the current economic environment.

The past three months have been a prime example of continued investor frustration, stemming from consistent volatility within the equity markets. The S&P 500 Index lost 5.2% in June, regained 7% in July, and gave up another 4.5% in August. While the volatility is not comforting, one must be willing to filter through day-to-day, week-to-week, and month-to-month fluctuations to accurately assess the longer-term prospects for equity returns. Again, it is trends such as these that make bonds such an attractive safe haven for so many investors.

Investors flocking to the safest investments, along with the amount of government stimulus that has been injected into the economy have caused interest rates to plummet, sending the prices of bonds higher. With interest rates at generational lows, the prospects for a continued rally in government and investment grade corporate bonds has diminished, leaving their valuations looking quite rich. The last time interest rates were at current levels was 1955. The following 10-year return for bonds was less than 2% per year, or just over the rate of inflation. While investing in bonds offers investors a high degree of certainty, the 10 year treasury is currently yielding just 2.8% and the interest payments are fixed. After factoring in inflation, taxes, and the possibility of interest rates moving higher, investors may be setting themselves up for a significant loss of purchasing power over the life of the bond. For those who opt for Treasury Inflation Protection Securities (TIPS) as a means to protect against inflation, the current yield is even lower than that of a traditional treasury bond.

We believe that large cap US equities provide a compelling alternative to the investment grade bond market. Contrast the 2.8% yield on the current 10-year treasury with the 10 highest dividend paying stocks in the S&P 500 Index, which boast an average yield of more than 4%. Further, while most bonds pay a fixed rate of interest, companies such as Johnson and Johnson (AAA rated with a dividend yield of 3.6%) have a consistent history of increasing their dividend payments over time. Not only do these companies offer current income, but they also protect investors against possible inflation. For those who remain unsettled about the prospects for the US economy, bear in mind many US domiciled dividend payers garner a significant portion of their revenues from developing and emerging non-North American economies, many of which are growing much faster than the United States.

For those that remain steadfast in their belief that investment grade fixed income will continue to outperform equity investments, it may help to consider why corporations issue debt to investors. Corporations finance capital investment with debt (i.e. issue bonds to investors) to earn a rate of return above the cost of that debt for their shareholders. If a corporation is not able to earn a rate of return that exceeds their cost of capital for a prolonged period of time, that corporation will eventually cease to exist. Corporations are willing to issue debt in the current environment because the current rates are unbelievably attractive. This is ideal for corporations, but we believe that those providing the capital (bond investors) may be getting the short end of the stick.

In short, we would be hesitant to increase strategic fixed income allocations in low yielding treasuries and high quality corporate issues while reducing strategic equity allocation targets. This is particularly true when high quality large cap domestic equities are exhibiting solid balance sheets and have the ability to sustain and increase already attractive dividend payouts. We currently view a gradual movement toward the upper end of prescribed equity allocation ranges for our clients as being prudent, while remaining fully aware this may be emotionally disturbing to some, if not all clients.

As we have written in a recent blog, a defining characteristic of the end of most bear markets is retail investor fatigue, including a complete loss of faith in common stocks and a persistent desire for only the safest investments (as evidenced by the flow out of stocks and into bonds cited above). Bull markets have been known to climb a "wall of worry" and we fully acknowledge that there is no shortage of economic challenges on the radars of investors.

Our current investment thesis is supportive of a gradual transition from a secular bear market, which has persisted for the past ten years, to a secular bull market in which the next major move in the equity markets is likely to be higher. Through all of the panic there exist meaningful signs of healing. Some of the most notable signs in our opinion are the actions being taken to address unfunded liabilities across the globe including austerity measures in Greece, an increase in the retirement age in France, and a movement of domestic municipalities away from expensive public defined benefit pension plans.

Much like the "peace dividend" that was unleashed following the collapse of the Berlin Wall (which signaled an end to the costly arms race of the Cold War), we could be witnessing the formative stages of the "public sector pension reform dividend." Simply put, financial markets performed very well in the 1990's as capital was re-directed to more constructive ventures such as drug development and the build out of the internet infrastructure. If indeed these unfunded liabilities are tamed, capital might once again be directed toward job creation, spurring productivity growth and investment, which could lead to corporate profitability and cause equity prices to resume their historic march upwards.

Reflecting on recent market activities, including the aforementioned austerity measures both domestically and abroad, financial regulatory reform, and the upward (albeit gradual) trend of economic data, we expect to see a continued pattern of two steps forward and one step back. We are encouraged by the recent merger and acquisition activities, which demonstrate a willingness on the part of corporations to deploy large amounts of cash. We are also hopeful that the fall elections will lead to more clarification on tax policy and healthcare benefits, allowing employers to understand the "rules of the game" as it pertains to future capital investment and hiring, thus allowing capacity utilization and employment to trend upward.

While the ills of our past will likely linger in the form of high national debt, elevated unemployment, and a slow growth environment for some time, we must be cognizant of the risks that exist when investment actions are driven by emotions. Further, assuming that strategies that have worked well in the recent past will continue to do well can be particularly damning. In the words of Wayne Gretzky, it often pays to "skate to where the puck is going to be, not where it has been."

Welcome Home Soldier…

After a near nine month absence, son-in-law Jeffrey Lehnert returned from Iraq to our home and the welcoming presence of his wife and daughters a few weeks ago. Following what I understand to be a fairly detailed debriefing from/to his senior officers at Buckley Air Force base in Colorado, he was immediately assigned equally pressing, domestic duties in Northville, Michigan. These duties included the preparation of rations for those under his command - cheerios, mostly - and some hazardous materials disposal (Natalie is only 18 months old). We are grateful for the well-wishes and prayers from friends and family. He returns to a country that is digging out of a mess, but rest assured, he is glad to be back home. We have thanked him for his service to our country.

Bob Bilkie

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