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TAKING STOCK ONCE AGAIN

BY ROBERTSON P. BREED, CFA, SENIOR VICE PRESIDENT

Though much has changed since March 2013 – the last time I wrote this piece – our opinion on positioning an investment portfolio has not. Back then our message was clear: "*Take stock – this one simple decision may largely determine whether or not you meet your spending and investment objectives over the coming decade and beyond.*" We were referring to the asset allocation decision or target "mix" of stocks, bonds and cash. Given the opportunity set available at that time – extremely overvalued bonds, reasonably valued stocks and yieldless cash – we suggested investors maximize their stock exposure given investment policy (and/or cardiac) limitations. We believed the stock market had potentially started a secular (or long-term) bull market where stocks would outperform bonds for an extended period. Doubters claimed the then four-year stock rally following the financial crisis was artificially engineered by central bankers; that money-printing by said central bankers would ignite runaway inflation; or that overwhelming deflationary impulses would eventually prevail and crash the U.S. financial system.

That worst case has not come to pass, and our call for stocks over bonds now seems prescient. As of June 29th, stocks have outperformed bonds since March 2013, rewarding those managers who allocated them a significant share. The race really wasn't even close: stocks, measured by the Standard & Poor's 500 Index, returned 38% (15.3% annualized) while bonds, measured by the Barclays Aggregate Bond Index, eked out just 3.5% (1.6% annualized).

In reviewing those returns, it's striking how circumspect investors have remained throughout stocks' dramatic outperformance. Talk about climbing the proverbial wall of worry – this bull market may be the most unloved in history!

This begs the obvious question: Now what? We are "taking stock once again" based on the same arguments we made two years ago. First, favoring bonds now seems inconsistent with most investors' need to meet both immediate spending requirements and preserve inflation-adjusted principal. Second, despite stocks' significant thirty-month run, the potential "Great Rotation" – the possibility investors ultimately abandon low-yielding (and potentially money-losing) bonds and rotate into stocks that promise higher yields and potential capital appreciation – has yet to materialize. With investors' "flight-to-safety" mentality now grudgingly receding and the Federal Reserve set to raise rates for the first time in *nine years*, some iteration of the Great Rotation seems increasingly likely. Regardless, the following facts remain:

- It's simply not possible to withdraw 4-5% of portfolio assets annually if a significant portion of the portfolio is earning 1-2% per year.
- Stocks continue to trend up. Though stocks are not cheap, bull markets rarely implode shortly after major indices make all-time highs, as seen recently.
- Bonds remain very expensive (i.e., bond yields are *extremely* low historically) and therefore carry real risk. Although the 10-year Treasury Note now yields 2.3% (up from 1.9% in March 2013), it yielded *more than 5%* as recently as 2007.

- Losses on bonds are magnified when yields are low. Paper losses in global bond markets have reached $1.2 trillion in the last three months alone.
- Many companies continue to pay dividend yields that are higher than the yields available on their bonds, a relatively rare occurrence. Furthermore, those dividends are *growing* while bond yields are typically fixed.
- Surprisingly, recent stock market strength hasn't fully eradicated the negative psychological outlook shaped by the financial crisis. This pessimism suggests additional buyers if conditions continue to improve.

Not so fast, say the doubters, subtly changing their cause for concern: Stocks are now overvalued after the big rally; Greece will default and catalyze a worldwide bear market; and the now six-year bull stock market will crash once the Fed starts raising interest rates.

To which we reply:

- Stocks *are* now more expensive than average. According to Ned Davis Research, Inc., the median S&P 500 company now trades at 21.8 times earnings vs. its 51-year average of 16.8 times. However, valuation is not always an effective timing tool; in 1997, for example, investors made fortunes from these valuation levels.
- Greece is but a side-show since the European Central Bank promised to do "whatever it takes" to keep the Eurozone together. While Greece now pays 14.3% to borrow for ten years, Portugal, Italy and Spain borrow for just 3.0%, 2.4% and 2.3% respectively. No contagion there. This doesn't mean Greece can't catalyze an equity market correction in the U.S. Negative headlines coupled with modest overvaluation and an extended period of low volatility can be a toxic combination. As such, investors should be prepared for a correction at any time.
- Fed interest rate policy is clearly *the* variable to watch, but the Fed does not need to hike rates immediately. Growth is sluggish, inflation remains absent and a large labor glut suggests wage growth will remain subdued. The Fed may want an initial rate hike as a nod to normalization, but hikes thereafter are likely to be slow and measured. Higher interest rates will reflect a brighter assessment of U.S. growth and inflation, so stocks could actually benefit after an initial adjustment.

Despite our relative preference for stocks, a place for bonds remains in nearly every investment portfolio. Though future returns may be muted, bonds help reduce portfolio volatility. Our charge is to utilize short-term bonds to reduce volatility enough to keep clients comfortable with their stock exposures.

So take stock once again and rest assured we are monitoring markets continuously and will adjust portfolios as conditions warrant.

2015 MARKET DIARY		
	6/30/15	**YTD Change***
Dow Jones Industrials	17,619.51	.03 %
NASDAQ	4,986.87	5.99 %
S&P 500	2,063.11	1.23 %
Russell 2000	1,253.95	4.75 %
10-Year Treasury Bond Yield	2.35 %	+18 b.p.

Source: *Bloomberg Capital Markets*

* Includes dividends for equity indices

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