Verus

Sound Thinking

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Ten thoughts for 2020

January 2020

A new year begins, and with it comes an opportunity to assess whether the correct areas were focused on in the previous year, and to create new guidelines for the year ahead. This piece will try to do that, and in doing so will try to help investors prioritize shorter-term actions they might take, while addressing longer-term issues to improve their success.

2019 - What worked and what didn't

The best place to begin is with the topics we suggested were worth investor attention last year. Reassuringly the results of that attempt at forecasting were fairly good – in fact, we can make a plausible claim that all 8 of 8 were relatively accurate. Here is a rundown of each suggested topic and an assessment of how worthwhile they were:

1. **Volatility.** At the beginning of 2019 we had just experienced a big volatility spike and a downturn in risk assets. We warned that this would likely have an effect on the forecasts made by risk models, and that investors should be careful not to overreact to those signals unless they were sure that the market had moved into a risk-off phase. The results from the remainder of 2019 supported this advice, as volatility dropped back to low levels and risk assets performed very well. Investors who had responded to short-term volatility spikes would have materially underperformed a "stay the course" approach.

2. **Central banks.** We warned that common assumptions around rising interest rates were out of line with underlying reality, and we suggested (very much against the crowd) that investors should be careful in positioning for rising rates. This forecast proved correct: with rate cuts rather than rate increases in the U.S., investors who had positioned in line with the consensus rate-rise view would have been hit hard in their fixed income portfolios.

3. **Credit.** We warned that the developing complexities and imbalances in credit market structures seemed unattractive and that while we did not expect a credit crisis, we urged investors to focus on higher quality credit areas based on the

traditional protective role that credit plays in portfolios. This view was rewarded in 2019, with both Treasuries and core fixed income providing excellent returns, and with no credit crisis materializing, causing good performance also to come from High Yield.

4. **U.S. equities.** We made the case that U.S. equity did not look especially rich, that the U.S. equity market had attractions whether or not we were moving into a downturn, and that investors should be wary of excessive negativity surrounding U.S. equities. While we didn't predict the exceptionally high performance that materialized, investors who followed this advice would have done well, and those who were already positioned for a downturn would have missed out on an exceptionally rewarding year.

5. **Diversification.** We warned that investors should be careful not to draw a lesson from periods where both risk and diversifying assets provided negative returns - that diversification itself is a failure. Instead, we suggested that investors should continue to focus on building portfolios that are balanced across a range of different asset classes and risk factors, and reminded them of the benefits of holding government bonds. Long-duration treasuries delivered terrific performance in 2019 (+14.8%), showing that part of this advice paid off handsomely. Other asset classes and risk factors, however, were less rewarding making the prediction only a qualified success.

6. **Brexit.** We pointed out that this story was more complex than some suggested, and that the market was failing to assess the possible benefits to the U.K. and threats to the rest of the E.U. that might arise from a British exit. As we now know, the story here has lasted longer than many expected, but the underlying reality remained intact. The market's relatively beneficent response to the recent general election suggests that the reality we outlined is increasingly well understood.

7. **China.** We focused on the gap of understanding that most U.S. investors have about China, and we suggested that time spent learning more about Chinese history, thought, culture and politics would prepare investors to make informed decisions about investments in China. This topic was not time-sensitive, but investors who had followed our advice might have been better equipped to understand the approach being taken by the Chinese government in response to the protests in Hong Kong which have shown few signs of abating over the past six months.

8. **Focus.** The final recommendation we made was for investors to focus on the key big decisions that would drive value-added in the portfolio. That advice is perennial, of course, but during 2019 it could have helped investors concentrate less on complex market timing questions and more on remaining exposed to underlying risk premia.

Altogether not a bad collection of guideposts for 2019, directionally correct and focused on the things which would have mattered to investors. Some will carry over into our 2020 views, while other topics will likely move to center stage.

2020 underlying environment

Before we move on to more specific items it is worth thinking about the broader environment. We are now in an election year in the United States. There are continued geopolitical pressures in the Middle East. The business cycle has now been running longer than is normal. Inflation remains relatively low, and there appear to be broad global deflationary pressures in many places around the world. This is matched by a very low interest rate environment with many governments able to borrow at negative interest rates. Brexit is about to happen, and the relationship between China and the rest of the world (especially the U.S.) remains under scrutiny. And finally, we are coming off a year where domestic equities have yet again produced remarkably high returns, with those returns paired with strong returns from fixed income securities.

This seems like a challenging environment, with investors left with even fewer certainties than usual. What are they to do? This leads us to our proposed areas of focus for the coming year. They are as follows:

1. Relativity: OK looks bad next to awesome
2. Earnings: The basis of equity returns
3. Certainty: P(Income) > P(Capital Gain)
4. Economies: Dory had the right attitude
5. Rates: Low rates may be normal
6. Brexit-it: The thump of falling shoes
7. Politics: Not a betting matter
8. China: Beta or alpha?
9. Commodities: Spikes, bleed and diversification
10. ESG: The value of clear thinking

Thoughts for 2020

RELATIVITY: OK LOOKS BAD NEXT TO AWESOME

The first thing to remember during 2020 is the danger of comparison in decision-making. When looking for your next house you should never look "just a little bit above your price range" for fun because once you've done that, everything else that is actually affordable will look just a little bit less than what you "need." In the same way, markets that have returned north of 15% or 20% provide a distorted comparison for investors this coming year. U.S. equities, in particular, delivered stellar performance in 2019, with the S&P 500 returning over 30%. Compared to that, a good single-digit return from U.S. equities in 2020 might look disappointing for investors, even though most long-term return expectations for U.S. equities are somewhere a little north of 5% per annum over the next ten years. This matters because investors will naturally bring this comparative thinking to the way that they assess risk allocations and performance during the year, and this comparative thinking can endanger their decision-making process. Mid-single-digit returns may not get the investor all the way to their required return (especially when that required return is 7% or greater), but this performance is neither an unmitigated disaster nor reason to underweight equities in the portfolio. Investors should, therefore, resist the urge to let the spectacular returns from risk assets achieved in 2019 affect their allocation thinking in 2020.

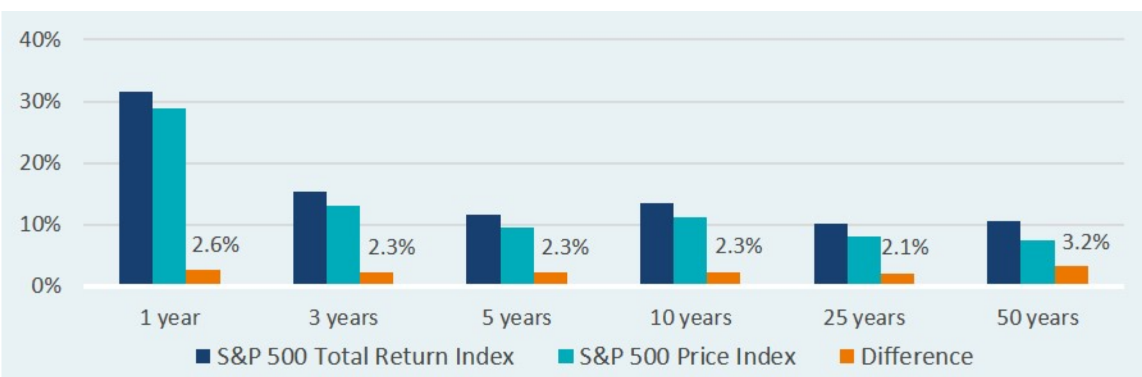
EARNINGS: THE BASIS OF EQUITY RETURNS

The next thing that investors need to focus on in 2020 is the degree to which earnings growth is, and will remain, the underlying driver of equity returns. In 2019 the earnings growth rate stalled and was nearly flat at 0.3% year-over-year, despite equity returns of more than 30%. Investors should be concerned about that relationship. However, much of this 30% return was simply the equity market "digging out" from sharp losses accumulated in the fourth quarter of 2018, making market upside in 2019 appear more robust than it was, and allaying some concerns. U.S. equities in reality finished 2019 only 13.4% above the highs established in 2018. A deciding factor for performance in 2020 will hinge on earnings rising again. Analysts expect a 9.6% growth rate for the year, which is near the long-term average. These numbers are likely based on a fairly moderate economic expectation, rather than forecasts of extravagant growth, which creates the chance of positive surprise. In particular, were the global economy to manage further mild growth, with continuing low interest rates and both shrinking trade uncertainty and growing global trade levels, there would remain the chance of upside surprise. What might be the lesson here for investors? Simply that when you buy equities you buy earnings streams, and those earnings streams tend to have a positive upside in expansionary environments. A mildly positive earnings growth environment can be one where investors should continue to own stocks at policy weights unless they can identify serious time-sensitive reasons for being concerned over event or market risk and they are comfortable with marketing-timing risk.

CERTAINTY: P(INCOME) > P(CAPITAL GAIN)

This idea can be best captured with the old adage "A bird in the hand is worth two in the bush." There are only two sources of return from an investment: income and capital gain. Of these two return sources one (income) is more certain than the other (capital gains), and one (capital gains) is more glamorous than the other (income); sadly, as we can see these two dimensions are opposites. Income is often the Rodney Dangerfield of the investment landscape, getting little respect, when, in fact, the return derived from income – and the concomitant compounding that it can generate in the portfolio – are incredibly important for achieving long-term investment goals.

TRAILING ANNUALIZED PERFORMANCE (AS OF 12/31/2019)



Source: Standard & Poor's, Bloomberg, as of 12/31/19

Investors should carefully consider the income element of the investment process, especially in the late-cycle environment of 2020. Income will likely be more certain in 2020 than capital gains. This means that investors need to take a hard look at income-generative opportunities, capturing opportunities where available. In doing so, they must be mindful that price volatility risk does not outweigh any potential income gain or unnecessarily put underlying asset income streams at risk.

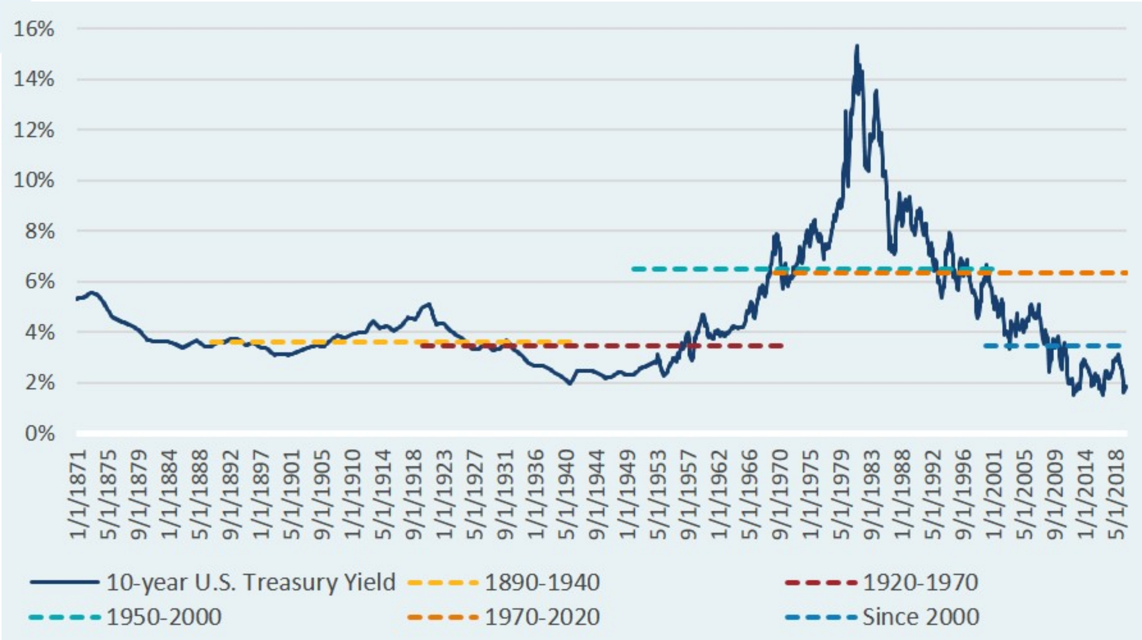
ECONOMICS: DORY HAD THE RIGHT ATTITUDE

Those familiar with *Finding Nemo* will remember Dory, the little blue fish who "just kept swimming, swimming, swimming." The U.S. economy seems to keep heeding Dory's advice, much to the surprise of many forecasters who have persistently predicted a recession during each of the last four or five years[1]. The underlying drivers of that ongoing growth – which has been moderate rather than particularly impressive – continue to be present: low inflation; low unemployment but still a significant, if shrinking, part of the population excluded from the workforce or underemployed; a deregulatory environment; a beneficial tax code; and a consumer prepared to consume prudentially. Each of these beneficial elements could grind to a halt, and we remain watchful about events derailing continued progress. But in the absence of material change to any of these elements, we remain fairly sanguine about the prospects of continued growth in the U.S. economy. The global economy remains more fragile, with many developed markets more challenged across a number of these dimensions than the U.S., and with emerging markets being dominated by China, in particular, which has economic and political issues of a different nature. The U.S., on the other hand, appears to be fairly insulated from many of these external factors. For investors this means that general confidence in risk assets should continue, particularly in those assets associated with the U.S. economy. At the same time, the real possibility of recession and negative events would call for sensible diversification in portfolios, but not to an extent of backing off risk as a whole.

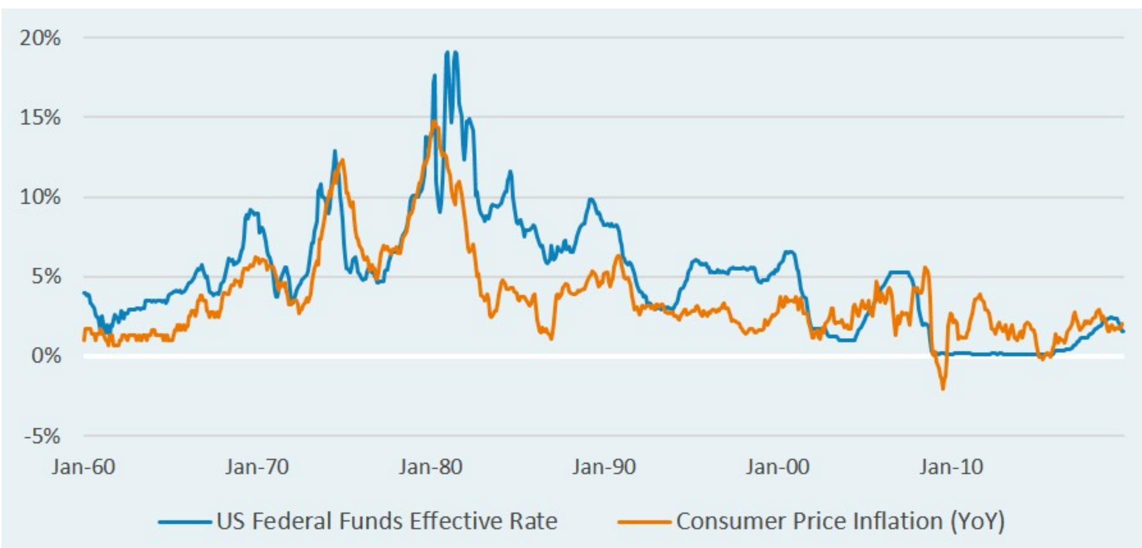
RATES: LOW RATES MAY BE NORMAL

The economic environment suggests interest rates will remain fairly low for some time, and investors need to take this into account in their behavior. This is particularly important because of the idea of "normalization of interest rates," a phrase that remains too common in investor parlance. "Normal" interest rates are rates that are approximately appropriate for the economic environment at the time – not rates that are at any particular nominal (or real) level[2]. When we look at the last 30 or 40 years of history, we can see a plausible case for suggesting that rates are abnormally low, and that they should rise in a mean-reverting kind of way.

1. *They also seem to suffer from the very short-term memory problems that afflict Dory, forgetting conveniently how their predictions of doom of the previous year failed to materialize, and then making the same forecast for the same reason the next year.*
2. *When rates are not at the appropriate market clearing rate then the implication is that the central bank – as it is likely responsible for rates being different from the market clearing rate – has better insight into where rates should be (or need to be) than market participants in aggregate. If you believe in even the weakest type of free market capitalism, you must believe that this is likely to be rare rather than common and, therefore, such rates cannot be appropriately described as "normal."*



Source: Robert Shiller, Federal Reserve Economic Data, as of 12/31/19



Source: Federal Reserve Bank of New York, Bureau of Labor Statistics, as of 11/30/19

However, a much longer-term perspective can be a challenge, and clearly the global economy continues to fight off deflationary pressure. The exact source of deflation is going to be a topic of debate and argument no doubt, but the power of such expectation is clear even as we observe its effects. This is akin to a physical phenomenon known as gravitational lensing, where light from an astronomical object is bent by the gravitational force of an object that sits between it and the observer who cannot see the object bending the light, but witnesses the effect of the bending. The underlying deflationary challenge may come from technology, rising trade, the introduction of additional human capital into the economy, regulatory changes in trade, or some other cause. Whatever it is, its effect is evident on inflation and on interest rates. It is reasonable to have concerns over the possibility of higher rates, as the effect on portfolios could be significant, and as the probability of such a rate rise is only priced by markets today as a very low probability. However, investors should not be lured into assuming that there is a "natural" rate of interest that is necessarily substantially higher than that prevailing today just because that has been the case in the past.

BREXIT-IT: THE THUMP OF FALLING SHOES

If Brexit is the event of the U.K. leaving the E.U., then Brexit-it is the event of Brexit itself – as a news topic - leaving the world stage. The election of Boris Johnson marked the end of the referendum process, with the psychodrama of the May regime now drawn to a close by a conclusive second decision from the electorate. That Brexit is a matter of weeks away is clear; even some of the most passionate anti-Brexit commentators have moved their position from "let's stop it from happening" to "let's see if it works." This changes the dynamics in many ways. The game theory for the E.U. now suggests that their optimal position resides in the most amicable exit for the U.K. While there are other political dimensions at play in terms of centralization and minimizing the damage to the perception of inevitability of the E.U., the economic interests of most E.U. member states are now firmly in the camp of a good trade deal, rapidly concluded. The last three years have been a debunking of predictions promoted by the Remain campaign, most notably that economic catastrophe would begin the day after a leave vote ("Project Fear," as it was described). The next three years will test the claims of the Leave campaign – that trade deals will be achievable, economic impact will be manageable, and the U.K. can reclaim its place on the global economic stage. Many shoes are expected to drop as events unfold for the U.K. and the rest of the E.U. We will find out to what extent the U.K. has been acting as a free-market voice stopping the regulatory excesses of the E.U. We will also find out the effect of the E.U. losing a major contributor and provider of political credibility (after all, the E.U. will be losing one of the permanent seats on the U.N. Security Council). The effects for investors are unclear, and this idea is not a suggestion for immediate investment action. Clearly the easy assumptions of commentators who failed to predict both Brexit and the recent Boris landslide should be treated with no more than the level of respect they have earned. It is also worth noting that many economic predictions of the effect of Brexit have been drawn in part from the assumptions of these same commentators. As usual[3], nobody knows nothing, and naturally they have happily communicated that nothing loudly and with great confidence. Investors should be careful basing strong views on those opinions without a track record of successful prediction.

POLITICS: NOT A BETTING MATTER

As we face an election year in the U.S., many investors will be tempted to change their investment strategies to take advantage of likely outcomes. In reality it seems most appropriate for most investors to focus on the big underlying probabilities, and where possible to avoid being tempted into making bets based on short term political ructions or the immediate market reaction to them.

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3. *With deference to William Goldman, this applies as much to the current political situation as it did to the movie business.*

What are those underlying probabilities? The economy is in relatively good shape, the President's supporters seem to be standing steadfast, and the market has risen significantly. History also suggests that charismatic communicators in the White House tend to be re-elected no matter how much their communication style alienates (or even horrifies) voters who disagree with them[4]. One-term presidencies require a catalyst, usually an economic one, and also generally require a positively poor communicator in the office. Bush (41) was notoriously bad at charismatic communication and was opposed by one of the most gifted communicators of the century. Carter was similarly poor at communication, and in Reagan faced an astonishing and well-honed communicator, as well as bad luck in terms of news-flow. Gerald Ford was in a unique situation when he had to fight both Carter's reputation for honesty and Chevy Chase's impersonation of one of the most athletically gifted Presidents as a bumbling fool. Hoover, although a good communicator, adamantly refused to campaign effectively and was opposed by FDR, again a communication genius in a relatively new medium, radio[5]. There are no obvious current Democratic candidates who could upstage the current President in the arena of in-your-face, real-time communication, in a world where we again have a new communication medium – for better or worse, Twitter – rather than radio or TV. While the balance of the year promises incredibly hard-fought political warfare, the balance of probability has to be, dispassionately, that a Trump victory is likely, which implies a continuation of the low tax, low regulation, relatively isolationist and mildly mercantilist policies of the first term.

The contrary case is harder to predict, as the opposing candidate is not yet clear. There seem to be two main possibilities. The first is a centralizing moderate figure, proposing a fairly business-friendly approach to economics, and building a centrist coalition that includes Republicans alienated by the President's personal style. This scenario would likely be unthreatening to markets but would still likely result in higher taxes and greater regulation. The second scenario is that a standard-bearer on the left of the Democratic Party would successfully rally support for a more radical agenda and can communicate that effectively to cause blue-collar Trump voters to stay home or defect. The effect of this scenario on markets would likely be more radical and might be negative were there to be indications of significant deterioration of the degree of business-friendliness. Much would depend on the candidate. In either case, the chance for a Democratic victory increases significantly if the economy becomes markedly worse, an event that might also increase the possibility of a more redistributive and regulatory focused platform from the left.

There is little an investor should be doing, at this stage. Trying to market time based on political issues is rarely effective. A Trump victory would likely provide some mild support for continued gentle upside – not necessarily because these policies are good, but simply as some of the most anti-business policies being bruited about in the primaries become less and less likely. A Democratic victory would have an impact somewhere from mildly positive to somewhat negative. Either way, focusing on the underlying big picture and the economic drivers of the market would be more effective for investors than worrying overmuch about politics.

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4. *The current President is the perfect example of a divisive politician whose supporters cannot understand why his opponents don't like him, and whose opponents cannot fathom how his supporters could support him. The current situation seems to expand that further, with even some of his supporters doing so despite their distaste for his communication style.*
5. *Hoover was, in fact, known as one of the most effective early users of radio in American politics, but his general refusal to play showman politics when confronting one of the greatest showman politicians of history in the depths of the depression was unlikely ever to be a winning tactic.*

CHINA: BETA OR ALPHA?

China is becoming a larger part of investor portfolios for a range of reasons. The Chinese economy is growing still, even though it may be growing at a slower pace than before, and in terms of sheer scale Chinese assets are likely to justify a place as an important element of all investor portfolios. There are many questions that these increasing allocations pose, however, and investors will need to address them effectively. Investors need to think hard about whether these allocations should be treated as beta: in other words, whether the trend of index providers of including larger and larger amounts of Chinese assets in their indexes is appropriate. These index inclusions produce a stronger and relentless push for investors to invest in China – the indexes are used to describe the neutral bet and, therefore, a decision to allocate less than index levels (even if only on prudential grounds) appears in portfolios as an active underweight. Investors also need to consider whether China allocations are best done in a discretionary basis by portfolio managers as part of a broader global or emerging portfolio, rather than as a specific allocation. There are arguments for each approach, but the implications are big enough that investors should be careful in determining which is right for them. Finally, with investors expressing more and more interest in ESG, the challenges posed by the different political/ethical structures that apply in China in comparison to the U.S. or other parts of the Judeo-Christian world will become increasingly relevant. Investors will need to continue to educate themselves on the Chinese economy, history and worldview, and how they relate to their own values so they can determine how allocations to Chinese assets fit within a holistic ESG approach. It is important to note that this cannot be approached as an exercise in *moral judgement* (and I am not doing so here) – saying one system or moral structure is better than the other – but simply as an exercise in understanding and assessing two different approaches to these issues, addressing their mutual compatibility, addressing where there are conflicts between them, and deciding how to deal with those conflicts.

COMMODITIES: SPIKES, BLEED, AND DIVERSIFICATION

Many investor portfolios contain commodities as a strategy to defend against unexpected increases in inflation, and the long slow bleed that those investors have suffered in this space requires reflection. Now is not a bad time to readdress this issue, and to model out and understand what role these allocations are playing. There are regular short-term spikes as gold, oil and other crisis-sensitive assets react in the short term to political issues and supply shocks; they should be accepted for what they are, but do not represent much of the argument for structural allocations to these assets. Much of the time, commodity exposures are expected to produce a slow negative relative (and maybe absolute) return within the portfolio. Investors who are not comfortable with that base case should consider other inflation-protection approaches that are more geared to economic growth, but which have less pure safe-haven characteristics. The real reason for commodity exposures, of course, comes in the rare but important situations where all risk and most hedging assets are being hit together, and where these commodity exposures provide truly diversifying and liquid protection against those conditions. This year may be a good year to spend some time revalidating the case for commodity exposure and, if appropriate, taking advantage of the next short-term spike in the asset class to reallocate to other inflation-hedging assets.

ESG: THE VALUE OF CLEAR THINKING

Our final topic is ESG — the inclusion of Environmental, Social and Governance issues into investment. In the last few years this has become increasingly important, and it now drives a significant amount of mindshare in the industry, with many managers and service providers now integrating a large amount of ESG-related work into their processes. The implication from current thinking suggests that the decision about ESG and its role in the portfolio would be quick, simple, and implemented easily with off-the-shelf products. The reality is that it is often more complex than that. The ESG approach of a portfolio needs to be driven by the beliefs, values, and goals of the investor themselves. The most important part of an ESG process is for a board to arrive at a reasoned and thoughtful approach to ESG issues and how they should be reflected in the portfolios. The approach agreed upon can land anywhere on the spectrum from no consideration whatsoever of ESG issues to a fully socially-conscious portfolio with a strong issue-orientated investment style. What matters in the end is that the board has come to a reasoned conclusion on the topic[6]. The next year will be a good opportunity for investors to work through some of these issues, better understand the implications of each approach from a range of available approaches, and ensure that whatever choice is made fits their organizational ethos. There is no perfect single approach to ESG, and ESG issues are hard to boil down to simple box-checking exercises. This is not a call for investors to spend all of 2020 analyzing ESG issues in detail, but simply a suggestion that at some point in the next year investors who have not an established opinion on these issues may want to think about where they stand on that continuum of "no interest" to "strong action," and consider what their position on that continuum means for their portfolios given the legal and fiduciary structure that applies to them.

Conclusion

And so we come to an end of our topics for the year. It would be nice to think that this year our success rate will be as high as last year's, but we'll have to wait until next year to judge that. In the meantime, we believe these topics are worthy of your consideration, and that spending time on them should be to your advantage as an investor. We wish all of our clients a very successful 2020!

6. *The typical board will have a couple of very strong supporters of an aggressive ESG approach, a couple of strong opponents of taking account of any ESG issues, and a number of board members with various degrees of ennui around the issue. To address ESG effectively, this group has to come to a collective decision they can all support — no easy task.*

ABOUT THE AUTHOR

Mr. Toner has a degree in Law from the University of Oxford in the United Kingdom and is a CFA charterholder (Chartered Financial Analyst). He is a regular author and speaker on a range of investment topics. He is a member of the Audit / Finance Committee of The Medina Foundation in Seattle. He is also a member of the CFA Institute and the CFA Society of Seattle. Mr. Toner is a trustee of Charles Wright Academy, an independent co-educational school based in University Place, WA, where he also chairs the endowment committee. He is also a board member at the Seattle Metropolitan Chamber of Commerce, where he co-chairs the finance & audit committee. He has been happily married to his wife, Heather, for 25 years, and is the proud father of two children.

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ABOUT VERUS

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