Commentary: January 2017

RETURNS COMMENSURATE WITH RISK

Capital markets may always reflect the aggregate expectations of investors, but those individual expectations can and will change. Sometimes those changes can come quickly with the resulting market impacts at the same time dramatic and confounding. The final months of 2016 brought with them ample reminder of these truths. Market trends after the November Presidential election left many wondering whether their portfolios should adjust to some new realty, particularly on the fixed income side of the ledger. As we wrote in last month's commentary, we do not presently believe any marked change in expectation or allocation is warranted. Furthermore, for those still worried about the future for their bond investments, we take the opportunity this month to provide some additional perspective on the important role fixed income can play in a portfolio.

Post-Election Divergence

In the wake of the unanticipated Trump victory in the U.S. presidential election, equity markets quite remarkably rebounded from a mid-year stall, with our preferred value-oriented and smaller-capitalization stocks performing particularly well. The consensus regarding the turn in fortune was premised on the potential for now President Elect Trump to reignite domestic growth through thoughtful deregulation, revision of the tax code and an otherwise uniquely pro-domestic-business take on his role. On the other hand, consideration for his unique appreciation for debt led to concerns that America's balance sheet might weaken. The combined potential of faster growth and a worsening federal government budget deficit reignited expectations for future inflation. As the Federal Reserve meantime absorbed both those ideas, Team Yellen maintained a bias for less monetary accommodation heading in to 2017. Altogether, rate pressures left fixed income markets severely lagging gains in the equity markets from earlier in the year.

The Bloomberg Barclays U.S. Aggregate Bond Index was off as much as 3.2 percent from the election through mid-December before bouncing to close the year down 2.1 percent. Returns for longer-duration bonds, meaning those that mature further out in the future, were particularly weak, with 20+-year bonds off closer to 7.6 percent. Those performance trends reflected the revised growth, inflation and monetary policy expectations. Corporate bonds, on the other hand, while also pressured, fared relatively well as their spread in yields over U.S. Treasuries compressed, also on account of more positive views regarding going-forward growth. Though inflation-protected bonds saw favorable relative flows, their broadly longer maturities also resulted in weak total returns.

Conversely, the S&P 500 gained just under 5 percent. We thus were not surprised when more than a few clients called in to express worries regarding their bond positions. We think some perspective is in order.

First, we will note that the broader fixed income market still closed the year meaningfully in the green, up 2.6 percent. And while the S&P returned just a bit less than 12 percent for the year, we need only look back a few days prior to the election to see the equity index underperforming the bond market on a year-to-date basis.

We often revisit the primary reason we invest: To potentially grow our saved monies minimally in excess of inflation and hopefully more so over time for purposes ranging from vacations and college tuition to unexpected emergency spending and retirement income. Risk goes hand-in-hand with the returns that provide that growth, however. And while that relationship generally holds for most investments, the sources and magnitudes of both risk and return vary among them. An illustration of historical return and risk of the broader equity and fixed income markets is revealing.

Bonds are Risky Too

Interest rate risk of the sorts already mentioned can weigh heavily on bonds at times. When interest rates rise, bond prices generally fall, and vice versa. While we have experienced a broad, multi-decade decline in domestic interest rates, many–including us–expect that trend to end. Even so, we maintain a wait-and-see attitude toward Mr. Trump's policy initiatives and their actual impacts, in particular in light of the potential for populist trade policy and a rather unpredictable approach to foreign relations to push growth in the opposite direction. We therefore find that, for the most part, present interest rates fairly reflect the broader macroeconomic picture even as we are likely to see the Federal Reserve continue on its path toward a more normal target for the federal funds rate (the rate at which banks loan each other money overnight).

Global growth is likely to remain weak on account of structurally weak productivity growth, globally aging populations and a global glut of savings. Our domestic picture might be a bit more optimistic, but not so much as to dramatically alter our view that, going forward, growth will be weaker than the historical norm maintaining the broader slowing we have experienced since the middle of the last century.

All this suggests we are likely to see additional bouts of fixed income market instability as the Fed clears its path to normal. Even so, we continue to believe that its pace will be slow. That is, we think rates will be higher over the next year, but we do not presently believe those rises will come quickly. We therefore believe fixed income investors will not suffer in some way more severely than the historical context suggests.

But Risk is Relative

The Bloomberg Barclays U.S. Aggregate Index has presented a fairly representative view of the U.S. fixed income market since 1976. Since then, the maximum loss from a prior peak was 12.7 percent (using the monthly data available from that time). The time frame was August 1979 through February 1980 when the Federal Reserve took extreme measures to tame the rampant inflation of the late 1970s. Rate rises came fast and furious, eventually breaking the inflation stranglehold gripping the economy. The bond market recovered those losses by May 1980, before dropping 9 percent from July 1980 through September 1981.

No doubt, the rate reset had dramatic implications for the return and stability bond portfolios at that time. But those losses, which reflected the largest the bond market has seen in recent history, were very tame in comparison to those experienced in the equity market. Indeed, the Bloomberg Aggregate has at worst has proved an angry kitten in comparison to the volatile beast the S&P 500 has been. Some statistics, excerpted from the data summarized in Figure 1, are relevant:

- Since 1975, the Bloomberg Aggregate has experienced three drawdowns in excess of 5% (using monthly data), while the S&P 500 has seen twenty such drawdowns
- Of those drawdowns exceeding 7.5%, the Aggregate has seen two while the S&P has seen ten.
- The Aggregate saw one drawdown of more than 10%, with the 12.7% already mentioned having been the worst. The S&P saw seven drawdowns exceeding 10%
- Indeed, that S&P 500 has seen six losses from a prior peak exceed 15%, three exceed 20% and two greater than 30%. The two worst were those of the Tech Bubble and the Financial Crisis, when the S&P 500 plunged more than 44% and more than 50% respectively from the prior peaks

Figure 1: Largest 15 Index Drawdowns

S&P 500

Begin	End	Trough	Drawdown
11.30.2007	03.30.2012	02.27.2009	-50.88
09.29.2000	10.31.2006	09.30.2002	-44.72
09.30.1987	05.31.1989	11.30.1987	-29.58
01.31.1977	08.31.1979	02.28.1978	-19.00
12.31.1980	10.29.1982	07.30.1982	-16.52
07.31.1998	11.30.1998	08.31.1998	-15.36
06.29.1990	02.28.1991	10.31.1990	-14.70
02.29.1980	06.30.1980	03.31.1980	-9.73
08.31.2015	05.31.2016	09.30.2015	-8.35
09.30.1986	01.30.1987	09.30.1986	-8.27
12.30.1983	08.31.1984	05.31.1984	-7.41
02.28.1994	08.31.1994	03.31.1994	-6.94
10.31.1979	01.31.1980	10.31.1979	-6.86
01.31.2000	03.31.2000	02.29.2000	-6.82
01.31.1990	05.31.1990	01.31.1990	-6.71

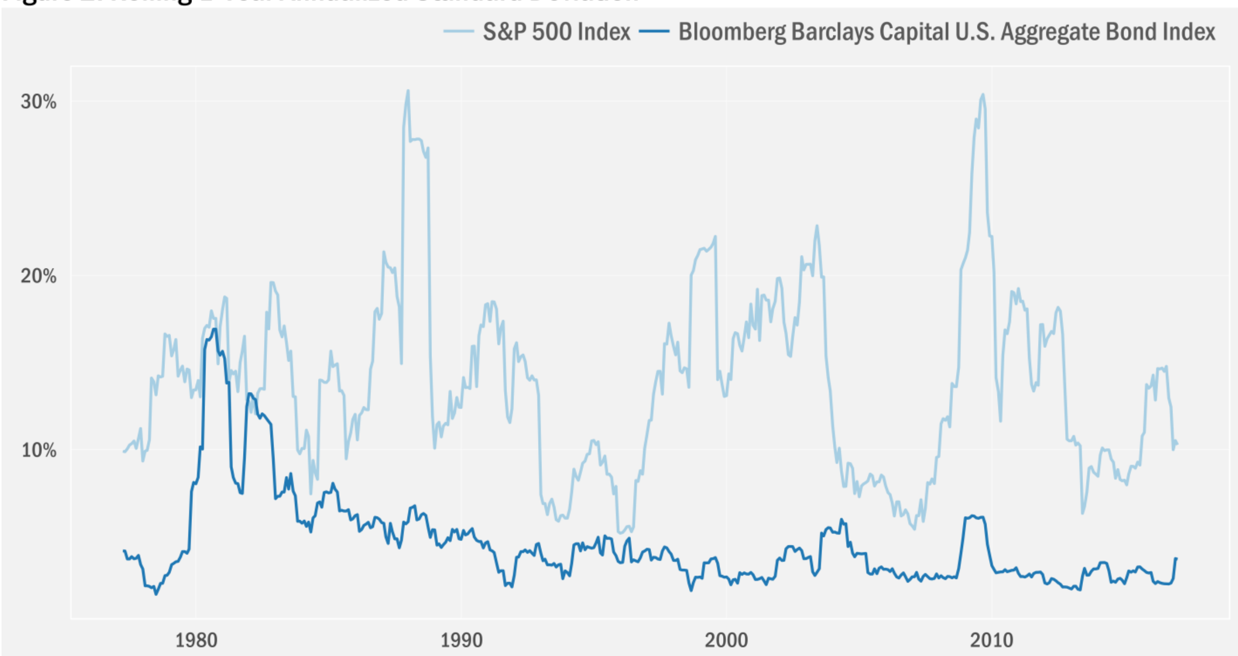
Bloomberg Barclays U.S. Aggregate

Begin	End	Trough	Drawdown
08.31.1979	05.30.1980	02.29.1980	-12.74
07.31.1980	11.30.1981	09.30.1981	-9.00
02.28.1994	02.28.1995	06.30.1994	-5.15
03.31.1987	12.31.1987	09.30.1987	-4.90
02.29.1984	07.31.1984	05.31.1984	-4.88
04.30.2008	12.31.2008	10.31.2008	-3.83
12.31.1981	03.31.1982	12.31.1981	-3.74
05.31.2013	05.30.2014	08.30.2013	-3.67
06.30.2003	01.30.2004	07.31.2003	-3.55
05.31.1983	09.30.1983	07.29.1983	-3.54
08.31.2016	12.30.2016	11.30.2016	-3.28
02.29.1996	10.31.1996	05.31.1996	-3.17
04.30.2004	08.31.2004	05.31.2004	-2.99
02.26.1999	03.31.2000	08.31.1999	-2.54
02.27.2015	02.29.2016	06.30.2015	-2.15

Monthly total return data from 03.31.1976 through 12.30.2016. Past performance is not indicative of future results. Drawdown may be measured as the maximum loss from a prior peak value and/or the length of time the portfolio requires to return to breakeven after a prior peak. One cannot directly invest in an index. Index performance does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Bloomberg

The relatively larger number of drawdowns beyond any specific level for equity markets speaks to their heightened volatility. As evidence, we can look at trailing volatility as another means of comparison. Looking at the standard deviation of the last twelve months of returns for each of the 478 twelve-month periods since March of 1979 (each month we measure the last twelve months of volatility, then move to the next month), there only have been four occasions when the broader fixed income market proved more volatile on a trailing one-year basis than the equity market. This basic difference is among the reasons we utilize fixed income exposures as a counterbalance to equity volatility in our portfolios.

Figure 2: Rolling 1-Year Annualized Standard Deviation



Monthly total return data from 04.30.76 to 12.30.16. Past performance is not indicative of future results. One cannot directly invest in an index. Index performance does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Bloomberg

Targeting Return, Tolerating Risk

Core to our investment approach is the acknowledgment that our abilities to take on capital market risk decline over time. When we can assume more risk in our portfolios, we can take on greater exposures to risker assets. Generally speaking, that means we can include more equity in our portfolios. Conversely, as our risk tolerance changes over time–it generally decreases–we should like to include less risky exposures in our portfolios, which generally means more fixed income.

Put differently, because we have a comparatively longer time to weather market downturns earlier in our investment plan, we can trade the assumption of greater risk for the potential reward of greater return. As we grow older, however, or as the needs from our funds grows, we may need to assume lower levels of risk to ensure that any market disruptions don't surprisingly unsettle our investment plans.

Naturally, over short-term periods neither equity nor fixed income markets always provide levels of return and risk that match those that may be integrated into our financial plans. The goal of our approach is to help ensure that short-term mismatches do not become long-term divergences.

Well Wishes for a Grand Start

As we enter the New Year, we want to offer our sincere appreciation to our clients for their continued confidence and trust in our work. We wish you all the grandest beginning to 2017 and a year full of comfort and success.

Important Information

Investing involves risks. Past performance is not indicative of future results.

One cannot invest directly in an index. Index performance does not reflect the expenses associated with the management of an actual portfolio.

The Bloomberg Barclays U.S Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market.

The S&P 500 Index represents 500 U.S. companies and captures approximately 80% coverage of available market capitalization.

Opinions expressed herein are subject to change without notice. SRCM has exercised reasonable professional care in preparing this information. The information has been obtained from sources we believe to be reliable. However, SRCM has not independently verified or attested to the accuracy or authenticity of the information.