

# Investment Commentary, Fourth Quarter 2011

## A Ray of Sunshine or an Oncoming Train?

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With the New Year upon us, and the lessons of 2011 hopefully learned and assimilated, we are becoming modestly less bearish, suspecting that sustained liquidity and slowly improving fundamentals will trump the geopolitical risks which continue to constitute major concerns for us. At this point, though, we feel that the highest priority should be given to revisiting medium- and long-term planning assumptions and resetting short- to medium-term return expectations to some lower level than in the past. In this commentary, we start with a review of 2011, discuss two important structural issues on which one needs to focus, and then outline our expectations for 2012, together with the risks which we still see looming.

### **2011 in Review**

2011 was marked by rising geopolitical tensions, muted economic growth, and market performance that differed dramatically by quarter. Herein, we consider these three main dimensions.

**Geopolitically**, the environment was anything but calm, with many of the fears which we and others expressed coming to the fore: the Arab Spring extended throughout the year; tensions within the European Community oscillated between the severe and the untenable; the U.S. fiscal process turned into a bit of a circus; Japanese politicians are still looking for a solution to a two or three decade old challenge; and last but not least, China and selected other countries are working to promote some alternative to the U.S. Dollar as the world's reserve currency. The recent threats proffered by Iran with respect to the Strait of Hormuz, as well as China's and Japan's reactions to the proposed Iran oil embargo, only add to these worries.

**Economic performance** was unimpressive around the world, but still somewhat differentiated. Europe probably slipped into recession in the fourth quarter, principally under the stresses of fiscal restraint and rising interest rate uncertainty. Japan rebounded from the first quarter natural disasters, but appeared to slip back into stagnation in the fourth quarter. The United States posted very slow growth in part due to poor job creation, although some light may have appeared at the end of the tunnel at the end of the year. Fortunately, while China and other rapidly developing economies did slow through the year, they still produced material growth. Inflation outside of the developing world remained a non issue, as excess labor and operating capacity is relatively ample around the developed world.

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**Markets** were also unimpressive in terms of performance, but one really observed somewhat of a “tale of four quarters.” The first graph, below, shows the daily price record of the S&P 500 and illustrates the nature of this story: modest gains in the first, flat performance in the second, sharp price declines in the third and material rebound in the fourth quarter. The interesting observation is that liquidity remained plentiful through the full period, while economic fundamentals unfolded in somewhat of a predictable, but steady manner. The “big event” in the third quarter was the fact that the European crisis suddenly came into sharper focus, as attention shifted from smaller countries such as Greece and Portugal, to Italy and, though to a lesser extent, France. Interestingly, though virtually as serious as Europe’s, the U.S.’s own fiscal challenges were broadly ignored by markets.



Source: Bloomberg, Author’s compilations and computations

To this humble observer, the pattern seems a bit surprising and suggests that traders were stronger players in markets than investors, particularly when one notes that global markets were especially correlated. The second chart at left illustrates this, displaying the comparative performance of the three major regional equity markets: U.S., EAFE (Europe, Australia and Far East) and Emerging Countries. Despite materially different fundamental economic fates and not so different starting valuation levels, they all followed a similar pattern, with the seemingly best positioned countries from an economic standpoint suffering the most! In short, investments simply driven by fundamental considerations did not perform as well as one might have expected. Though the average holding period for U.S. institutional investors has significantly shortened (from 4 years in 1969 to 4 months in 2009), one still saw a measure of medium term focus at least until the more recent past. The last twelve months would appear to have taken this away, with the main performance driver seemingly the proverbial “risk on/ risk off” trade. This probably helps explain the pundits’ quandary: how can we simultaneously have higher correlations and higher volatility? Traders would all be moving in the same direction at the same time, which would help explain the rise in correlations (markets and individual securities all move much more in synch). At the same time, as there are few contrarians willing to take the other side of these trades, volatility would tend to rise: all players move in the same direction at the same time creating supply/demand imbalances.

### Two fundamental questions

The last few years brought to the fore the fundamental issue of whether we are experiencing a cyclical phenomenon or living through a structural shift. Our view has been that this is a structural shift for a while, and we see no reason to change our mind at this point.

One of the crucial insights associated with the notion of a structural shift is that one or several of the tenets which we might have held dear for some time may need to be revisited. Two specific issues come to mind which we are now starting to evaluate in much greater depth:

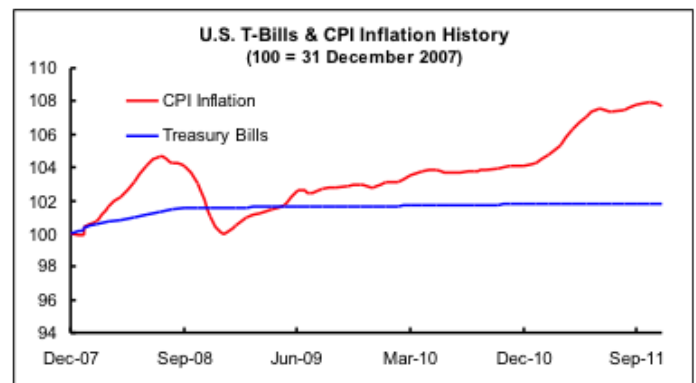
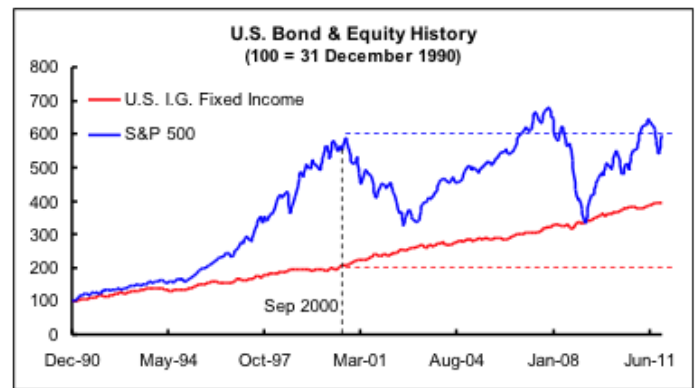
1. Are the return expectations which we have had for the three main asset classes - cash, bonds and equities – still valid or do they need to be reviewed?
2. Are so-called alternative strategies still likely to produce the superior return/risk trade off to which we had become accustomed since the mid-1990s?

### Long term return expectations

Capital market theory tells us that cash, bonds and equities constitute the three major asset classes and that their expected returns should be linked in some fashion. Most analysts agree on the notion that long-term equilibrium returns for cash should reflect expected inflation plus some real interest rate factor, the latter because of monetary policy settings which promote non-inflationary economic growth. Bond returns should reflect cash returns plus some maturity premium, as investors need inducement to take the extra maturity risk associated with bonds relative to cash. Finally, equity returns should reflect bond returns plus some equity premium, which is required so that investors are willing to accept extra equity risks. In short, equities should provide higher returns than bonds, which in turn should earn more than cash. Typical bond maturity premium estimates are around 1.5%, while equity premium estimates are more volatile, and yet average around 2.5%, relative to bonds.

These theoretical tenets, however, have at times been somewhat challenged! For instance, in Japan, since 1990, compounded annualized equity returns have been

negative, while cash and bond returns have been positive; theory says that such a situation is unstable, but it has indeed prevailed for quite some time. In the U.S., as shown in the graph below, equity prices have been effectively flat (i.e. posting virtually zero returns) since the Fall of 2000, while bonds did provide material returns during the same period; theory again suggests that this should not happen, but it did! The final nail in theory’s coffin may well be the fact that cash rates are supposed to exceed inflation, while they have not for most of the last four years, as shown in the second graph, below.



Sources: Bloomberg, FRED database and author's compilations

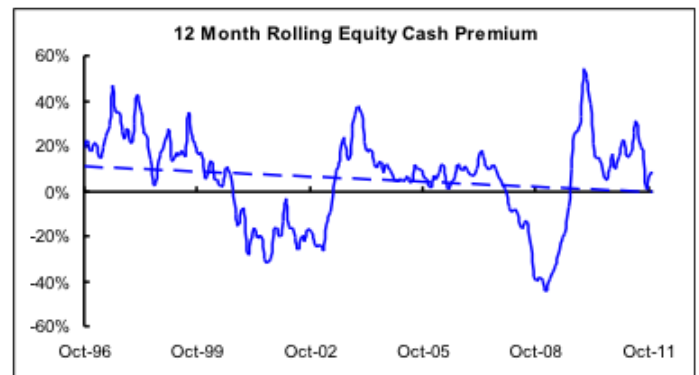
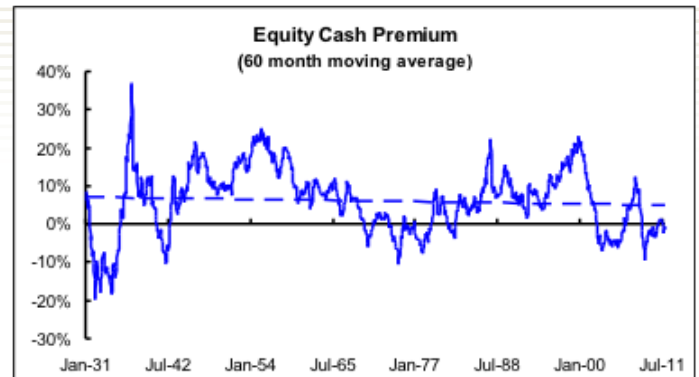
In such an environment, what can rational return expectations be? Two immediate insights come to mind.

1. Projecting the current environment into the future suggests much lower returns than history would suggest.
2. The future may need to be broken down into at least two, and arguably three distinct time horizons.

Let us review each of these assertions in turn.

**Short- to medium-term returns could well be somewhat lower than history might suggest if the current environment is extrapolated into the future.** Looking at the history of the equity return premium over cash in the following charts indeed suggests two observations: first, though it has oscillated substantially over time, it has averaged around 4% to 6% over the very long term, with a visible tendency to shrink as time passed, as illustrated in the first graph at right. Second, focusing on the last 15 years (which gives us a relatively full cycle, taking us from mid-point before the full inflation of the 1999-2000 technology bubble to the present), the equity cash premium has averaged about 4% (3.95%) as illustrated in the second graph at right. Interestingly, this is not inconsistent with long-term classical capital market estimates of an equity premium of 2.5% and a maturity premium of 1.5% for bonds. The major difference between this and traditional observations is that cash rates are, at present, quite a bit below their equilibrium level, which should be around 4%, if inflation and real short-term rates were both around 2%!

Thus, with current cash rates of around zero, this would point to equity returns in the 4% range! Simultaneously, the bond maturity premium has averaged about 3% (3.11%) over the same period, which though higher than “normal” is not inconsistent with a very easy monetary policy, subdued economic growth with ample excess capacity



Sources: Ibbotson and internal databases, author's compilations

and the purchasing of U.S. Dollar bonds by foreign central banks. Combined with still virtually zero cash rates, this bond maturity premium would point to expected bond returns in the 3% range; interestingly, this would require 10 year Treasury bond rates to fall further, as the current yield is 2% or less. Such an environment is a far cry from the traditional 4% cash, 6% bond and 8% equity return expectations! Ostensibly, excess liquidity flows could easily lead to these central estimates being exceeded but the message is clear: the current environment could be materially different from the past!

Yet, that very environment appears fundamentally unstable: cash rates should not remain lower than inflation for any material period of time. Thus, at some point, one would have to see this postulated scenario break down, and this would likely have to occur in a two-step process:

- First, inflation would likely pick up as a result of the excessively easy monetary policy underpinning these excessively low cash rates. As cash rates start to move up, prodded by a Fed which starts to tighten monetary policy, long-term bond rates would likely follow, which ought to translate into negative bond returns: the yield cushion is rapidly overcome by losses of principal. Initially, this could well also result in some lowering of corporate P/E ratios, which would constitute some head wind for equities as well.
- Once the adjustment to a higher inflation environment is completed, one would reasonably expect the “normal hierarchy” of returns between cash, bond and equities to reassert itself.

In short, investors might form return expectations centered on three broad premises:

- **Returns should remain pedestrian in the short-term**, stimulated as they might be by easy money and the excess liquidity associated with it, but constrained by abnormally low short-term rates. This environment can last for a while, but should not be expected to remain for more than a few years, unless the U.S. and Europe have effectively caught the “Japanese disease;” in that case, returns could stay low for quite a bit longer!
- **Some intermediate adjustment period should be expected to bring the current state to an end**, during which return expectations should probably be even more modest, if not negative for bonds and equities.
- Once the structural adjustment has taken place, one would expect capital market principles to reassert

themselves, with higher nominal returns across the board, and a restored hierarchy between cash, bonds and equities.

*An important implication of such a three-step scenario is that investors might well revisit all their wealth planning assumptions, as plans developed using more optimistic hypotheses could lead to potential disappointments.*

### **Alternative strategy potential**

As a rule, we do not like to speak of alternative assets as a group: they comprise a wide range of approaches, ranging from various forms of market neutral or arbitrage strategies, to concentrated equity portfolios, with a broad spectrum in-between. Yet, they have broadly disappointed in the recent past. Thus, we will succumb to the temptation partially to aggregate what should really be disaggregated!

The three graphs on the next page display annualized rolling 24 month “alphas” for three groups of two sub-strategies within the broadly-defined alternative space: 1) equity long/short strategies, comprising equity hedge and emerging markets, 2) relative value strategies, comprising arbitrage, credit and event-driven (which are some of the strategies employed by multi-strategy managers) and 3) global trading strategies, comprising macro and managed futures.

Importantly, we should first define the term “alpha.” In industry jargon, alpha is the value added generated by investment decisions. Here, we compare strategy sub-indices to a naïve benchmark, which we define as the alternative an investor has outside of the non-traditional investment universe. Thus, the benchmark set for both relative value hedge and global trading strategies comprises U.S. Treasury Bills (because these strategies tend to be

“cash based” or market neutral) plus a 4% annual premium (as we saw earlier, this constitutes a reasonable hurdle when compared to fixed income and equity alternatives). The benchmark for long/short equity strategies comprises an equity index (S&P for Equity Hedge and MSCI EM for Emerging Markets) for 50% and 50% fixed income (U.S. 1 Year Treasury Bonds and U.S. 90-Day Treasury Bills, respectively).

A common feature of our analysis is that all three of these groups have experienced reduced alpha generation over the last 20 years. At some level, this should not surprise to the extent that the industry has grown massively, spurred in part by a particularly profitable business model from the point of view of the investment manager. It is therefore logical that a number of “marginal” managers came into the space that arguably may not have belonged in the first place. This alone would dilute apparent industry alpha, very much in a similar way that the growth of boutique managers in the 1980s diluted the perceived value added of active (as opposed to passive) traditional managers. Thus, it may be that the broad indices we show here have lost some of their value. Yet, interestingly, the indices we use are not limited to the so-called “investable” managers, and thus still include a few of the pioneers who may even be closed to new business!

A second and probably more important observation relates to the performance of each of the strategies in the last several years. Indeed, as we observe these charts, all but one of the six sub-strategies (arbitrage being the notable exception) have been in or recently crossed into negative alpha territory. To some extent, this may reflect a cyclical rather than structural development. Indeed, the shift from an investor- to a trader-dominated market environment discussed earlier can explain higher correlations, and

thus a lower chance for differentiation across individual securities, as the tide raises or lowers all boats. This would make most strategies which involve long and short positions less able to generate alpha, as rapid moves into and out of markets would make it hard to capture relative differences in individual securities’ valuations. Similarly, the trendless volatility of the last several quarters also explain the lack of success experienced by managed futures managers, who often rely on both short- or long-term trends, as confirmed in the graph below.



Sources: HFR and Internal databases, author's compilations

At the same time, one must ask the obvious question: what if this was not cyclical, but secular? Though we do know that there are still managers who are, even today, generating material alpha, the conclusion that the industry as a whole is less fundamentally attractive should drive the cautious investor to choose a lower strategic exposure. Answering this cyclical versus structural question requires a considerably deeper analysis, which will be undertaken in the coming quarter. The three main questions which we will be addressing and on which we will be reporting next quarter are:

1. Given the rise in the amount of assets under management in alternative strategies, are these strategies still able to generate superior risk-adjusted returns?
2. Is there a widening disparity between top and bottom performing managers?
3. How have managers with more favorable liquidity terms performed relative to the broader universe of alternative managers?

Thus, though these disappointing results might suggest that one revisit the allocations to certain or all of these strategies, it is probably more prudent to defer the decision until the analysis reveals what may actually be occurring. It is indeed important to note that this is not the first time that these types of strategies have generated negative value added. In all prior instances, some recovery ensued, suggesting that one would want to be sure to avoid the classic trap of selling at the point of maximum pain, which might turn out in hindsight to be a local low!

## Prospects for 2012

2012 appears to us most likely to be another year of transition, for three major reasons:

1. We see no reason to become more optimistic with respect to geopolitical developments;
2. Economic growth prospects around the world do not appear particularly exciting, though this negative might be partly offset by reduced inflation risks;
3. Liquidity is likely to remain plentiful.

We initially had set four major conditions to consider some re-entry into riskier assets:

1. Some reduction in geopolitical risks;
2. Some indication that governments appeared to start addressing their problems;
3. Some indication that various economic and market trends were bottoming out
4. Some indication that sentiment had turned negative, with improved valuation levels.

Though it is hard to argue that much has changed and that one should be aggressively adding risk to portfolios, intellectual honesty requires us to admit that some minor improvement may be taking place and sufficient to add some modest amount of equity-like risk to portfolios:

1. The U.S. economy appears to be displaying its traditional resiliency in the face of still somewhat inept political processes. Job growth and housing starts may be bottoming out, while manufacturing is posting encouraging growth.
2. European leaders appear to have finally recognized that real steps had to be taken. Though the road ahead remains anything but easy, one senses some greater urgency to get moving, with the recent credit downgrade creating a “four-zone” Europe adding to the motivation, as many want to avoid another rating reduction.

3. Though growth has recently slowed down in Japan, real steps are being discussed in Japan to address fiscal problems, and the recent government shuffle was meant to ease the process.
4. China's economy remains on track for a "softish" landing, as reported growth is still significant, while inflation does appear to be responding to earlier steps to slow it down. The problems of the "grey banking system" are still, however, present and social tensions, though suggesting that China will keep choosing growth to maintain social peace, have the potential to create short-term hiccups.
5. Though they are still not at particularly low levels, global valuations have fallen below long-term averages, indicating some limited negative sentiment; this is particularly true in Europe and Emerging Markets.
6. The main dark cloud remains the geopolitical scene which appears at least as volatile today as it did a year ago, and we would include addressing the U.S. fiscal challenges and the future of the U.S. Dollar in this category.

### **Investment implications**

Though the current investment environment does remain treacherous, there may be some room for portfolios to accept a bit more risk. In the short term, we emphasize the following eight themes:

1. Though equity risk still requires caution, the lesson of 2011 is that liquidity, for as long as it is plentiful, will likely remain significantly directed toward equities. Thus, with valuations appearing modestly cheaper than long term averages, there may be some room to add to positions when they have been particularly underweighted. While it would have been nice to make such a call a quarter ago, the reality is that one must resist the temptation of catching a falling knife; prudence suggests that one only act when one can point to at least a few signs that things have stopped deteriorating.
2. This might however be just a trade if the political system in the U.S. prevents serious consideration of the country's fiscal challenges, or Europe finds it impractical to address its problems. Thus, any addition to existing positions should emphasize liquidity to ensure that one retains the flexibility to reverse the decision if circumstances warrant.
3. Credit risk does appear more attractive, as deleveraging in several parts of the investment chain seems to have brought a lot of the "semi-forced" selling to an end. Higher yielding bonds may thus offer some relative attractiveness, providing potentially equity-type returns, with considerably higher current yields. One area which appears particularly worthy of consideration is the less liquid end of the market, principally because seeing these deals through to maturity would appear more tenable when investors cannot rush out in panic.
4. There may also be room for some lengthening the average maturity of fixed income portfolios – particularly when they comprise heavy cash or near-cash allocations – as lower short-term inflation risks and a decided tendency by central banks to maintain liquidity should work to limit the risks of capital losses in bonds, absent some major geopolitical development, such as a currency crisis.

5. Pending our more detailed analysis of the real prospects for alternative-type strategies, it is best to consider remaining in somewhat of a neutral position, both to avoid selling out at what could prove to be a bottom and to ensure that one does not have an over-exposed position in an area which may offer more limited prospects in the future.
6. Commodities would not appear to offer particularly appealing potential, if only because the discounting of slower economic growth ahead might make short-term trends somewhat unfavorable. The long-term case is however intact, as barring a complete global economic collapse, the rapid growth of highly populous countries like China, India, Brazil and Indonesia should be expected to put pressure on the supply/demand balance for many natural resources.
7. Gold and oil remain somewhat distinct cases, as they should continue to play a role hedging portfolios against global systemic and geopolitical risks. Oil predictably rose when tension in the Persian Gulf ratcheted up, and this confirms its role as a geopolitical hedge. Despite recent weakness, gold remains the ultimate guardian against the disfavor of fiat currencies.
8. Real assets, finally, would seem to retain their potential as hedges against long-term inflation – which could well be the ultimate exit strategy for many heavily indebted countries – but the short-term outlook remains clouded by continued supply excesses in many countries and the low urgency currently felt on the inflation front in the face of a slowing global economy.

## Conclusion

As has been our view for a while now, we still feel that the one important element, which investors should endeavor to ensure, is that whatever strategy they decide to adopt can be sustained over time. The real enemy at this point remains the risk of changing our minds at the worst possible time. Thus, one must be able both to sustain the current strategy if actual – as opposed to market – developments do not suggest otherwise; equally, one must be able and ready to modify the strategy appropriately if fundamental events warrant it. This must mean that whatever strategy is chosen must be selected with a great deal of intellectual clarity and with a sharp focus on assumptions and process. Indeed, only a well defined decision tree can lend itself to the “forensic” analysis required to change one’s view in a calm and deliberate manner.

In short, as mentioned in previous commentaries, the prudent investor will seek to capture as many of the opportunities as might be available but will be particularly careful to define his or her real risk tolerance and need for higher returns, hopefully through a cautious evaluation of his or her individual goals and the size of the assets needed to defease them. For many, this may involve taking a wealth preservation strategy, remembering that wealth is created in entrepreneurial ventures and protected in the public markets. For a few, this may involve continuing to seek long-term returns and accepting the inevitable volatility, arguing that one’s balance sheet strength and long-term horizon allows such relative aggressiveness. The spectrum of possible investment stances is thus large, but the **main focus should be on ensuring that one is in the right position within this spectrum rather than being mesmerized with short-term return opportunities.**

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