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Market Commentary

Survival is the only road to riches... And I view diversification not only as a survival strategy but as an aggressive strategy, because the next windfall might come from a surprising place.

–Peter Bernstein

2017 began with a rally in growth stocks and outperformance by foreign markets. What the media termed the 'Trump Rally' in reality reflected a global recovery buoyed by stable growth in Europe and China. Compared to the S&P 500 return of 6.1%, the MSCI EAFE Index of developed markets outside of the US returned 7.4%, while the MSCI Emerging Market Index delivered 11.5%. Within the US, only the Energy and Telecom sectors posted negative returns. While growth outperformed in the US by over 500 basis points, it continued to lag in most foreign markets and value strategies continued to dominate. Despite declines in energy prices, MLPs delivered a 3.9% return and continued to grow distributions. Bond markets stabilized after the post-election volatility.

During the decade of the 1990s the S&P 500 outperformed foreign stocks, on an annualized basis, by nearly 10 percentage points. This outperformance made it difficult to justify investing outside the US; after all, had not the US invented the Internet and housed all the leading companies? However, circumstances changed in the following decade. The overvaluation of US stocks, substantial pro-market reforms in emerging markets, and the integration of the Eurozone led the S&P 500 to underperform foreign stocks during the 2000s. After the 2008 Financial Crisis, the US was able to deleverage its banking sector and implement monetary stimulus faster and more decisively than Europe. Emerging markets initially outperformed during the early years of the recovery as their financial systems remained intact. However, by 2013 a slowdown in Chinese investment in real estate and infrastructure led to declines in key commodity prices and sparked a global slowdown in the industrial and natural resource sectors that disproportionately impacted emerging markets.

The US, due to its lower reliance on external trade, dodged this slowdown. However, the US market now finds itself with a much richer valuation and slower potential earnings growth rate than most markets around the world. While expectations outside the US revolve around continued recovery of demand in Europe and across the major emerging markets, domestic optimism seems to center on Washington's ability to deliver potential fiscal stimulus, regulatory reform and corporate tax cuts. Betting on the dispersed and diverse global drivers of economic activity rather than the success of Congress in crafting and passing economically beneficial legislation seems like a no-brainer even without the handicapping effect of higher US valuations.

The high statistical correlation to the S&P 500 exhibited by foreign stocks does not negate their benefit to portfolios. Correlation measures to what degree two things move together and ignores any differences in the relative magnitudes of the moves. For, example, a portfolio that is 90% cash and 10% in an S&P 500 index fund will perfectly correlate to one that is 100% invested in the S&P 500 index fund. Similarly, a strategy that tracks the S&P 500 but miraculously outperforms it by 200 basis points per year will likewise perfectly correlate to the index. The benefit of foreign stocks lies in their ability to smooth year over year returns. If both the US and Foreign markets perfectly correlate, but over any given ten year period there is a fair chance of one outperforming the other by a significant magnitude, then it makes sense to include both in portfolios. This becomes a near necessity when a portfolio has significant distribution requirements, as withdrawals lead to an absolute decline in value that cannot be made up later when returns 'revert to the mean'. During the 2001-2010 period the S&P 500 returned 1.4% on an annual basis, whereas the MSCI Emerging Markets Index returned 16.2%. A 10% allocation to Emerging Markets would have increased the return to 2.9%, more than doubling the return on the portfolio compared with remaining solely invested in the S&P 500. By the end of 2010, a portfolio taking a 4% fixed withdrawal from the 90% S&P 500 / 10% Emerging Market allocation would have a 22% higher value than a 100% S&P 500 portfolio with the same withdrawal rates. This lead would only have been reduced to 19.0% after the over 10 percentage point underperformance of emerging markets relative to the S&P 500 over the subsequent 2011-2016 period.

Rising corporate leverage provides another worrying trend in the US. While the banking sector, having learned the lessons of 2008, remains well-capitalized, the debt levels of non-financial companies within the S&P 500 currently are well above the levels reached before the 2008 Financial Crisis. This trend exists to a lesser degree with 'main street' business, as monitored by the Federal Reserve Flow of Funds reports. Low interest rates, arcane international tax laws and yield-hungry investors all contributed to the current situation. While current debt levels remain manageable, the higher leverage promises greater investor pain during the next recession. Comstock has favored active management strategies that avoid highly levered companies, a factor which should translate into better downside protection.

Interest rates remained stable during the quarter as the bond market settled on the prospect of one or two more rate increases this year. In our experience, investors tend to be overly concerned about the impact of rising rates on their bond portfolios. As long as the time horizon is longer than the portfolio's average duration, the risk is manageable. Bond mathematics ensures that the return of a constant-duration portfolio will converge to its starting yield over a time horizon between its duration and twice the duration less one. For example, the duration of the Barclays Aggregate Index currently is 6.0 years and the yield is 2.5%. If one bought a Barclays Aggregate Index fund today and held it for 6 years under most interest rate scenarios the return would be 2.5% per year (i.e. the starting yield). In an extreme scenario, say rates stay constant for five years then increase by some very large amount the final year, it might take as long as 11 (2 x 6 -1) years for the return to converge to 2.5% annualized. Historically, the five year annualized return of the Barclays Aggregate Index closely tracks the starting yield. Short of succeeding at the impossible task of going to cash before rates go up and then buying long term bonds after rates are finished increasing, maintaining an intermediate duration bond portfolio remains the best strategy. An intermediate (3-6 year) duration allows for a yield that at least covers expected inflation of 2-2.5% whereas shorter maturities ensure losses in purchasing power. Additionally, as rates tend to fall during recessions, bond duration traditionally added a powerful diversification benefit during market downturns. Although low current interest rate levels have reduced this potential benefit, it remains of some value to portfolios.

The last recession ended in June 2009, so the current expansion has lasted nearly eight years. Only during the ten year expansion of the 1990s has the US economy gone longer without a recession. This expansion could last longer, or a downturn could happen within the next few years. Lacking a crystal ball, the best strategy consists of examining what risks exist compared to prospective returns within particular market segments. Passive indexing strategies performed well over the past few years, but they did so largely by bidding up valuations among securities thinly owned by more risk-conscious active managers. While market-timing remains a loser's game, it makes sense to lighten or avoid altogether segments with unfavorable risk / return prospects. Too many investors make the mistake of chasing returns late in a bull market when the opposite strategy of rebalancing and ensuring adequate safe liquidity to ride out a downturn provides results that best serve long-term financial goals.

[i]: Leibowitz, Martin L., Anthony Bova, and Stanley Kogelman. 2014. "Long-Term Bond Returns under Duration Targeting." Financial Analysts Journal, vol. 70, no. 1 (January/February): 31–51

- Stephen C. Browne, CFA
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