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COMPREHENSIVE WEALTH MANAGEMENT

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weighing the investment outlook

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Our individual clients as well as members of Investment and Finance Committees of institutions are intelligent, knowledgeable people who endeavor to stay well informed regarding politics, economics, and world affairs. So, it is not surprising that they ask pointed questions when we discuss our economic and investment outlook with them. In recent years, most of their questions have actually represented concern regarding the sluggish US economy, Europe's financial problems, the budget problems of many states as well as the US Federal Government, uncertainty with respect to US tax policy, and similar issues. Given all of this uncertainty, many of our clients have a difficult time understanding how in the world the US stock market could have risen 40% over the past two years. Similarly, some challenge our decision to hold a significant allocation to stocks, and to European equities in particular. Aren't we aware of all of the financial challenges facing the world?

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The problem with focusing entirely on the outlook is that it represents only one half of the investment equation. **Security analysis is all about evaluating the outlook for an investment versus its price.** This is true of both individual securities and asset classes. With respect to stocks, we too worry about all of the economic and political issues cited above. But we try to evaluate these concerns in the context of price. In other words, we constantly ask the question: do stock prices fairly discount all of the risks that are inevitably associated with investing in them? For example, it may be perfectly rational to purchase a security with a negative outlook if the price is sufficiently cheap. In fact, that is the focus of distressed security investing. Similarly, one should avoid an investment with a terrific outlook if the price more than reflects that outlook. Arguably, that was the prevailing situation in early 2000 when the technology bubble popped.

the scales of justice

I like to think of investment analysis in terms of The Scales of Justice in which the investment outlook represents one side of the scale and valuation or price the other. The challenge is to decide whether the scale is in balance or tilting to one side or the other. In the case of liquid markets such as stocks and bonds, there are millions of investors who are continually analyzing the economic outlook, politics, forecasts of corporate profits, interest rates, recent price trends, and many other variables. And, while these investors employ different methodologies and assign different weights to each of the variables, in the end each distills all of that information into an outlook which is then compared to valuation in order to make a determination of whether to buy or sell. Some investors conduct this analysis in a disciplined, quantitative manner while others take a more informal "gut feel" approach. But, either implicitly or explicitly, every investor makes the call.

While some investment professionals certainly disagree, at Diversified Trust we believe that the scales are in balance most of the time. After all, if a large number of investors thought that any market was not fairly priced, they would buy or sell accordingly and the price would quickly adjust. Most important,

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if we believe the scales are in balance, we allocate each client's assets in line with the long range target exposures dictated by their Investment Policy Statement. These exposures represent our best judgment as to the risk: return profile that is most consistent with the client's investment objectives.

a very high bar

Because we believe that the market gets it right most of the time, one should set a very high bar when considering a departure from long range target weightings. If you think about it carefully, there are six requirements for a successful tactical shift:

- First, you must have a view that is different from the consensus outlook that is priced into the market. In other words, you have to believe that the market is wrong. By the way, it isn't that easy to figure out what outlook is actually built into current prices.
- Second, the potential return (or capital preserved in the case of defensive shifts) has to be very large.
- Third, you must have very high conviction in your analysis.
- Fourth, you must have access to a cost effective, liquid vehicle to implement your investment view.
- Fifth, you must ultimately be proven correct. Or, if events have not yet completely played out, then the market consensus must move in the direction of your point of view.
- Finally, you have to get the timing right with respect to unwinding the tactical shift and returning to the long term target weights.

In all due respect, we should all be quite humble in assessing our (or anyone else's) ability to outsmart the investing world. To reinforce this point, over the past twenty years, the average investor in stock mutual funds has earned an annual return of only 3.5% as compared to the return on the average stock mutual fund of 8.0%. The difference is attributable to poor timing decisions.

Let's consider the current example in which some investors have chosen to avoid European stocks due to all of the concerns regarding the economic and fiscal outlook. Yes, there are significant issues, but they have obviously been widely publicized and discussed. Moreover, the current price earnings ratio for European stocks is 9.8 versus the long term average of 15 which means

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they are selling at a 35% discount to normal value. So, is the scale balanced or not? In order to suggest that it is not, you are implicitly asserting that you have better insights (and are more bearish) than the consensus regarding the outlook for European markets. While we certainly do have opinions, we are hard pressed to make the assertion that we have superior knowledge.

a focus on value

While we constantly focus on both sides of the scale, we typically have more confidence in our assessment of relative value because it is much more quantifiable. The investment outlook potentially contains an infinite number of variables so it is difficult to figure out which are most important much less forecast them accurately. But, in the case of value, there are well known metrics such that different investments can be evaluated versus their own history and one another. Given the difficulties in making tactical shifts that were cited above, we only make them when we believe that there is a very significant discrepancy between the outlook and observable valuation metrics. Two recent examples should make the point.

In order to compensate for the potential of default, high grade corporate bonds have historically provided incremental yield over US Treasury issues of comparable maturity of approximately 150 basis points or 1.5%. As a result of the gloom and doom associated with the financial crisis, that spread was 650 basis points or 6.5% in early 2009. We made the judgment that these spreads were pricing in something close to the end of the world. While we indeed had plenty of concerns, we did not believe that the outlook was quite that bleak. We therefore created our Credit Opportunity Fund which was invested primarily in high grade corporate bonds. Spreads returned to normal in less than a year and the Fund returned 21.7% over the first nine months of its existence.

Second, very large capitalization blue chip stocks have historically sold at a price earnings ratio that is 15-20% higher than that of the market as a whole in recognition of their clean balance sheets, cash generation and global prominence.

In contrast, for the past five years, these stocks have sold at parity or a small discount to the market. We believe that the favorable characteristics are still very much in place and that the discount to the market is unwarranted, particularly in a highly uncertain economic environment. If anything, these

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companies should be selling at a greater than normal premium due to their inherent quality. Thirty percent of our Equity Opportunity Fund is allocated to high quality large capitalization stocks and they have outperformed the broad market by about 3% over the past twelve months.

conclusion

Several very keen observers of the investment scene have recently commented that the current environment is characterized by more uncertainty than at any other time in their careers. We agree that there are plenty of things to worry about and therefore maintain highly diversified, balanced portfolios for our clients. But the risks have been widely discussed and markets are pretty darn good at evaluating them and adjusting accordingly. And, many "safe" investments such as US Treasury Securities have been bid up to the point that they offer only minimal returns. So, it is probably a mistake to be too cautious. In all likelihood, the scales are more or less in balance. ■

Important Notes And Disclosures

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