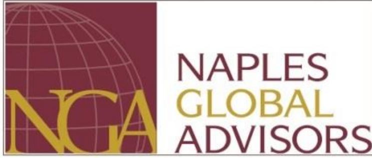

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The Global View From Naples

"Success seems to be largely a matter of hanging on after others have let go."

~William Feather, author of The Business of Life

It was the most challenging first quarter for the global financial markets since the 1920s. At the low point in mid-February, the S&P 500 Index had declined nearly 11% with numerous foreign markets trading even lower. Investors were bewildered, as the collective economic data was not reflecting that degree of extreme negativity. It was as if the proverbial "herd" had sensed a storm was brewing and darted for cover when a few gusts of wind were felt. We poured through the earnings reports from our stable of firms, which collectively reflected slowing sales growth (predominantly impacted by currency), but balance sheets remained strong and leverage was not disconcerting. As we watched our flashing red monitors, the domestic economic backdrop of low unemployment, low interest rates, and a favorable real estate market did not warrant the high degree of alarm. We remained reluctant to modify allocations for those clients who could tolerate the storm. By quarter's end, investors who held their allocations steady had managed to regain most of the lost ground, with the stock market scenario playing out quite similar to the rapid decline and recovery experienced last August and September.
As market participants are forced to deal with turbulent price swings, they are wondering aloud about the rewards. Below is a noteworthy table that highlights long period return and volatility metrics for key equity indexes:

		15 Yr. Avg. Annual return*	Std. Deviation
S&P 500 Index	(Large-cap)	5%	18%
S&P 600 Index	(Small-cap)	9%	19%
Barclays U.S. Bond Aggregate		5%	3%

*Source: *Lipper* for year ending 12.31.15

The annualized risk and volatility (standard deviation) results pose quite the conundrum. Small-cap stocks provided higher risk-adjusted returns over large-cap stocks, but investment grade bonds far and away enjoyed the more favorable risk/reward trade off. Understandably, investors are likely to be drawn to the historical characteristics of investment grade bonds, based on the results of the past 15 years. However, before placing bets there are important factors to consider:

1. The likelihood of the aggregate bond index repeating the results of the past 15 years.

2. A reasonable portion of pricing volatility for equities has been effectively transferred from intermediaries to end investors. It is quite real, and should be actively managed.

3. Knowing the value of what you own and why you own it is going to be vital for portfolio success and resiliency.

The first point is that an extension of the bull market for bonds is improbable, given the multi-year trajectory of declining interest rates. For a continuation of the bond market rally, there would need to be global deflation on a massive scale, with broad swaths of negative interest rates over an extended period of time. However, that does not mean bond yields are poised to move back up to the levels of '08 and '09. In fact, *Sanofi*, a French pharmaceutical firm,

was recently able to sell 3-year notes at an interest rate of .05%, the lowest on record for a non-financial firm. At that low coupon level, there would need to be an extensive return component from capital appreciation to replicate even the past five years of the bond market's rally. We view that scenario as unlikely and advise against overemphasizing future return expectations from bonds.

Our second point regarding volatility was recently developed and expanded in our mid-quarter risk letter. Dodd-Frank regulations have, quite effectively, transferred a portion of risk from the balance sheets of institutions, like *Morgan Stanley* and *Bank of America*, over to investors. The intermediaries of the past have been fined, heavily scrutinized, and forced to deleverage. Quite bluntly we are not expecting the banks or regulated exchanges to step up with liquidity to try and calm the nerves of the financial markets. Additionally, electronic trading and ETFs have compounded volatility. As partial evidence of this, during the past 12-months there have been broad equity market moves of 1% or greater a total of 81 times, more than all of 2013 and 2014 combined. In the new world order of investing, to increase the odds of success, it is imperative to have your financial house in order. This means having **a well-defined and segregated pool of ultra-safe liquidity** (what we are terming a "rainy day" fund), **lower overall debt**, **logical diversification**, and **an appropriate asset mix**. This is the recipe that will allow you to sleep comfortably through the inevitable storms that will accompany capital market investing.

This leads directly to the third point of knowing what you own, and having some understanding of its contribution to the risk of the overall portfolio. Our valuation process focuses on balance sheet strength, along with consistency of earnings per share and dividends per share. Our implementation process involves the utilization of a logically sized and geographically diverse grouping of securities. It is also important to reiterate that we make the decision for every investment transaction within our clients' portfolios, evaluating live market impact and transactional costs. While we seek to be long term investors, for any number of reasons (bond calls, dividend reinvestment, risk reallocation, etc.), trading activity occurs each business day at our firm. Being active market participants helps our team stay attuned to relative valuations, yield and credit realities, pricing discrepancies, and the inevitable opportunities that exist in the global financial markets.

One of the many benefits to living in Naples is that it is a conference destination. All types of professionals find their way here (filling up the restaurants, hotels and those oversized shuttle vans) all with the intention of educating themselves on issues impacting their industry. We took advantage of this recently by attending a conference well stocked with the leading North American and European insurance firms, as well as the key ratings agencies (*Moody's*, *AM Best*, *S&P,* and *Fitch*). An interesting takeaway about the insurance sector is that while many firms are direct competitors, they are also often clients of one another. As an example, if *Travelers* has a particular insurance segment that has expanded quickly, say Northern California commercial property risk, they are able to "slice" off pieces and transition that risk to another firm that might be underweight in the segment, through reinsurance contracts. Given the public responsibility of the insurance business, it has become a highly regulated, closely analyzed, and transparently ranked segment. The conference further affirmed that there are skilled and highly engaged professionals working in an ultra-competitive industry who are charged with analyzing risks in an ever evolving and complex world. Session topics were as varied as "liability for driverless vehicles," to the "impact of negative interest rates on portfolio returns." Other discussions involved actuarial modifications from "longer lives due to medical advances and healthier lifestyles." The implications are, in part, added years of premium payments, extended nursing home stays, and lengthened investment horizons, all of which could magnify obligations or profits for the insurance companies. Not the easiest of tasks, but we see an expanding world population with the collective means and desire to protect their assets. This includes the basics of insuring the lives of primary bread winners, along with their possessions. It also means having to analyze and rate new risks emanating from cyber-crime and global terrorism. When combined, these factors read to us as compelling reasons to own stakes in the future cash flows of the insurance sector, presuming risks are properly assessed and priced.

Finally, there was a conspicuous absence of other local analysts at the conference. It continues to confirm what we believe to be a large part of our value proposition, which is, going the extra step to better understand what we own and the premise for inclusion in our portfolios. That knowledge leads to more informed convictions, and a stronger resolution to better tolerate short-term pricing swings.