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Market Outlook & Strategy

Third Quarter of 2019

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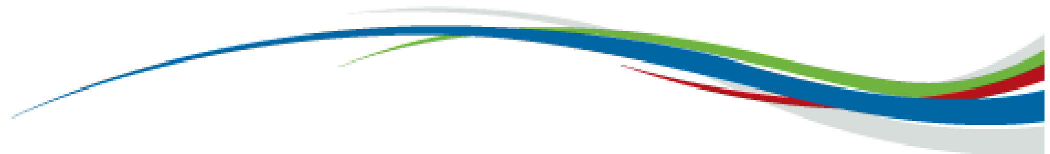

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Executive Summary

- The equity markets were decidedly uninspiring during the quarter. The U.S. equity market increased a modest +1.1%, with a fair bit of volatility along the way. Investors showed increasing concern over rising recession risks and so opted to invest in more defensive sectors.

- International equity markets all landed in negative territory. Developed international markets returned -0.9%, and emerging markets declined by -3.6%. In Europe, Germany flirted with recession due to the decline in global trade and troubles in Asia. Asian markets struggled due to slowing growth in China, political instability in Hong Kong, and the Trump administration's decision to threaten new tariffs.

- Most of the action during the quarter was once again in the fixed income markets. Growing concerns over slowing global growth led the Federal Reserve to approve a rate cut of 25 basis points in July for the first time since the financial crisis, followed by another 25 basis points in September. The European Central Bank also eased.

- As a result, fixed income returns were nicely positive. The Bloomberg Barclays U.S. Aggregate Bond Index gained +2.3% during the quarter. Investment-grade corporate debt added +3.1%, while U.S. Treasuries were up +2.4%. Finally, real estate also had another good quarter and has been the top-performing asset class year-to-date.

- This quarter's report focuses on how asset allocation affects portfolio durability in retirement when most investors are taking regular distributions. We update a study that was conducted almost a decade ago that found more diversified portfolios are superior to more conventional retirement portfolios, both from a risk and return perspective.

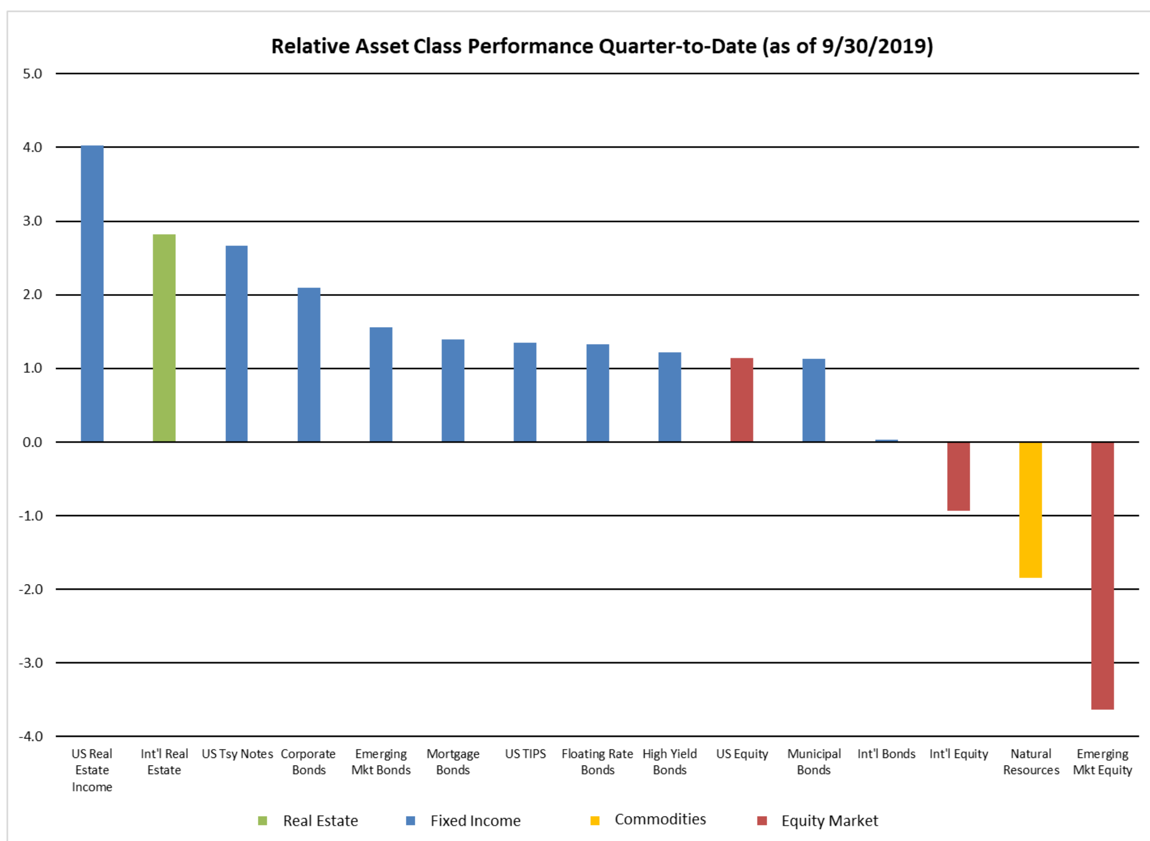
- Our updated findings still show the benefits of holding a more diversified portfolio from a risk perspective, but such a portfolio no longer is the leader in terms of returns. The new leader is the classic 60% U.S. equity / 40% bond portfolio, primarily because of the outperformance of the U.S. market over the last decade. However, such a portfolio was almost twice as volatile as the more diversified one.

- Artemis Strategy: We did not make any changes to the portfolios this last quarter as we are by and large happy with how we are currently positioned.

Markets in Review – Q3 2019

The equity markets were decidedly uninspiring during the quarter. The U.S. equity market increased a modest +1.1%, with a fair bit of volatility along the way. See Figure 1. Investors showed increasing concern over rising recession risks and so opted to invest in safer parts of the equity market, namely value-oriented stocks, which have been lagging growth stocks for much of the last decade. Growth concerns also led them to shun smaller-company stocks.

Figure 1: Index Returns by Asset Class in Q3 2019 (%)



International equity markets landed in negative territory, with developed international markets returning -0.9% and emerging markets declining by -3.6%, in part due to dollar strength. In Europe, Germany flirted with recession due to the decline in global trade and troubles in Asia. Asian markets struggled due to slowing growth in China, political instability in Hong Kong, and the Trump administration's decision to ramp up the trade war with new tariffs on China.

Emerging markets fared the worst due to the escalating trade tensions. In addition, Argentina suffered a major sell-off in equities, and several countries more sensitive to a stronger US dollar came under pressure.

Most of the action during the quarter was in the fixed-income markets. Growing concerns over slowing global growth, a strengthening dollar, and the trade war with China led the Federal Reserve to approve a rate cut of 25 basis points in July for the first time since the financial crisis, followed by another 25 basis points in September. The European Central Bank eased, too, cutting its deposit rate to -0.5% from -0.4% in September and committing to an additional EUR 20 billion per month stimulus package for the foreseeable future.

These actions led bond yields to continue to fall during the quarter. In addition, investors flocked to U.S. Treasuries in search of safety, and the demand added downward pressure across the curve, though more at the shorter and longer ends. The yield on the 10-year Treasury dropped to 1.47% before retracing upward to end the period at 1.65%. The 30-year Treasury breached the 2% threshold and marked an all-time low at 1.94%.

As a result, fixed income returns were nicely positive. The Bloomberg Barclays U.S. Aggregate Bond Index gained +2.3% during the quarter. Investment-grade corporate debt added +3.1%, while U.S. Treasuries were up +2.4%. Overall, funds with longer duration profiles generally benefited from the Fed's dovish signals and out-earned those positioned at the short end.

Finally, real estate also had a good quarter on the back of interest rates declining; real estate has been the top-performing asset class year-to-date.

Addendum: A Note on Last 12-Month Returns

For those of you who monitor your portfolio on a regular basis and hold more equity than fixed income (most of you), you might be wondering why the value of your portfolio hasn't increased much over the last 12 months. The basic reason is that almost all of the equity gains we have seen in the markets year-to-date have gone to recouping the losses incurred late last year when global markets declined sharply. This is demonstrated in Figure 2 (next page), which shows the 12-month returns of the same market indices shown in Figure 1. Here, we see that the only equity market showing a positive (+1.2%) return between October of last year and the end of September is the U.S. equity market.

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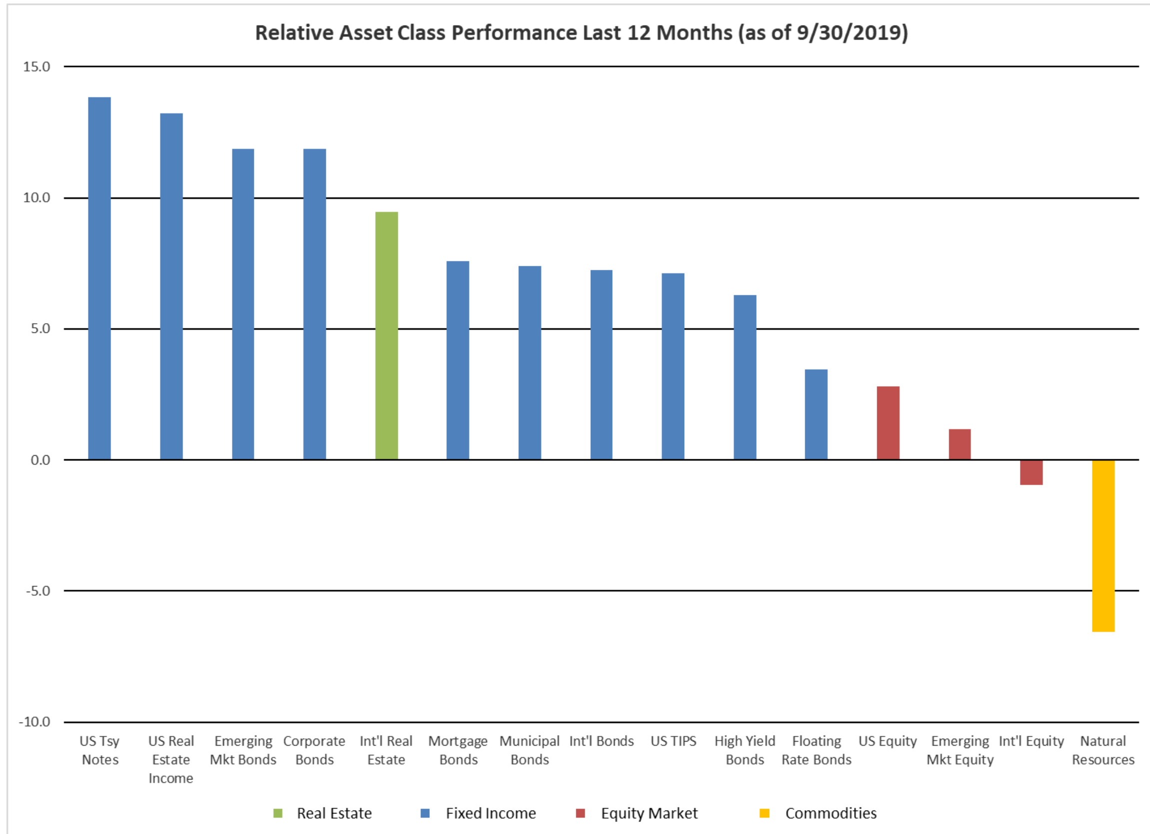
The media has been very confusing on this point, primarily because it focuses on year-to-date returns. But in this case, because of what happened last fall, that's only half of the recent story.

Figure 2: Index Returns by Asset Class – 12 months ending September 30, 2019



What is the Right Retirement Portfolio?

Some years ago, we wrote an Artemis Brief summarizing interesting new research that shed light on how asset allocation affected portfolio durability in retirement, when most investors are taking regular distributions.[1] The purpose of the research was to test whether increasingly more diversified portfolios might be superior to those that are heavy on bonds,

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[1] See "What is the Right Retirement Portfolio?" Artemis Brief Number 3, by Leigh Bivings, Ph.D, CFP. This and all of our Briefs can be found at www.ArtemisAdvisors.net.

dividend-paying stocks, and cash, which many consider to be the conventional way to structure a retirement portfolio.

The study analyzed the performance of progressively more diversified retirement portfolios based on the average of the 17 rolling 25-year periods between 1970 and 2010. As we pointed out in our original article, the study was notable for including the early 1970s market downturn, when both bonds and stocks were devastated and inflation was rampant, the bear market of 2001-2002, and the more recent financial crisis of 2008.

The most notable finding was that the most diversified seven asset-class portfolio, which included allocations to large and small U.S. equities, non-US equities, U.S. bonds, cash (T-bills), real estate and commodities, had the highest average internal rate of return of 12% over the 17 rolling 25-year periods. Moreover, it was the only portfolio to have an average worse-case drawdown that was actually positive over the same periods. See Figure 2.

Figure 2. Risk and Return of Retirement Portfolios in Distribution Mode: 1970-2010

Portfolio Asset Allocation	17 Rolling 25-Year Periods Between 1970-2010		
$500,000 starting balance, 5% withdraw rate, 3% inflation of annual withdrawal	Average 25-Year Return (IRR%)	Median Ending Account Balance after 25 Years ($million)	Average Worst Case 3-Year Drawdown (%)
Equal-weighted **Three** Asset Portfolio: Cash, Bonds, Large U.S. Stock	9.9%	$2.5	-4.8%
Equal-weighted **Five** Asset Portfolio: Cash, Bonds, Large U.S. Stock, Small U.S. Stock, Non-U.S. Stock	11.5%	$3.9	-9.4%
Equal-weighted Seven Asset Portfolio: Cash, Bonds, Large U.S. Stock, Small U.S. Stock, Non-U.S. Stock, Commodities, U.S. REITs	**12.0%**	**$4.7**	**0.7%**
60/40 Allocation: 60% U.S. Stock, 40% U.S. Bonds	11.6%	$4.2	-12.7%

Source: Craig l. Israelsen, “Still Seeking Stability”, *Financial Planning*, April 2011

Very recently, we decided to update these results by adding data we now have from 2011-2018. The last seven years have by and large been a period of U.S. market outperformance, low and declining bond yields, and fairly high volatility. In addition, commodity and cash returns have been very poor.

Our results are shown in Figure 3 (next page). The biggest difference is that the classic 60/40 allocation now has the highest average internal rate of return of 11.7%, and the most diversified seven asset-class portfolio fell to second place at 10.8%. This is not surprising,

given the strong run for U.S. equities and the low cash and commodities returns previously mentioned. Of note, the three-asset-class portfolio, which is the most similar to the "conventional" retirement portfolio, remains in last place with an average IRR of only 9.1%; this underscores the "cash drag" problem of the last decade when cash yields have largely been inexistent.

Nevertheless, in terms of average worst-case, three-year drawdown, the seven-asset-class portfolio remains in first place and thus is still portfolio for those of you who are concerned about sequence-of-returns risk when taking retirement distributions. (Recall that

Figure 3. Risk and Return of Retirement Portfolios in Distribution Mode: 1970-2018

Portfolio Asset Allocation	25 Rolling 25-Year Periods Between 1970-2018		
$500,000 starting balance, 5% withdraw rate, 3% inflation of annual withdrawal	Average 25-Year Return (IRR%)	Median Ending Account Balance after 25 Years ($million)	Average Worst Case 3-Year Drawdown (%)
Equal-weighted **Three** Asset Portfolio: Cash, Bonds, Large U.S. Stock	9.1%	$1.77	-7.3%
Equal-weighted **Five** Asset Portfolio: Cash, Bonds, Large U.S. Stock, Small U.S. Stock, Non-U.S. Stock	10.3%	$3.22	-14.3%
Equal-weighted Seven Asset Portfolio: Cash, Bonds, Large U.S. Stock, Small U.S. Stock, Non-U.S. Stock, Commodities, U.S. REITs	**10.8%**	**$3.82**	**-6.7%**
60/40 Allocation: 60% U.S. Stock, 40% U.S. Bonds	11.7%	$4.36	-15.2%

Source: Artemis Financial Advisors; Craig l. Israelsen, "Still Seeking Stability", *Financial Planning*, April 2011

sequence of returns risk is the risk that ongoing withdrawals on top of a series of early bad returns causes the portfolio to be fully depleted before the good returns finally arrive to average out in the long run.)

Bottom line: Blending a wider variety of assets to reduce volatility and sequence-of-returns risk seems to be a pretty robust result. This is less so for performance when the outperformance of one or more key asset classes (e.g., U.S. equity) is concentrated. It remains to be seen, however, whether this result will hold over the next decade when the expectation is that a reversion to the mean will make it likely that international returns will catch up due to their lower current valuations.

Artemis Portfolio Strategy

Recently, several clients have expressed some nervousness about slowing economic growth and the potential risks of a recession. As such, they have wondered whether we should sell some equity in their portfolios and wait until the uncertainty subsides.

The problem with this approach is twofold. First, no one is good at predicting recessions; even our last three Federal Reserve chairs did not anticipate the last recession, and they have access to a lot more data than you and I do! Second, even if the equity markets retreat (and there are some real risks out there), one is still faced with the equally hard decision as to when to put the money back to work. Ideally, the time to do so is when the market is beaten up, but nervous investors are rarely ready to jump in when the market is at bottom, in part because it's also hard to make this call. If the last recession is any guide, those investors who "went to cash," tended to stay in cash for quite some time, thereby missing the stellar returns of 2009 in which the U.S. equity market increased by +28%, international developed markets by +41%, and emerging markets by +78%. These investors lost a lot of money permanently, and it was very painful for many of them.

In addition, this summer we saw the Federal Reserve step in twice to boost economic growth with interest rate cuts, and the European Central Bank eased as well. We also note some glimmers of hope that the global manufacturing recession is bottoming-out and that the Chinese economy is stabilizing. On the downside, the rate of private fixed investment by companies has slowed down measurably and we're not expecting growth in corporate profits reported for the third quarter. All of this means that central bankers may need to be a bit more aggressive, but at least they are now engaged again.

Absent specific requests by clients to go more defensive due to pending cash needs for higher education or something else, we have largely been sitting tight. We are very happy that we became more defensive with our fixed income allocations earlier this year, giving us the ability to raise cash irrespective of the state of the equity markets. We also like the fact that we lightened up a bit on some of our deep-value positions. We are not doing anything more at the moment, as current valuations are pretty attractive, and we don't want to miss the inevitable rotation.

We are, however, keeping close tabs on the trade negotiations and Q3 earnings, which are just now starting to come out We need positive news on both of these fronts for markets for stocks to move sustainably higher, and so far it's been positive on earnings.

Market Index Descriptions (for Figure 1 and 2)

Equities:

The **Dow Jones U.S. Total Stock Market** is a market cap-weighted index providing broad-based coverage of the U.S. stock market. Considered a total market index, it represents the top 95% of the U.S. stock market.

The **MSCI EAFE + Canada (net)** is a market cap-weighted equity index that is designed to measure the equity market performance of developed markets, excluding the U.S.

The **FTSE Emerging Markets All Capitalization China A Inclusion (net)** is a market cap-weighted index representing the performance of large-, mid- and small-capitalization stocks in emerging markets.

Fixed Income:

The **Bank of America Merrill Lynch U.S. Treasuries 7-10 Year** measures the performance of U.S. Treasury securities that have a remaining maturity of at least seven years and less than 10 years.

The **Bank of America Merrill Lynch U.S. GNMA Mortgage Backed Securities Index** is a market cap-weighted index, including generic-coupon Ginnie Mae mortgages, with at least of $150 million principal amounts outstanding.

The **Barclays Capital 1-15 Year Municipal Bond** measures the performance of tax-exempt investment grade debt of U.S. municipalities having at least one year and less than 15 years remaining term to maturity.

The **Bank of America Merrill Lynch U.S. Corporate 5-7 Year** measures the performance of U.S. dollar denominated investment grade rated corporate debt having at least five years and less than seven years remaining term to maturity.

The **Bank of America Merrill Lynch Global Government Bond II Ex-U.S.** tracks the performance of public debt of investment-grade sovereign issuers, excluding the U.S.

The **J.P. Morgan Emerging Market Bond Global Core** is a broad, diverse U.S. dollar-denominated emerging markets debt benchmark that tracks the total return of actively traded debt instruments in emerging market countries.

The **Bloomberg Barclays U.S. Treasury U.S. TIPS** measures all publicly issued, U.S. Treasury inflation-protected securities that have at least one year remaining to maturity.

The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks the prices of futures contracts on physical commodities on the commodity markets.

The **Fidelity Real Estate Income Composite** is a benchmark that combines the total returns of the Merrill Lynch Real Estate Corporate Bond Index (40%), Morgan Stanley REIT Preferred Index (40%), and the FTSE NAREIT All REIT Index (20%).

The **Dow Jones Ex-U.S. Select Real Estate Securities** measures the performance of equity REITs and real estate operating companies (REOCs) traded globally, excluding the U.S.

The **Bank of America Merrill Lynch U.S. High Yield Master II** tracks the performance of U.S. dollar denominated below investment grade-rated corporate debt publicly issued in the U.S. domestic market with a maturity of at least one year remaining.

The **S&P/LSTA U.S. Leveraged Loan 100** reflects the performance of the largest facilities in the leveraged loan market.