Argent Wealth Management
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Investment Outlook
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Second Quarter 2010 Investment Outlook

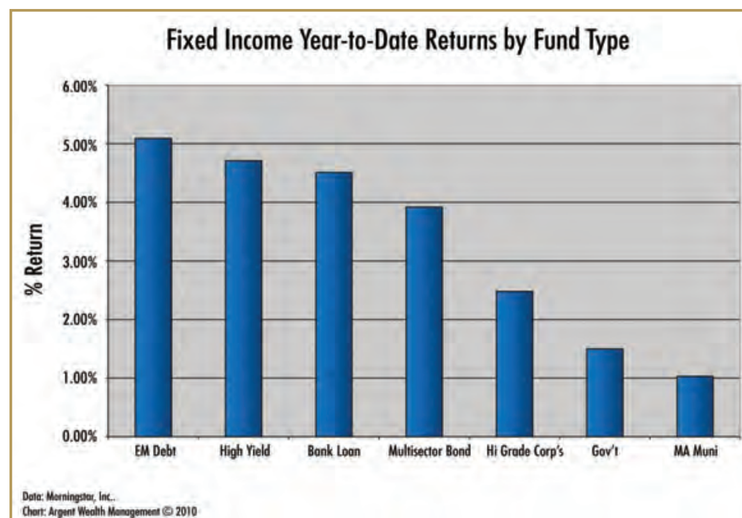
Review of the First Quarter: Not a Bad Start

Investors and capital markets never cease to amaze and baffle. In the first quarter, investors continued to bid up prices of financial assets, particularly those of a riskier bent — despite the very recently concluded “Great Recession” and its associated bear market of a lifetime. This trend was most pronounced in fixed-income markets. Yield spreads are now below historical norms for most non-Treasury categories: corporate bonds, emerging-markets debt, even high yield. It’s as if the train wreck of September and October 2008 had vanished from investors’ collective memory.

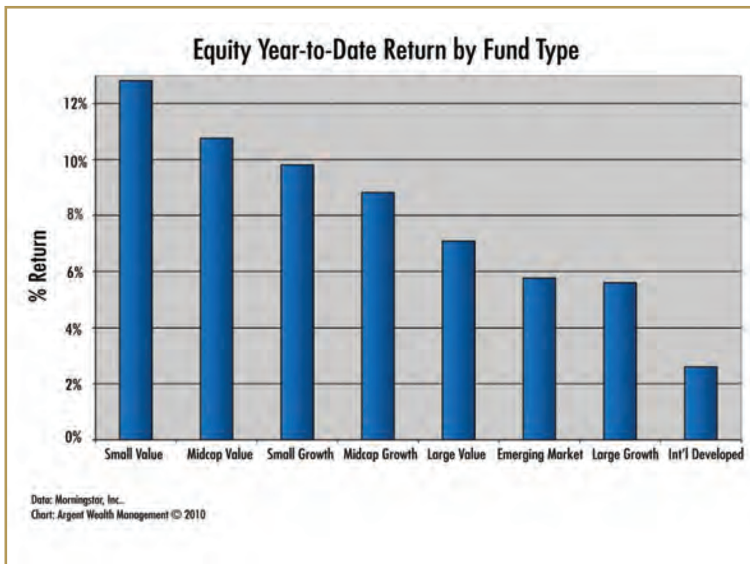
To be sure, we are delighted with how the quarter went. Our clients participated in and benefited from the robust bull market. In last quarter’s Outlook we predicted that markets were likely to keep grinding higher, barring a major external shock. We also said that we were fully prepared for a correction of some severity. Well, we did get a minor correction early in the first quarter, but that was quickly forgotten as markets resumed their resolutely upward march in February and March.

But with prices and expectations now pitched higher, there is less room for error, and even greater potential for a substantial correction. For such an event to occur sometime in the second or third quarters would be fully consistent with historical norms for this stage of a bull market. This is not to say that we expect a new and brutal bear market. But today’s environment does call for a rigorous focus on risk controls. It also makes the quest for attractive investments outside the traditional equity and fixed-income categories more urgent — a topic we will explore later in this article.

A more granular review of the quarter by asset class highlights its overall patterns. On the fixed-income side, the story is remarkably consistent: riskier was better. Emerging debt was the best-performing category, followed closely by high yield and bank loans. At the bottom were higher-quality government bonds, including municipals (though even those areas posted respectable gains).



On the equity side, the tilt toward risk was similar, albeit not as consistent. Small- and mid-capitalization U.S. equities led all categories for the quarter with handsome 8%–12% gains. These returns exceeded those of larger-cap stocks, even though bigger companies usually have relatively stronger balance sheets and steadier cash flows.



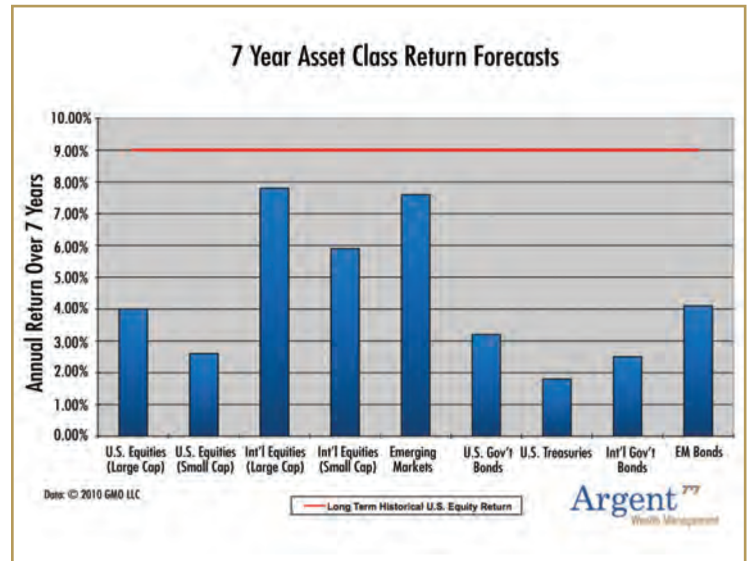
International equity markets modestly lagged U.S. stocks in the quarter, seemingly bucking the trend to greater risk-taking. But a longer-term perspective reveals consistency even here: non-U.S. assets, particularly emerging markets, far outstripped their U.S. counterparts from the March 2009 global low to the end of last year. And patterns within foreign markets during the first quarter clearly conformed to the theme of greater risk-taking. Emerging markets outpaced their developed-country counterparts, and smaller-cap stocks surpassed large-cap issues.

What's Reasonable to Expect for Long-Term Returns?

It's tempting to conclude that the Great Recession is over, the U.S. and global economies are headed for a prolonged period of economic expansion, and the performance of stocks and bonds will mirror the wonderful returns of the 1980s and 1990s. Unfortunately, we don't think that will be the case. In fact, returns on both equities and bonds over the next several years are likely to fall well short of their historical averages.

Chart 3 was constructed using forecasts of asset-class returns from the investment firm GMO (Grantham, Mayo, Van Otterloo & Co.). GMO's forecasts have often proved to be remarkably accurate. Their rigorous and unemotional process starts with current asset-class valuations (price-to-earnings ratios for equities, yields for bonds), then estimates future earnings potential, bond yields, and ending valuations. The results are sobering.

On the equity side, price/earnings ratios today are above their historical averages, while potential earnings growth is more modest than in the 1980s and 1990s. Barring another equity-market bubble that would lift P/E ratios into the stratosphere by period end — highly unlikely in our view — probable returns over the next 7 years are positive but certainly not exciting.



The picture is brighter for international markets. Many of them, particularly those of emerging economies, have strengths that U.S. equities lack. On average, debt levels are lower in developing countries, demographics are more favorable, and growth potential is greater. Also, many foreign markets are priced more reasonably in relation to future earnings-growth potential than U.S. stocks. We have consistently favored non-U.S. asset classes in recent years, and this analysis fully supports our view.

On the fixed-income side, the analysis is more straightforward. By far the best predictor of future returns on longer-term fixed-income securities is the starting point on yields. Bond yields are inversely related to bond prices. As yields go up, prices go down, and vice versa. At this writing, money-market yields hover near zero and the yield on 10-year Treasuries is a paltry 3.8%. In other words, yields seemingly have nowhere to go but up. So there is little room for optimism on that front.

If interest rates start rising to historic norms, as we believe is likely to happen, then returns on fixed income assets will fall short of the starting yield level; as there would be some depreciation in the value of fixed income assets. The magnitude of depreciation would depend on the maturity of the bond; longer-term bonds are hurt most severely by rising yields, while very short-term bonds and money-market instruments would eventually be aided by rising reinvestment yields.

As with equities, fixed-income markets outside the United States enjoy better prospects. Yields are generally higher abroad, and U.S. investors may enjoy a currency-related boost to returns if the U.S. dollar weakens.

The Search for Return: Alternatives to Traditional Asset Classes

Given the sobering return expectations for traditional stock and bond markets, it is essential to explore the potential for higher returns and greater safety in "alternative assets," a term that encompasses an extremely wide variety of strategies. Fortunately, the picture here is encouraging.

Alternative investments include anything beyond the realm of traditional equities, fixed income, and cash or money markets. Absolute-return strategies, hedge funds, private equity, real estate, commodities, managed futures, and many other investment categories fit under this big tent.

It is impossible to generalize about such a broad range of assets. Each type of strategy has its own nuances and attributes. Careful research is essential. Nevertheless, there are many opportunities, some of them extraordinary, worth examining in this capacious universe, as well as attendant risks.

On one end of the alternatives spectrum are exciting innovations among absolute-return funds. Such vehicles seek to earn positive returns in any market environment: up, down, or sideways. The funds we favor in this category have modest return potential (6%–12%), but enjoy a very high likelihood of achieving positive returns, have low correlation to both stocks and bonds, and exhibit high predictability.

Absolute-return strategies are now available in transparent vehicles that are totally liquid, with daily pricing and redemptions. In our view, a carefully selected and vetted absolute-return fund may now be a better choice for inclusion in a portfolio than many fixed-income assets.

At the opposite end of the alternatives spectrum are extraordinary opportunities in secondary private equity. Currently there are a plethora of distressed investors – endowments, foundations, banks, individuals – who are unable or unwilling to meet current and future capital calls, and thus are urgently seeking to sell their interests in private-equity funds. In some cases, the discounts are staggering: 50% or more off current valuation.

A steep price cut does not, of course, automatically make an asset worthy of purchase. Junk is still junk, even if it is greatly marked down. But many of the secondary private equity interests available today at deep discounts are quite appealing. The underlying companies are attractively valued, growing, profitable, and have pristine balance sheets. Now *that* is an opportunity!

But a cautionary note is warranted here. Private equity is a complex asset class suitable only for a minority of investors. Minimum investment amounts are high, commitments are long term and illiquid, and investor qualifications are stringent.

Commodities and real estate have appealing long-term potential. We believe a cycle favoring such so-called "hard assets" is nearing. Indeed, such a cycle already has been long underway for commodities. Demand for commodities seems almost certain to accelerate as the global economy continues to expand. Gigantic budget deficits and exploding debt levels in the United States and other developed countries reinforce the potential for commodity price appreciation and relative underperformance from financial assets. Hence we continue to add (modestly) to commodity allocations.

Real estate is an entirely different matter. We sold virtually all the property-related investments in our clients' portfolios well before the bubble burst in 2006 and 2007, avoiding the debacle that followed. At present we are carefully evaluating the sector, but have not yet begun to invest in it.

Cycles in real estate tend to be prolonged and to lag the underlying economic cycle. The severity of the current downturn, along with unprecedented job losses, is likely to push the onset of the next bull market in real estate even further out. Despite continued softness in many local markets, though, some opportunities are beginning to emerge. As employment trends improve and rents stabilize, we will look to add real-estate assets to client portfolios.

Final Thoughts

While investment cycles have been around for centuries, the landscape for investing has changed in profound ways. Never before has the opportunity set been so ample, the range of vehicles so wide, and the markets so global. Success in today's environment requires both flexibility and a vast breadth of investment expertise. Long gone are the days when a portfolio composed only of U.S. stocks and bonds could deliver attractive returns and sound diversification.

A portfolio containing a broader range of assets has superior return potential, but more importantly it has less risk. The challenge is to carefully and prudently tailor each portfolio to the specific needs and unique circumstances of each of our clients.

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