Argent Wealth Management

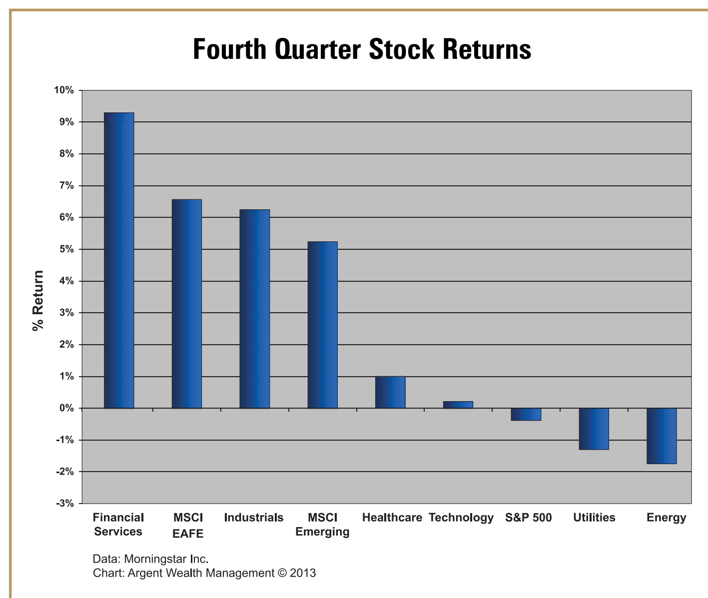
QUARTERLY Investment Outlook

Winter 2013

# First Quarter 2013 Investment Outlook

## Fourth Quarter and Full Year Review: Shifting Market Leadership

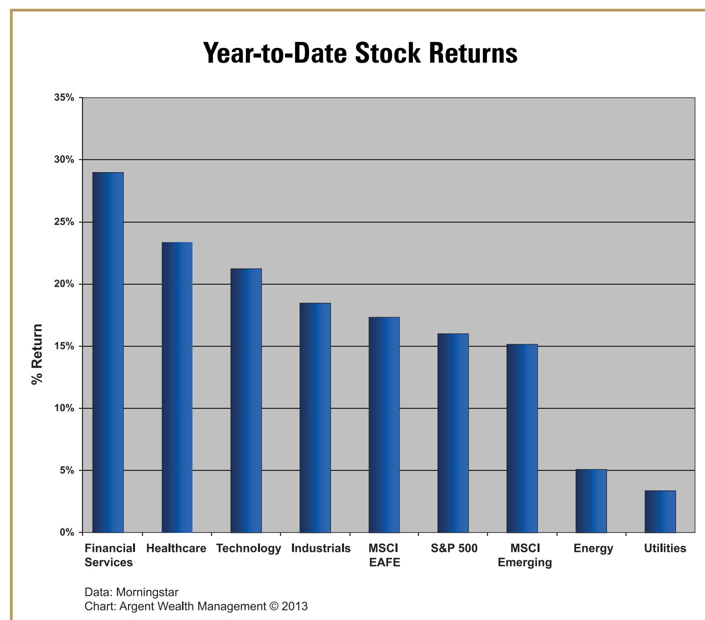
Without question, the most striking market observation from the past quarter was a dramatic shift in market leadership across several different dimensions. U.S. returns badly lagged most non-U.S. markets. Particularly impressive were the sharply positive returns of core European Equity markets, with some of the most depressed and toxic countries such as Italy and Spain at the top of the pack.



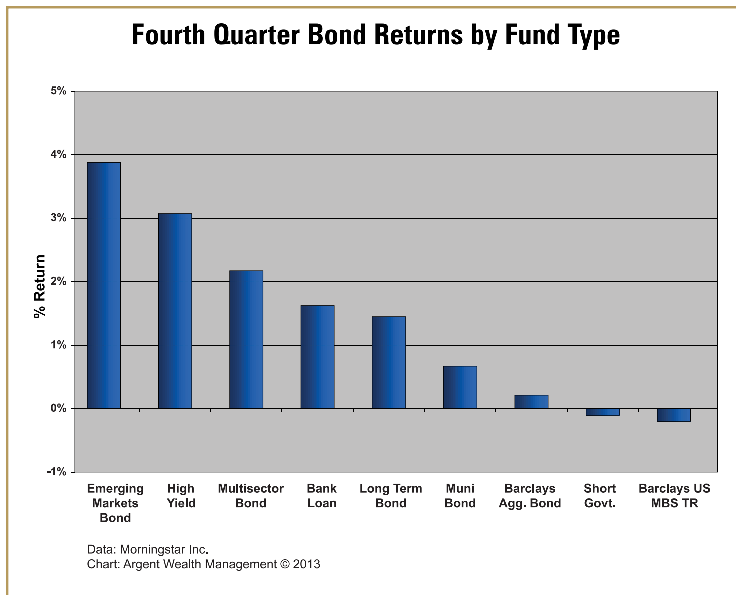

Another key example of the shift in market leadership was across sector (i.e. Financials) and style (i.e. Value). Here as well, the top of the pack was generally characterized by the most toxic and avoided sectors by most investors such as Commercial Banks.

Policy actions and election results were at the center of market changes. Suddenly, the European Central Bank (ECB) seemed to be getting their arms around stabilizing their banking systems. Yield levels on the problematic creditors of Spain, Italy and Portugal have steadily and persistently declined. This has boosted confidence that the resolution to the European debt crisis is underway.

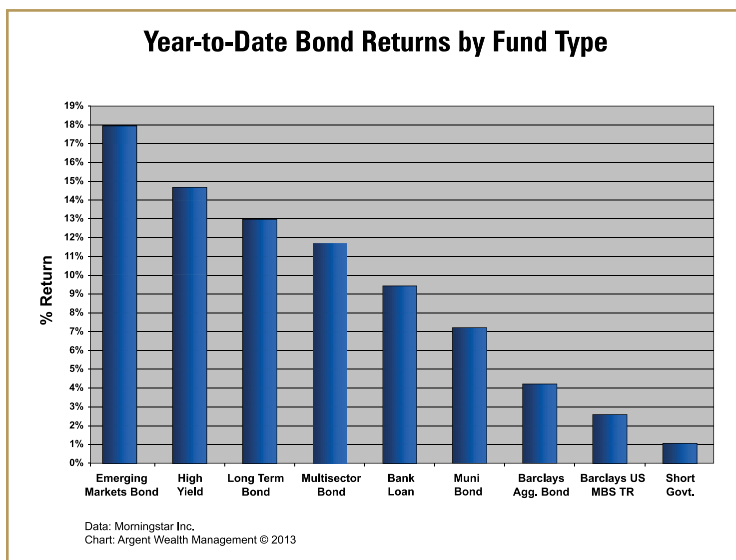
On the other hand, the U.S. Fed floundered over the quarter as doubts started to surface about the prudence of the last round of monetary stimulus and an eventual exit strategy. Obviously, the truly pathetic debate and poorly constructed eventual last minute deal with the "fiscal cliff" threw a wet blanket over U.S. returns. Sadly, the President and Congress have once again punted on dealing with the serious stuff such as entitlement reform and spending cuts. With Debt Ceiling and automatic sequestration cuts looming, we fully expect additional bouts of market volatility.



These market conditions affirm several critical principals of the way that we invest our clients' assets. First, it is critical to be broadly diversified by geographic region, style, sector and asset class. It is impossible to predict with any reasonable degree of accuracy the precise timing of these shifts, so asset allocation changes should be moderate in size and prudently implemented. Second, investing with a primary goal of being "comfortable," or in the consensus of market opinion, is a very poor way to manage risks and achieve superior returns.




Often markets correct too far in both up and down periods. Excellent returns are achieved by adding (in modest and disciplined increments) investments that have fundamental value but are deeply oversold and discarded by the retail investor.




Importantly, we utilize investment managers in each sector that do not cater to crowd psychology or invest with a goal of being comfortable. These outstanding managers take a longer term view and focus on the fundamental value of an investment. We are pleased to report that our managers did a terrific job of adding value in 2012, and over longer-term periods. Fortunately, our clients have enjoyed excellent returns.

### 2013 Market Outlook: A Less Robust Opportunity Set

Entering 2012 (see 2012 Investment Outlook) we were optimistic about a wide range of attractively priced equity and fixed income assets. Investor sentiment was still depressed from the traumatic third quarter of 2011. The list of compelling investments included U.S. and Non-U.S. Developed Equities, Emerging Market Equity and Debt, High Yield, Mortgages, Senior Secured Loans and Corporate Bonds.

This year's list is considerably shorter. Additionally, many areas that we still favor have expected returns, in our opinion, in the high single digit range rather than the double digit range of 2012.

Success in managing under such market conditions will require a different play book than the one used last year.

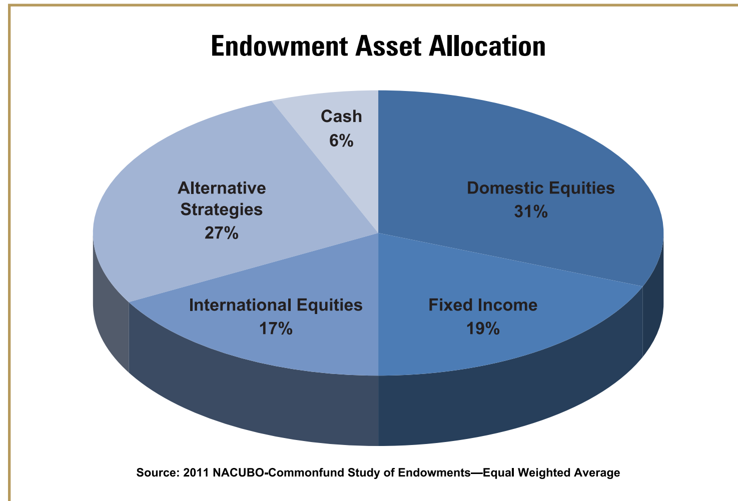
First, we believe that it will be critical to trim or eliminate completely asset categories that are exceptionally expensive and whereby investor sentiment is overheated. A prime example currently is the "on-the-run" High Yield Bond category. Yield levels are now at the lowest levels in history by a wide margin. Retail cash inflows have been massive. Issuance of new bonds is surging and there are now signs of a deterioration of bond covenants and credit quality. It should not come as a surprise that we are reducing positions currently.

Secondly, we believe that a more significant portion of returns this year will be the result of successful tactical management. That means trimming or selling completely overpriced and overheated asset classes. We also expect to opportunistically raise cash levels. We will actively manage the overall level of portfolio risk and wait patiently for market volatility and hence opportunity.

Critically, there is a huge difference between "tactical management" and "market timing." We are by no means suggesting either an "all-out or all-in" philosophy or a directional call on equities. Such strategies have a poor record. Rather, we are referring to moderate, but significant, active adjustments in portfolio risk levels. Additionally, we expect changes in asset allocation across a wide range of asset class-

es and strategies. Cash levels will rarely reach the 20% level, and only under the most extreme market scenarios.

Finally, success in 2013 will require active and creative use of an even wider array of asset classes. These assets classes will be both Traditional (Equities and Fixed Income) and Alternatives (Hedge Funds, Absolute Return, Private Lending, Private Equity).




Fortunately, the range and quality of attractive investment strategies has never been larger. Long gone is the "stocks, bonds and cash" framework of the 1980's. Today, individual investors have the ability to invest in many asset classes such as Hedge Funds and Private Equity that were formally limited to large endowments.

As we have noted in prior reports, endowments have both higher returns but less risk than the average individual investor. That is due to the skillful use of a significantly wider range of assets including Private Equity, which is exactly what we provide for our clients. Endowments often lag slightly in sharply up equity markets, but significantly outperform in sharply down equity markets. This leads to higher compounded returns over time.

**Endowment Vs. Public Equity Returns**
**June 2002 – June 2011**

| Benchmark | Annualized | Worst Year (2008 – 2009) |
|---|---|---|
| Endowments | 5.24% | -18.70% |
| S&P 500 TR Index | 2.73% | -26.21% |

Source: 2011 NACUBO-Commonfund Study of Endowments
Calendar year ending June 30

## Best Ideas for 2013

### Non-U.S. Equities

We believe that the recent shift of momentum away from U.S. Equity markets will likely continue, albeit in an inconsistent manner. Both starting valuation levels and the potential for economic growth (selectively) appear more promising abroad.

The U.S. economy, in our view, will continue down a path of low and uneven growth. Fiscal austerity (both tax increases and expenditure cuts) will constrain the rate of growth. Valuation levels in the U.S. are certainly reasonable in absolute terms and cheap versus most other investments, particularly High Grade Bonds. Expected returns, under these conditions are reasonable, but not spectacular. It would take a large bump up in price earnings ratio to produce double digit returns, on average, over the next several years. We do not expect that.

Comparatively, Emerging Market Equities have relatively cheap Price-to-Earnings ratios, stronger fiscal conditions and materially better prospects for earnings growth. These markets have been depressed versus the U.S. market over the past several years, in part due to the slowdown in China. We believe that slowdown is now passed and Emerging Market governments are generally stimulating growth.

### Managed Futures / Alternative Assets

We look to this category with three critical goals in mind; 1) a significant reduction in portfolio volatility, 2) truly "non-correlated" returns versus both bonds and stocks and 3) an "insurance policy" for risk events and bear markets.

Such volatility reduction and portfolio insurance seemed unnecessary in 2012. While returns were generally positive, this was the weakest area of our clients' overall portfolio.

With expected market returns more modest in 2013 and the opportunity set more limited, we expect this category to be more productive. Managed Futures (and Hedge Funds in general) have experienced back-to-back disappointing years based largely upon the "macro" driven environment. There are many similar periods over the past several decades. However, if history serves as a guide, and we think it will in this case, these periods lead to more "trending" market environments.

Critically, Managed Futures has an excellent long-term return profile with a complete lack of correlation with stock and bond returns. These strategies can deliver positive returns in both up and down equity markets!

### Private Assets: Private Equity, Private Credit, Real Estate

Private assets have continued to play an increasing role in client portfolios.

We view this sleeve of a well-constructed portfolio as the "turbo-charger" of returns. Here, returns can be well beyond what is available in public markets. For example, the average Private Equity fund has returned an annualized 5% more than the S&P 500 over the past 20 years!

**Private Equity Vs. Public Markets**

| Benchmark | Annualized 20 Year Return | A $10k Investment would be worth: |
|---|---|---|
| Cambridge Associates LLC U.S. Private Equity Index | 13.6% | $128k |
| S&P 500 TR | 8.5% | $51k |

Source: Cambridge Associates, Through September 30, 2012

However, that high potential return does not come for free. These asset classes are complex, have long holding periods, and are potentially illiquid. They are not appropriate for all clients. That is why we carefully consider the suitability, overall liquidity constraints and time horizon for each client. We prefer to "ladder" investments over a 3 to 4 year cycle. This greatly reduces the risk of any single investment, and smooths out the cash-flow.

Typically, a 20% allocation to a diversified portfolio of Private assets is optimal. This percentage does vary widely depending on the unique circumstances of each client.

### Idiosyncratic Credit

There remains a limited number of attractive areas of fixed income credit markets. In sharp contrast to 2012, these areas are more challenging to find.

But, with the Fed and other central banks around the world still holding short interest rates at or near zero, the massive demand for income assets is unabated. The challenge is isolating those pockets where expected returns are still ample and risks reasonable.

Several examples include RMBS (Residential Mortgages) and "off-the-run" High Yield. In each area spreads are still wide and credit quality acceptable and/or improving. While the "herd" has bid up the on-the-run sectors, skillful managers can still find ample opportunity in these more complex and less traveled pockets of opportunity, such as distressed debt.

### Conclusion

The resultant portfolio has the characteristics that we seek; very broad diversification across asset class, sector and style, attractive return potential and significantly less volatility than appropriate market benchmarks. Simply stated, our goal is to exceed our client's expectations while taking the least amount of risk possible.

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