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CHARTWELL VIEWS

September 2, 2015 **Current investing ideas** *A continuing series*

May You Live in Interesting Times

Not quite the Chinese curse investors want to hear right now, but unfortunately apt. There are 7 reasons being put forth to explain the dramatic decline in stock markets around the world during August, and they center on China -

1. *China is in the midst of a hard economic landing, to well below its targeted 7% growth rate. As the world's second largest economy, its growth slowdown is negatively affecting most of the world's commodities-based economies;*
2. *Because of China, global economic growth is slowing; commodity weakness is the harbinger of a global recession; deflationary pressures are building. This will affect almost all companies;*
3. *There has already been a multi-quarter decline in corporate earnings; expectations will worsen;*
4. *Corporate credit spreads are widening, which increases the risk of owning stocks;*
5. *Uncertainty regarding Federal Reserve policy;*
6. *Internal market technical factors are negative;*
7. *There is general investor nervousness amid seasonally slow trading volume.*

It probably doesn't do anyone much good to point out the Shanghai stock market is still up year/year, while the S&P 500 is down. You'd think if China is the epicenter of this widening circle of doubt, its markets would be down further. Perhaps that is still to come.

The market drop, which traces back to July 20th but really lit up on August 17th, scrubbed over 12% off the S&P 500's valuation. It is a true correction (*>10% decline, from peak to trough*), and one that easily takes out last September/October's 7.4% dip as our worst recent equity market experience. The July/August swoon in 2011, when the market plunged 16.5% in 28 days, was worse. It took 168 days to re-take the peak.

I wish that reasons #6 and #7 explained the problem. These are largely self-correcting, as technical charts "correct" themselves as we move through time and so do seasonal factors (senior management gets back from the beach, and cooler heads prevail).

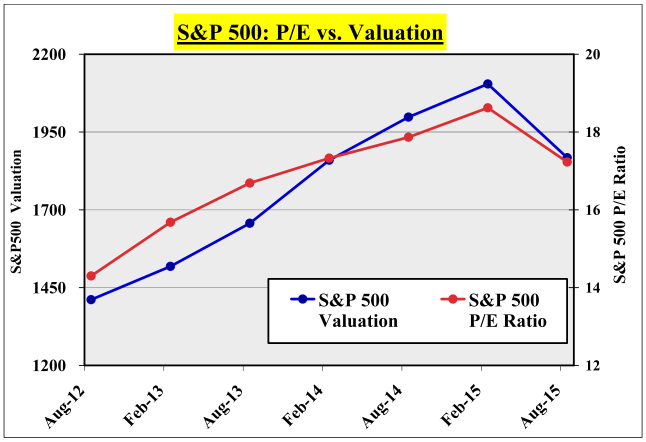
Unfortunately, we don't think that accounts for the volatility. Nor do we think the strategic imperative at work here is explained by Fed policy. The market fully expects the Fed will begin inching the fund's rate off zero later this year, and has so for many months. That is "priced in" to the market. Whether the funds rate is zero or just near zero is less important than the path of growth and inflation going forward.

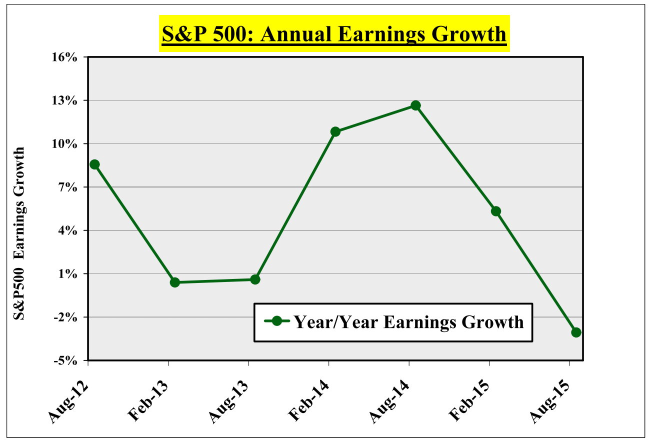
Thus, rationales #1 and #2 get a strong nod as *proximate* causes. The vibrant "reflation" theme, which took crude oil prices up to $60/bbl, has been replaced by an even more virulent "secular stagnation thesis". Hard commodities and even some foodstuffs prices have plunged below marginal costs, forecasts of GDP growth rates have once again been marked down, and the Chinese market's "growth recession," as it shifts from an industrial-centric to a consumer-centric economy, is expected to threaten many other emerging markets. China shocked the market with an abrupt change in policy, removing its currency peg and letting the yuan float, but the sharp 4% devaluation is unlikely to be of much direct consequence to the US. It has certainly ramped up anxiety levels, though.

However, we think the primary driver of this market's weakness is closer to home, more basic, and perhaps even harder to sort through. We think the stock market had (has?) become too expensive for the growth in corporate profits that was (is?) being delivered. This is a function of many moving parts, including revenue stagnation, weak labor productivity, margin erosion, rising employment costs, and negative currency effects on both the income statement and balance sheet (for the multi-nationals).

Chartwell Consulting (USA), LLC
Asset Management Consulting Services
34 Park Street, Montclair NJ 07042

Phone (973) 783-2900
Fax (973) 783-2998
www.chartwellusa.com





What we're looking at above is the last three year's of S&P 500 performance. From 8/27/12 through 2/27/15, or 2.5 years, the S&P rose like clockwork every six months, returning a cumulative 49% before dividends. This included five peak-to-trough drops of 4% or more, all of which were short-lived. We can see on the right that annual earnings growth was anything but consistent during this time, and has recently been on a decided downward trend. Yet, investors were excited enough to take the market's P/E from a below average 14.3x, to a well-above average 18.6x.

In February of this year, we logged in very weak 4th quarter earnings. This was followed by a weak first quarter, and finally, a poor second quarter. By mid-July, it became apparent that earnings "growth" has been negative for three straight quarters, during which time the market's valuation continued to rise (albeit modestly). While investors obviously felt that paying 14.3x for an uncertain future was acceptable three years ago, paying 18.6x for declining earnings is not. Something had to give, and over the past month it did.

For the first time in all of our lifetimes, the next global recession may not be precipitated by the United States. The Chinese economy is as large as the US, and a "growth recession" in that country could pull global growth rates to very low levels. And, in consequence, US corporate earnings could take some hits, as will Europe's, Japan's, and major EM markets. That's why China may be an important <u>piece</u> of the puzzle.

The critical **strategic** factors for equity markets and equity investors have always been earnings, cashflow, and the multiples assigned to them. If enough "animal spirits" have been drained from US investors by the past six weeks' drawdown, then maintaining a market PE above 17.0x could become problematic. At current earnings levels, that equates to an 1843 S&P. If 3rd quarter earnings aren't robust, the S&P 500 index could print 1800. ***Or***, all of this goes away before January as the equity markets recover, <u>if</u> the next six months' earnings growth were to bounce off the floor.

What can investors do to rationally sort through all of this uncertainty?

First, keep thinking in strategic terms.

Trying to tactically trade institutional portfolios is unlikely to be considered prudent, even for those investment committees able to do it well.

Institutional investors must first dispense with their primary tactical imperative – liquidity.

Raise sufficient liquidity to meet 100% of the next twelve month's obligations as they fall due. We've harped on this many times before, but it's that time again. In a volatile and uncertain market, you've got to remove nearly all market risk factors from your liquidity account. Don't count on raising future necessary cash from highly valued risk assets. Raise the cash now. Bite the bullet.

- If your program is going to spend $1000 over the next twelve-to-eighteen months, <u>*net*</u> of the cash contributions it is <u>100% certain</u> to receive, then be sure you have $1000 in cash equivalents.
- If earning 0.0% galls you as much as it does us, then put $10<u>50</u> in a AA (or higher) rated bond fund which maintains a duration of <2.5 years. But, cash might be better if you don't want risk having "some explaining to do" with your boards.

Now turn to short-term investment strategy.

- Although none of us know what the markets *will* bring (versus *might* bring), ask yourselves if there is a real structural **need** (even if emotionally) to take <u>evasive action</u> right now. We're not talking, for the moment, long-term investment theory and the Capital Asset Pricing Model. We're referring to the need to immediately reduce the downside capture <u>potential</u> of your program, regardless of impact on forward return forecasts.

- We imagine that endowments or foundations with high *and* inflexible distribution requirements, or defined benefit pension plans with low funded ratios *and* large liabilities relative to the size of the plan sponsor, might fit this bill.
- If you decide you simply must reduce the program's risk profile at this juncture, then –

Review the Strategic Asset Allocation targets in your Investment Policy Statement.

- Don't jump right into the process of changing the policy. First, that takes too long if done prudently. Second, there is too much negative emotion in the room right after any risk asset falls double-digits, even if its forward long-term total return prospects remain high. Re-making your entire investment policy at this juncture risks throwing out the proverbial baby with the bathwater.
- Instead, focus on the policy's rebalancing trigger points for each asset class and sub-class. The high-low ranges.
- Starting with the most volatile asset class, in terms of historical short-term downside capture (we can help with this), consider taking its current allocation right down to the low end of its rebalancing range. If the strategic target is 15%, with a rebalancing range of 12-18%, then sell the current exposure down to 12%.
    - If an exposure is already below its low-end trigger, the committee needs to decide if the current environment is so dire that an exception to policy is required, so it can continue to keep the asset below its strategic range. If the committee can't pass that vote, then best practice suggests bringing the asset exposure back up to the low end of the range. Ironic, we know.
- Work your way down the list of risk assets. Be mindful that broad risk asset categories, such as total equity, total domestic equity, total non-US equity, also usually have minimum composite allocation targets.
    - You might breach these minimum composite allocations if you take every individual risk asset sub-class, or even single managers, down to their low-end allocation range.
    - Unless the committee votes to temporarily suspend its own strategic policy, breaching a previously established major asset class minimum allocation, in the midst of a down market, is usually not considered best practice.

Having sold down some investment assets, you need to buy other investment assets, or leave the proceeds in cash.

- Since you've already raised 12 months' liquidity needs, leaving proceeds in cash would be pure market timing stuff. Not recommended here.
- Begin by adding cash to your lowest risk investment asset, in terms of historical short-term downside capture (again, we can help you with this). Take its allocation up to the high end of its rebalancing range.
- Do the same with each successively "riskier" asset, until are left with your liquidity reserve.

The result will be a program portfolio that remains within your current strategic asset allocation policy, but is at the lowest end of that policy's risk spectrum.

Begin the discussion about when to actively rebalance back to the current policy targets.

- This is a hard conversation to conclude, because the metrics here are unclear. For example, do you rebalance the program's emerging markets equity exposure back to its neutral target once it has re-traced 50% of its losses? 25%? 75%?
- Most committees are good sellers into a weak market, but then fail to re-balance (buy) into a strengthening market. People are twice as happy at avoiding a $1 incremental loss as they are at capturing a $1 incremental gain. And, committees are made up of people.

Finally, discuss whether your program should formally consider a new Strategic Asset Allocation policy, *but only after you've worked your way through the above very long checklist.*

In conclusion,

- We think the market break is a function of heightened concern about high multiples in the face of near-term earnings declines. Global economic growth issues factor into that fear.
- If the recent market volatility worries you, first nail down 12 months of forward liquidity;
- Then, reduce the downside capture risk of your entire program through a systematic review of each investment asset. Remember this is risk reduction time, as it was volatility that got you to this point.

Richard Shaffer, CFA
Director of Research
Chartwell Consulting