



A Dangerous Mindset

August 2016

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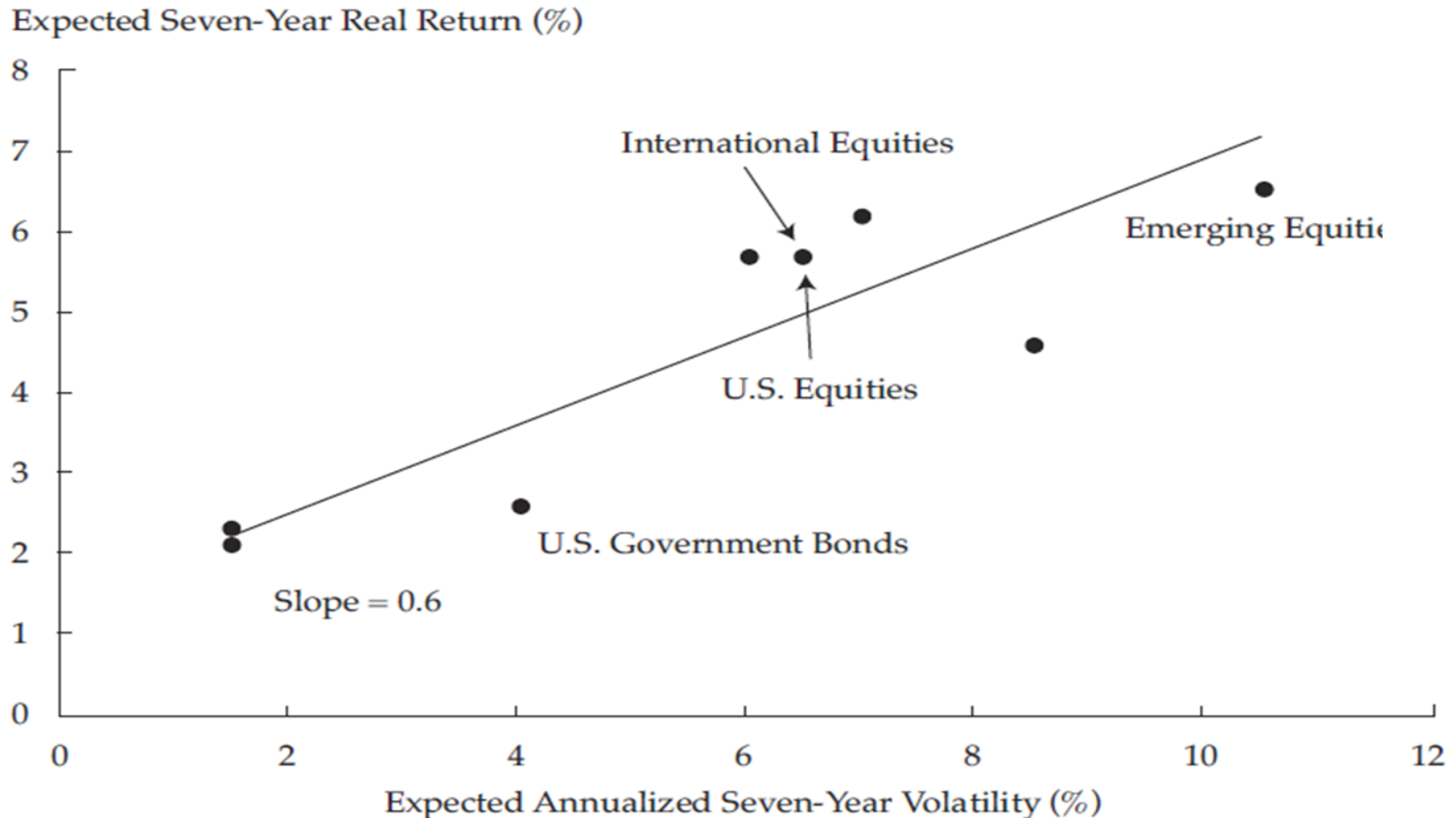
Key Takeaways

- ✓ Artificially low rates have pushed prices artificially higher
- ✓ Higher prices today = lower returns tomorrow
- ✓ Different results require different thinking



Risk and returns at equilibrium

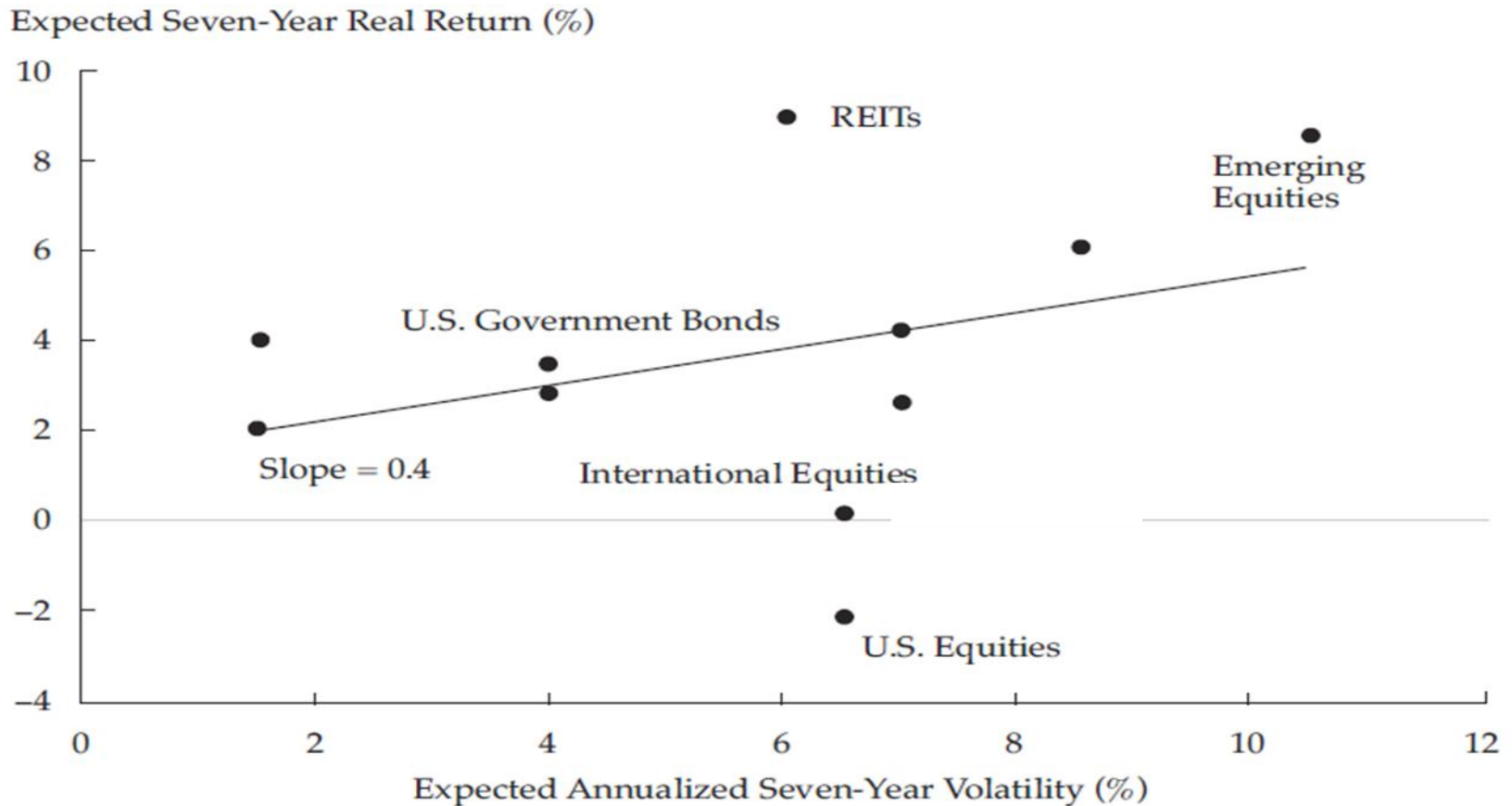
This is a scatter plot of asset class returns and volatility. The regression line depicts the risk–return trade-off under these equilibrium assumptions. In other words, the higher you move up the return scale, the further you move to the right on the volatility scale. This is normal. Generally speaking, more “risk” equals more reward (at least according to portfolio theory; value investors may take issue with this assumption).





Risk and return in the tech bubble

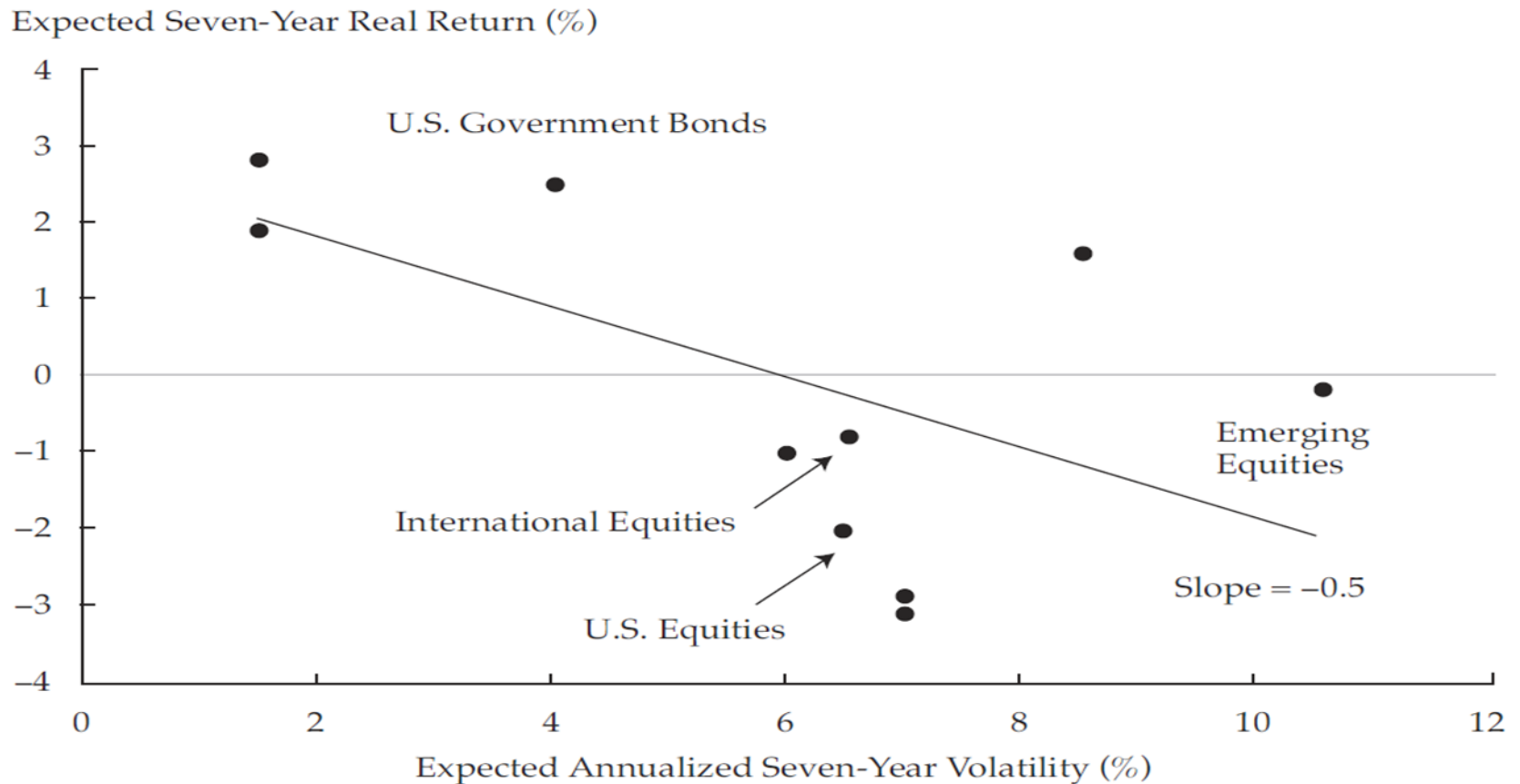
This is the same scatter plot as of June 2000. It shows US equities were priced for negative returns. It also shows that some assets were very cheap, despite the extreme valuation of other assets. REITs, for example, had an expected return of nearly 10%. Emerging market equities and debt were cheap. Small-cap equities were cheap. So, a well-diversified portfolio did just fine from 2000-2002 despite a 50% decline in large cap stocks.





Risk and return in the financial crisis

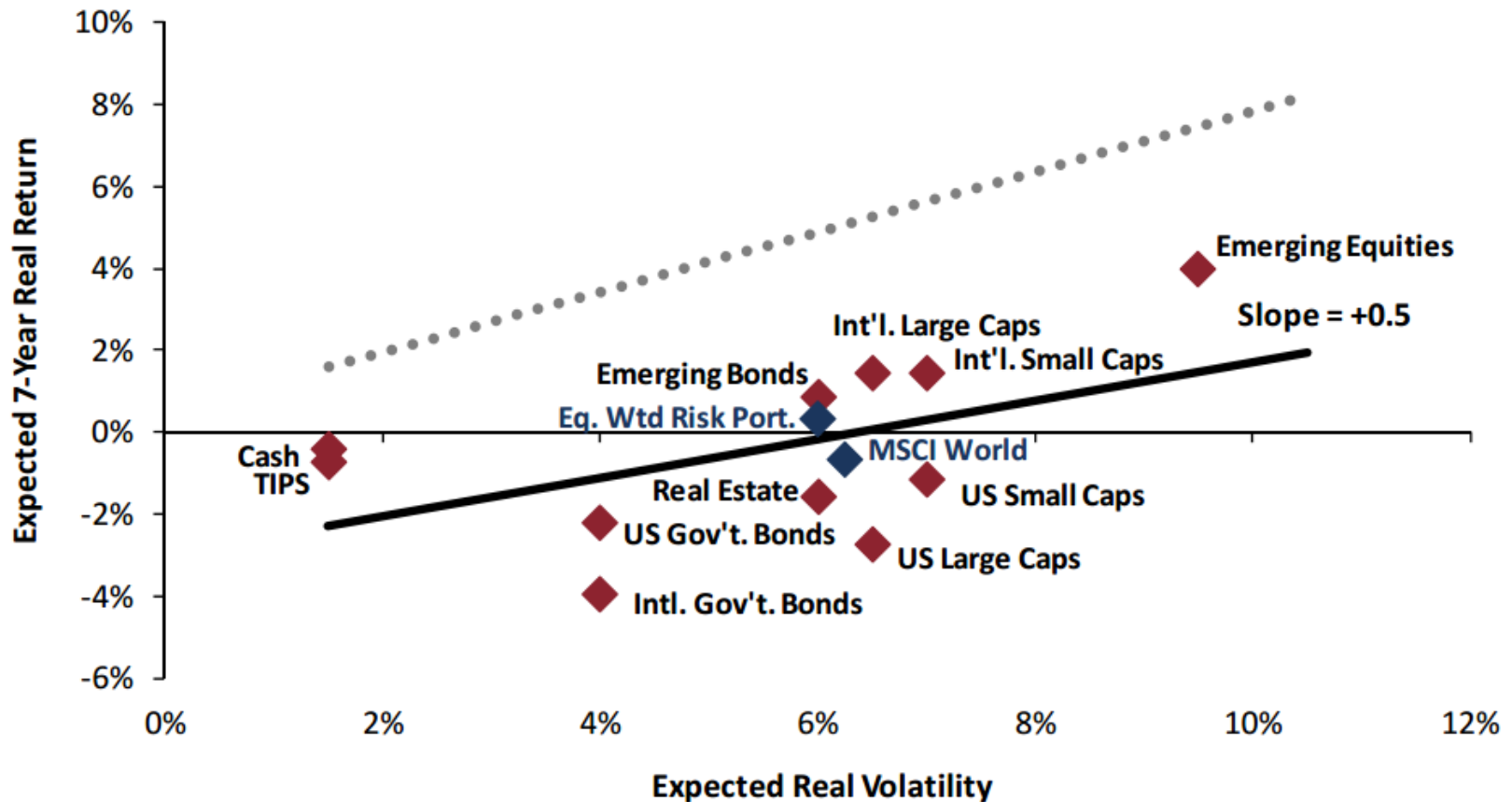
Asset class forecasts in June 2007 indicated a serious problem. Nearly all equity markets had negative expected returns. This chart shows a very different story from the one in 2000, which was a problem caused by the tech sector. In 2007, a negatively sloped regression line meant investors were paying for the privilege of taking risk. Cash and bonds were the only “safe” trade. At least investors could earn interest on safety at the time.





Risk and return . . . today

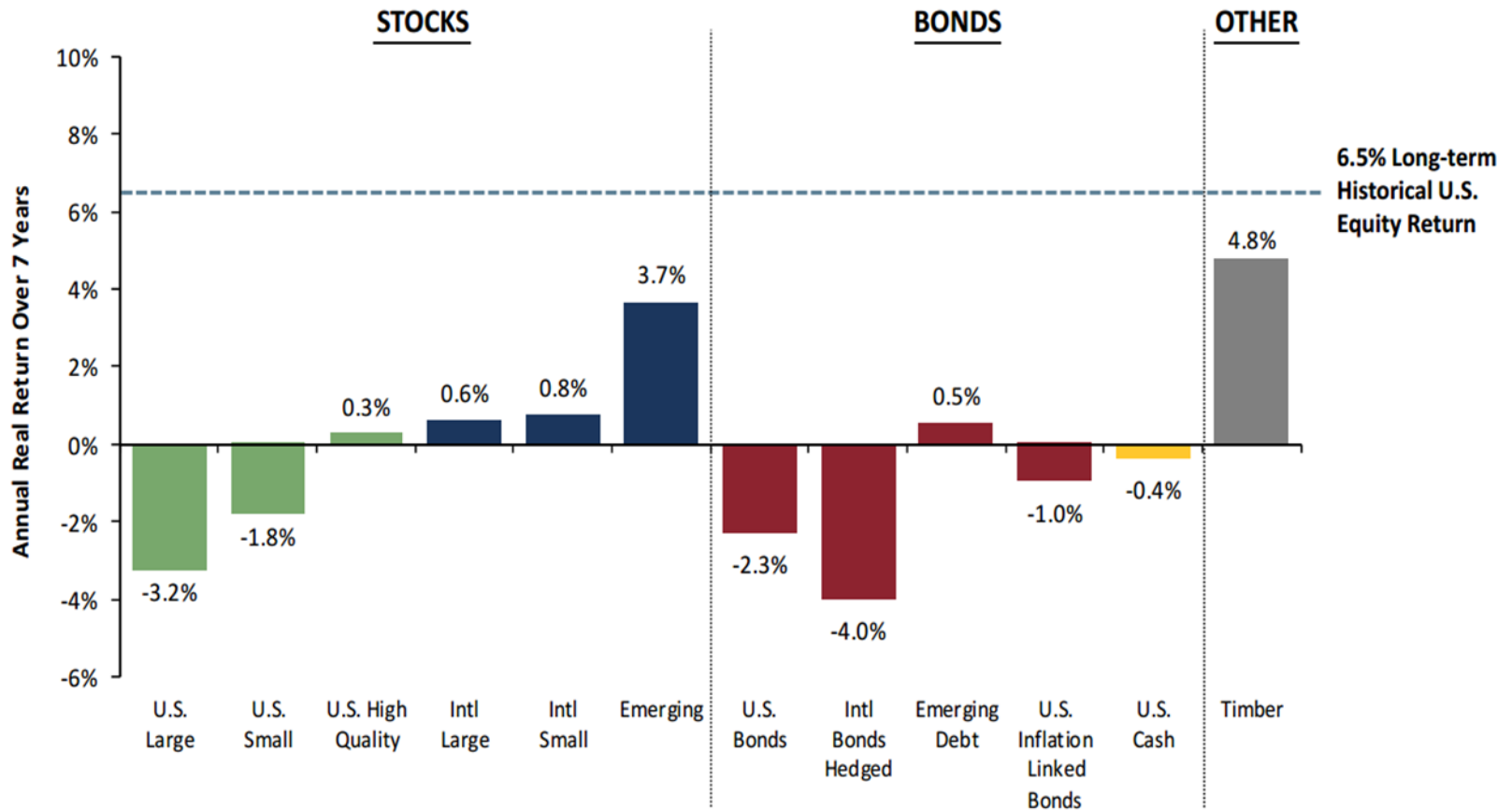
The most striking thing about this chart is how low the line is on the page. The dotted line shows what the line normally looks like at equilibrium (our first slide). Today's slope is somewhat flatter. But the real problem is how low the line is on the page! It's 4% or 5% lower than normal! There are no "safe" trades that offer positive returns.





Real asset class return forecasts

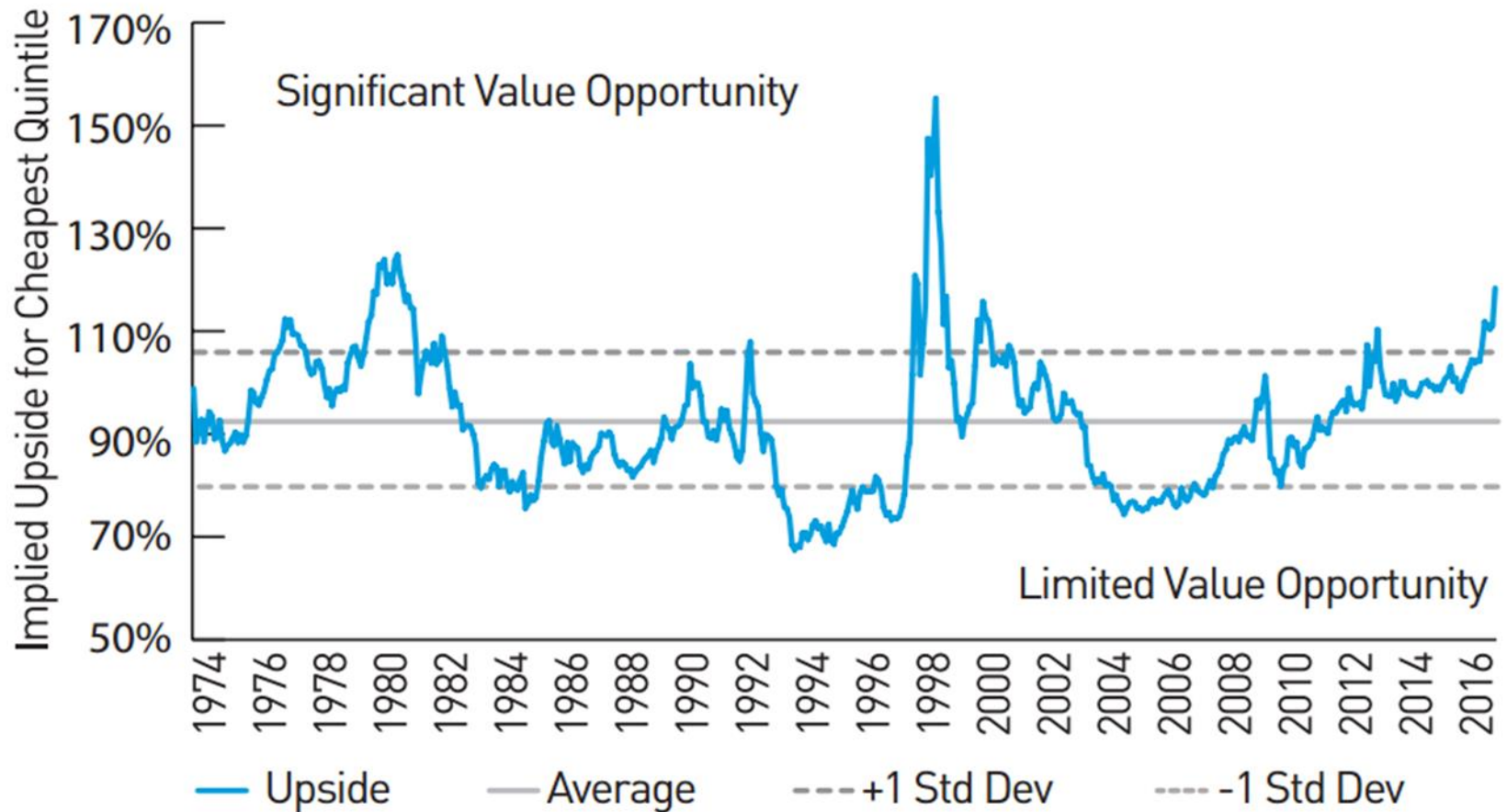
As a result, real asset class returns from today's prices are likely to be significantly lower than normal. US large cap stocks look particularly expensive. We believe the overvaluation of large cap equities has been driven by fund flows into "bond-proxies" and dividend stocks.





A story about value spreads

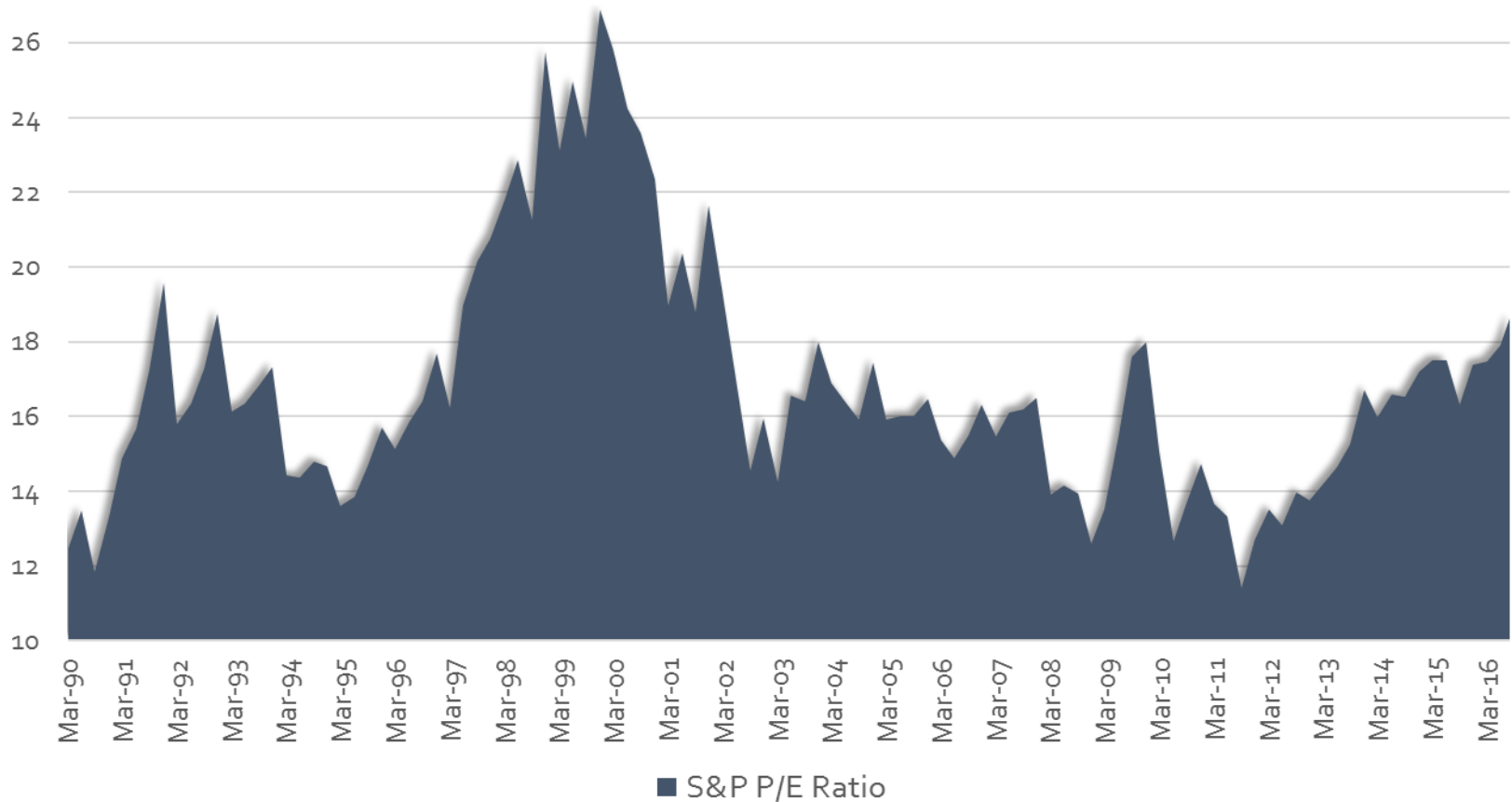
Value spreads measure the difference in valuation between cheap and expensive stocks. When spreads are wide, the opportunities for value investors should be greater (other things being equal). Today, value spreads are about as wide as they have ever been. In the 90's extreme spreads were driven by extreme valuations across the tech sector. Today, interest rates have played a major role in widening value spreads. Bond proxies are the most expensive they've ever been. "Anti-bonds" the cheapest.





This is “normal”

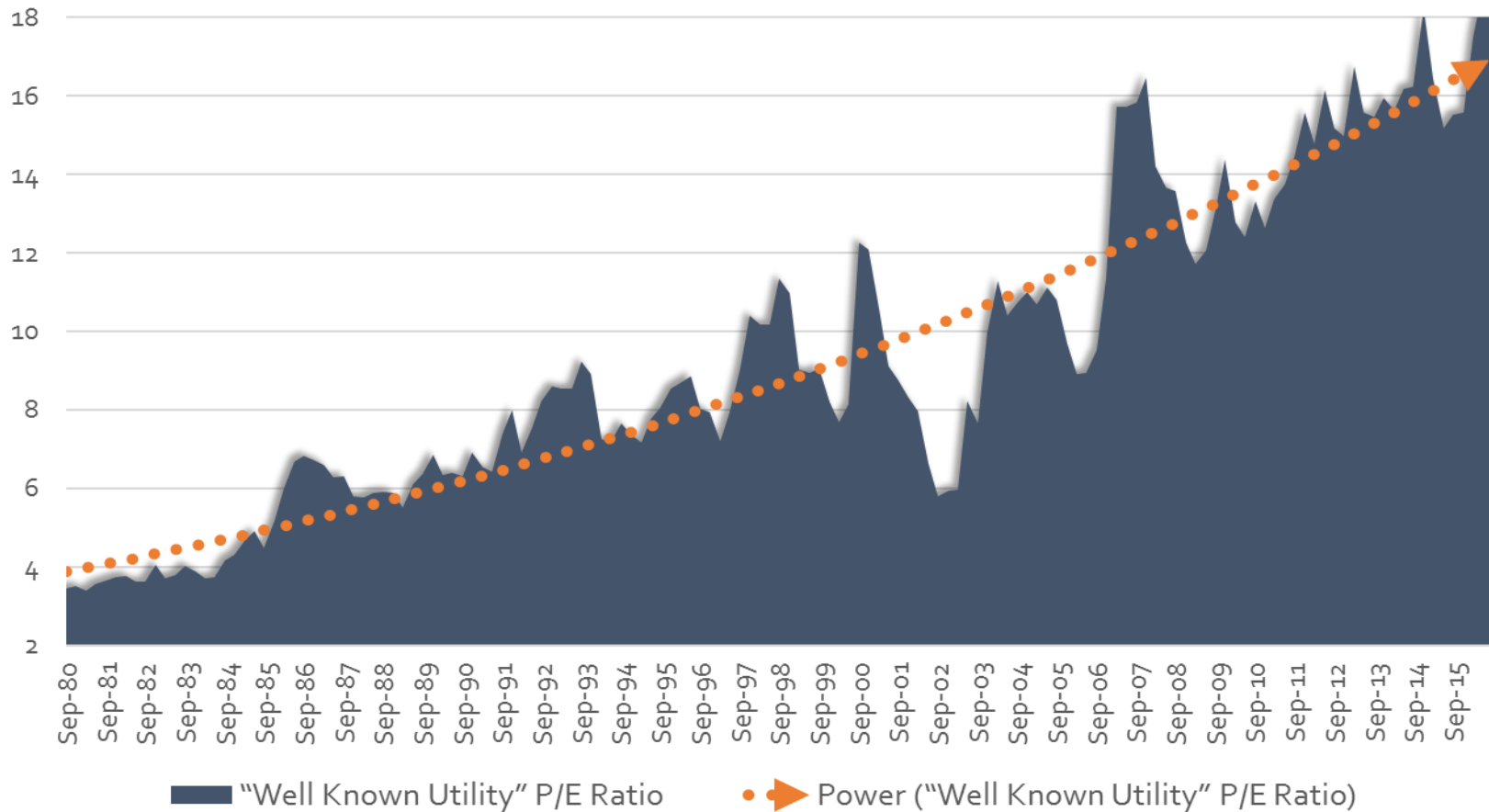
The price investors have been willing to pay for a dollar of earnings has fluctuated over time. This is normal. Sentiment shifts from fear to greed and back again as markets rise and fall. The market's price-to-earnings ratio follows suit. Over the last few decades, it has fallen toward single digit territory. It has also approached and exceeded 20 on multiple occasions.





This is not normal

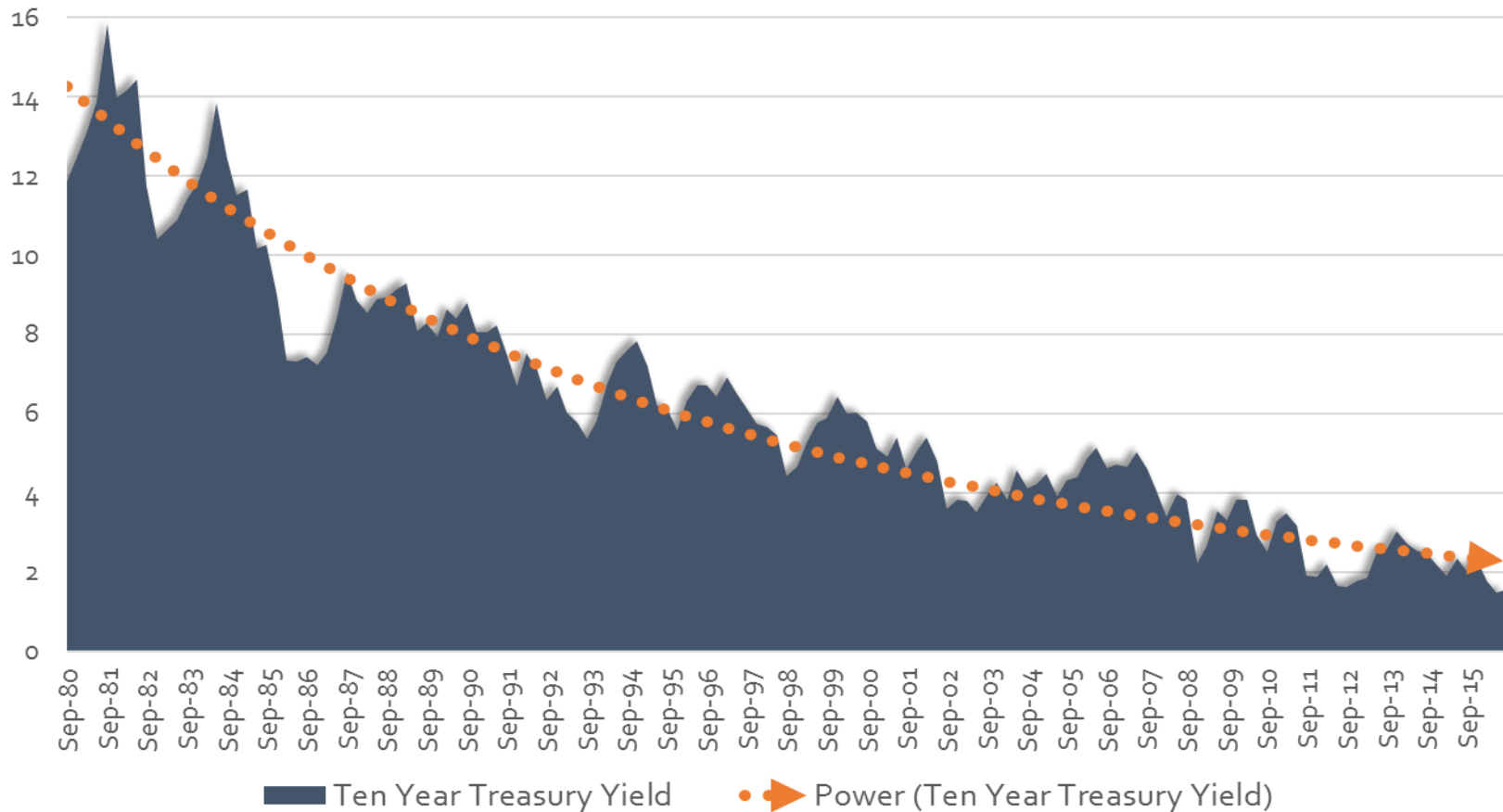
In comparison to the chart on the previous page, the valuation of this “well known utility” has steadily marched higher over the past three decades. In the 80’s this company was trading at single-digit multiples, earning double-digit returns on capital and throwing off a dividend yield approaching double-digits. Today, the company trades near 20x earnings, generates roughly zero returns on its capital, and yields about as much as risk-free bonds at equilibrium. How can we explain this?





Lower rates = higher multiples

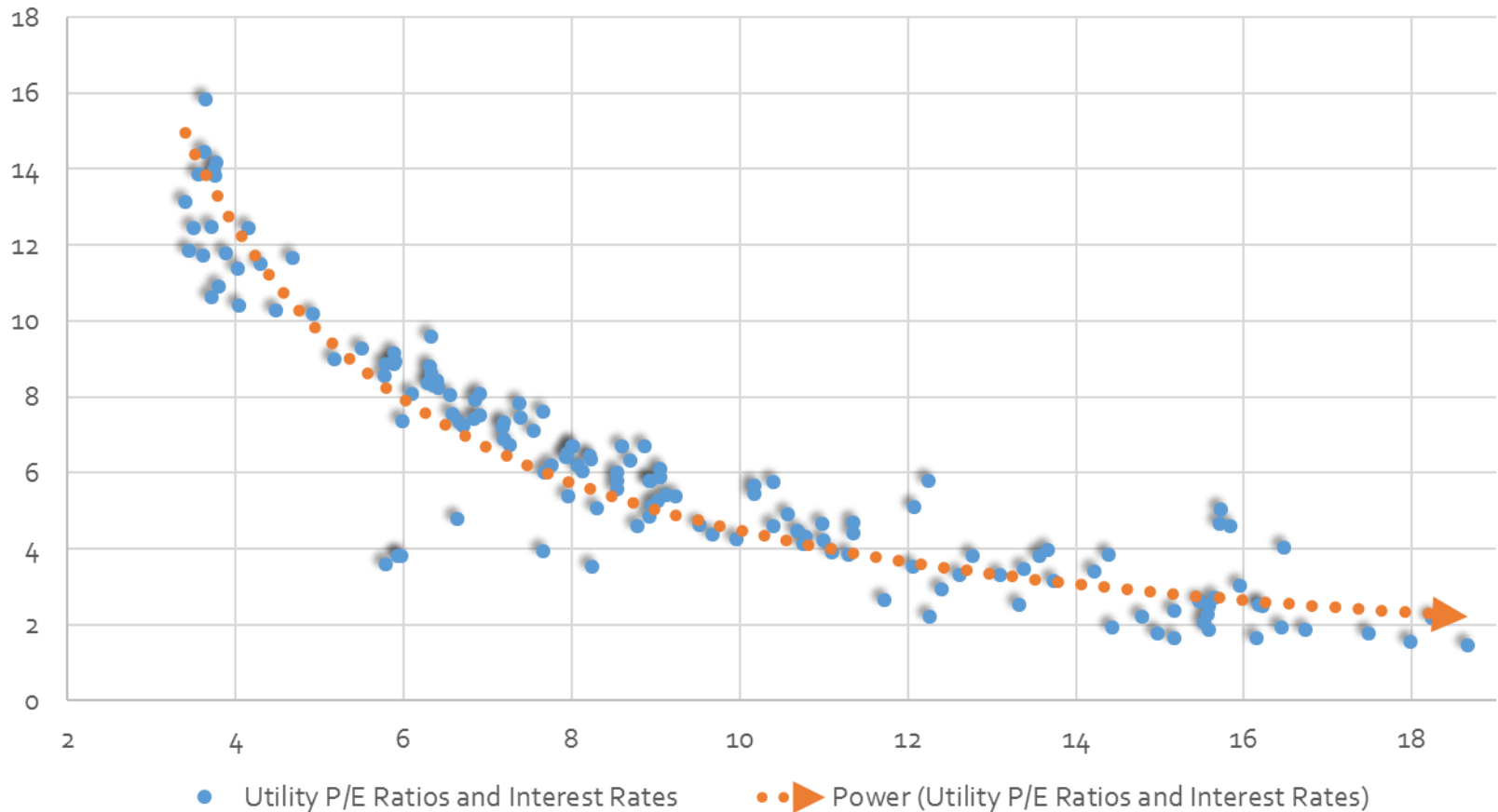
Zero percent interest rates have pushed the prices of all assets higher. A lower discount rate can be used to justify almost any valuation today. At the same time, lower rates have “forced” investors to seek out yield wherever available and independent of price. The “safest” assets are dangerously priced as a result.





If the glove fits . . .

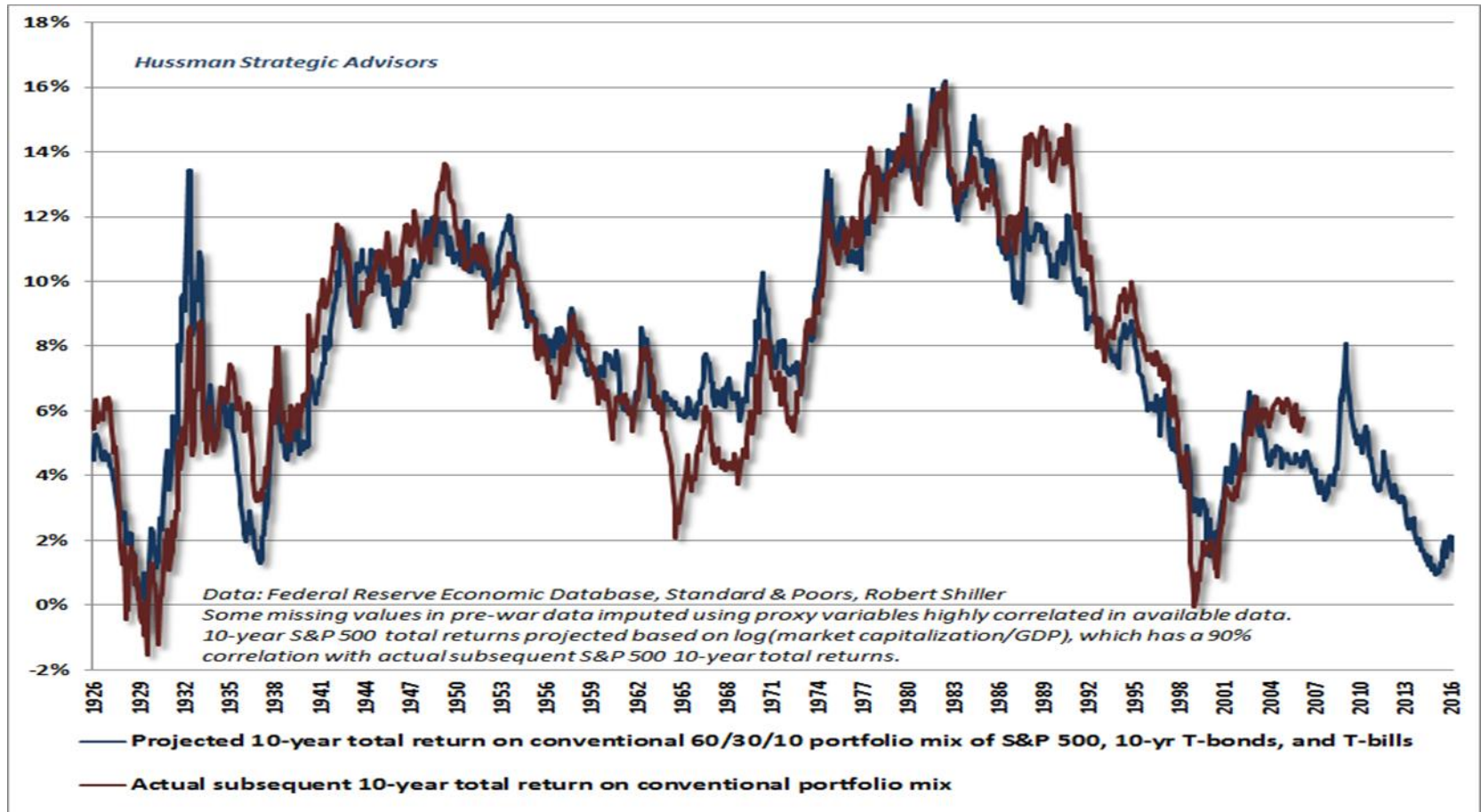
The relationship between interest rates and stock valuations is near perfect for the utility sector. The chart below shows that as rates have declined (vertical axis), price-to-earnings ratios have exploded higher (horizontal access). While we've only charted this relationship for the utility sector, suffice it to say that the price of most "safe-assets" have been driven to extremes in a desperate search for yield.





This is the challenge we face today

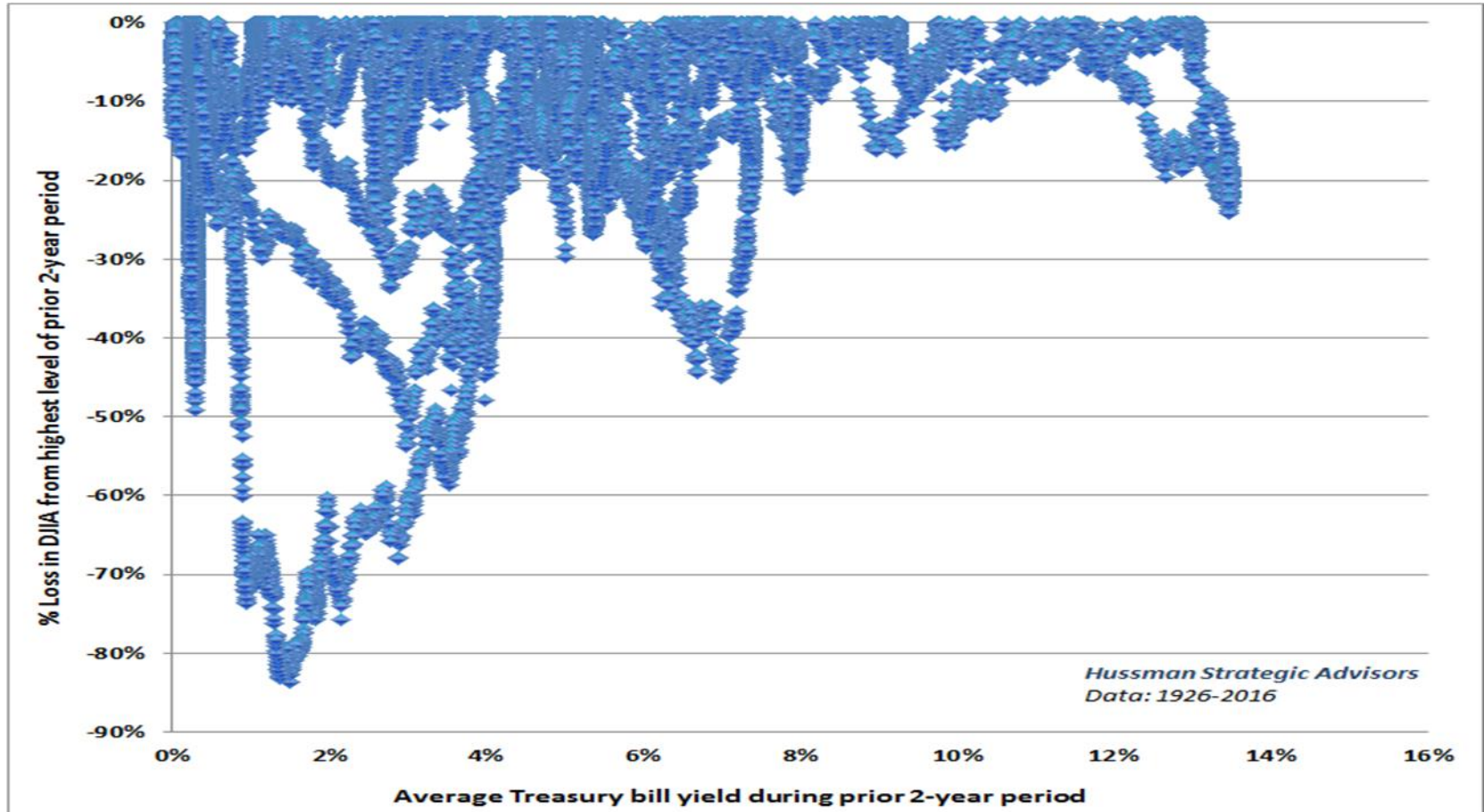
Prospective returns on all components of a conventional asset mix are now about as low as they have ever been. A traditional balanced portfolio has returned 6% - 8% on average historically. Today, we are looking at 0% - 2% but everyone is still stuck in a 6% - 8% mindset. That is a dangerous mindset.





A dangerous mindset

There is one little problem with this line of thinking. If low rates were positive for stock markets, you would expect periods of low rates to be associated with smaller losses, across history. Unfortunately, just the reverse is true. The worst stock market losses in history have come in low rate environments.





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