KPF GLOBAL INVESTMENT STRATEGIES LLC

First Quarter of 2015

April 2015

KPF GLOBAL INVESTMENT STRATEGIES LLC

Executive Summary

- After two years of diverging global performance—with the US clearly in the lead—the first few months of 2015 have seen some rebalancing. International equity and real estate have staged a strong rebound, helped by a combination of more competitive currencies, lower commodity prices and, in some countries, supportive monetary policies. The US economy, meanwhile, has shown signs of weakening. **The rebalancing of global demand that we wrote about last quarter appears to be underway,** but it's unclear yet whether the outcome of that process will be benign.

- We are now entering the seventh year of a strong recovery in asset prices following the crash of 2008-09. With many markets now fully valued, investors are wondering what lies ahead. Will there now be seven lean years, in accordance with the Biblical parable? While we don't believe that investors will be required to offer seven years of penance, there is no denying that US asset markets are very expensive—indeed, overvalued. For this reason, we anticipate lower market returns over the next decade than investors have come to expect. **A combination of slower economic growth, persistent low inflation, and high starting valuations will likely restrain US asset returns over the medium term.**

- **Over a 5-10 year horizon, the single most powerful predictor of an asset's return is its current price.** Not only do valuations drive returns, the prices currently offered in the US equity and debt markets have rarely been higher than they are now. Conversely, equity and debt yields have rarely been lower. Thus, it is not realistic to expect US bond markets to post returns that are consistently in excess of 3%, or for the US stock market to produce gains much beyond 7% on average. Returns could be considerably lower over the next few years. However, investors who pursue value-oriented investment strategies and opportunities overseas may be able to achieve higher rates of return than is implied by these static projections.

- We consider valuation to be the primary criterion guiding adjustments of our clients' asset allocations away from their long-term strategic targets. However, the rewards from value investing can be slow in coming; markets may deviate from "fair value" for a very long time. Reversion to the mean can take years, so value investors had better be patient—and comfortable veering away from what's currently popular (and pricey). History suggests that they will be amply rewarded for their patience.

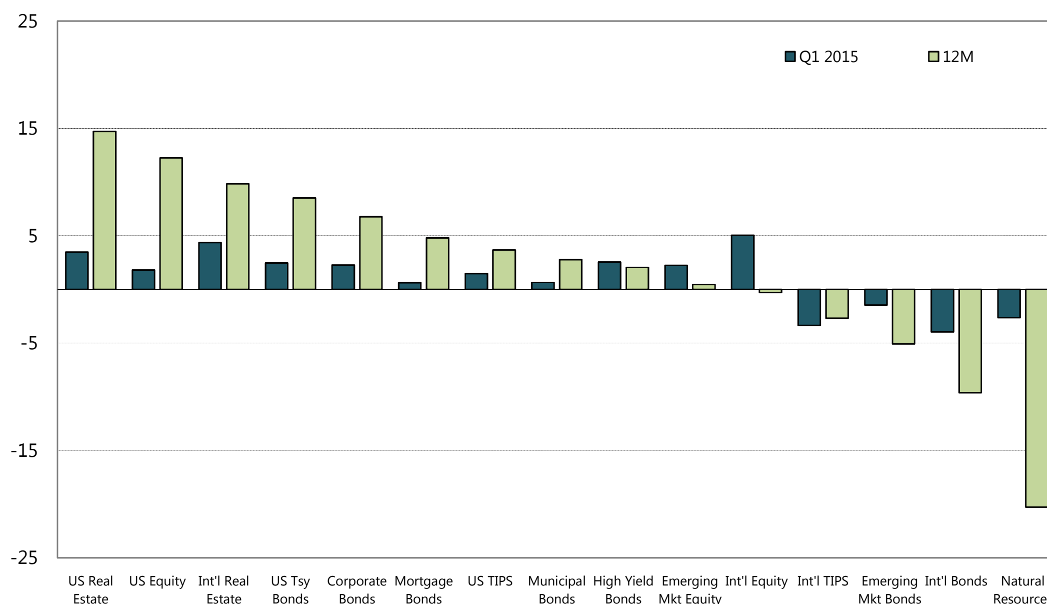
- **Fortunately for value investors, the US markets are not the only game in town.** For those who are willing to look beyond US borders, and who can tolerate the higher volatility associated with foreign investments, opportunities abroad are more attractive.

- Our market return projections are not as gloomy as those offered by many others. However, we do expect lower returns and increased volatility in the future. It's been a scant six years since global markets bottomed in March 2009, yet many investors seem to have forgotten what volatility looks like. **Few financial markets deliver their average returns in smooth and predictable increments.** Investors who believe they have a high tolerance for market risk based on the artificial context of the past six years may learn something new about themselves over the coming decade.

Market Overview

After two years of diverging performance in the global financial markets—with the US clearly in the lead—the first few months of 2015 have seen some rebalancing of results. International equity and real estate have staged a strong rebound, helped by a combination of more competitive currencies, lower commodity prices and, especially in Europe and Japan, supportive monetary policies. These forces are boosting earnings of overseas firms, while making foreign-currency denominated assets more attractive relative to those in the United States. The rebalancing of global demand that we described last quarter appears to be underway. Initially, there appeared to be more "catching up" of foreign economies and markets than "catching down" in the United States, but the outlook has clouded in recent weeks. Although the European economy is on a firmer footing, Japan remains sluggish and the Chinese economy is slowing abruptly. There is a disquieting mismatch between the performance of asset prices vs. economies, and we are watching the global economy and financial markets closely.

Figure 1. Benchmark Asset Class Returns



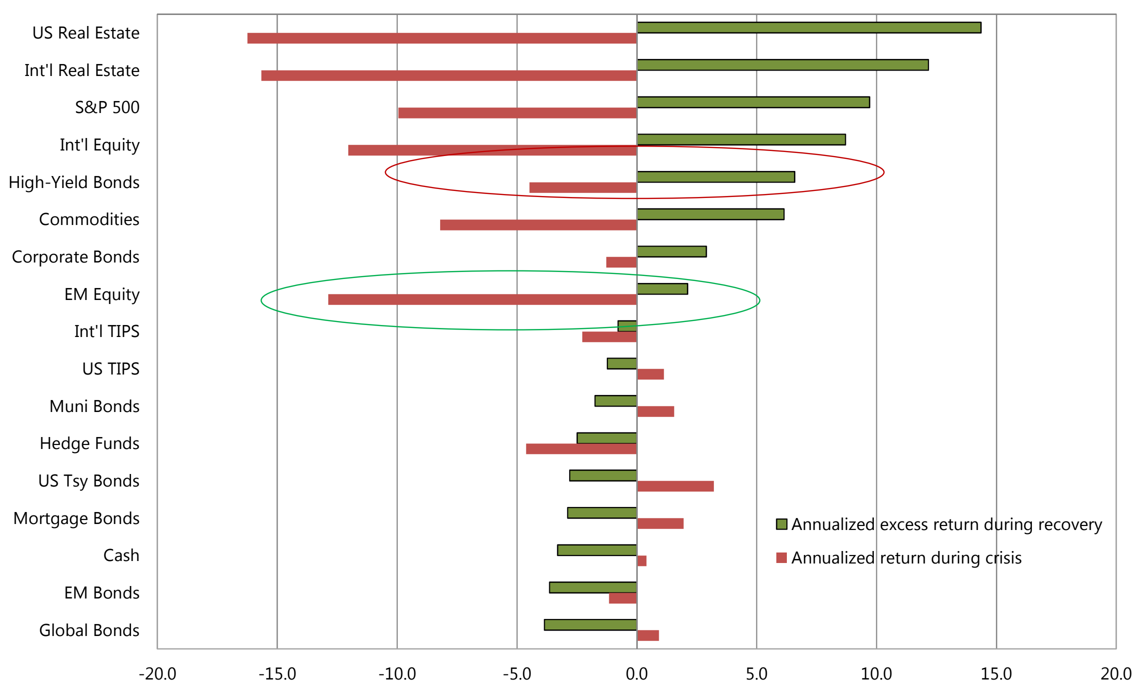
Source: Bloomberg

The first quarter witnessed broad-based, though modest, gains in global financial markets (Figure 1). In addition to foreign equity, US fixed income sectors performed well; evidence of slower growth has tempered expectations of tightening by the US Federal Reserve, easing market interest rates. US real estate posted another strong quarter, bringing its 12-month return close to 15%. Foreign currency-denominated debt fared less well, as the strength of the US dollar offset gains in overseas bond markets. Although the global commodity markets show signs of stabilizing, there is little evidence, as yet, of a better balance between natural resource supply and demand.

We are now entering the seventh year of a strong recovery in asset prices following the financial crash of 2008-09. With many markets now fully valued, if not overvalued, investors are wondering what lies ahead. Will there now be seven lean years, in accordance with the Biblical parable?

Investors may not be required to offer seven years of penance. As Figure 2 shows, the gains in most asset classes during the recovery period (reported as the excess return relative to the asset class's long-term average) have generally been on par with losses sustained during the crash. Some, such as the international equity markets, have not yet recovered fully. One exception is the high yield debt market, which has posted annualized returns well in excess of what was lost during the crash. By contrast, emerging market equity has a long way to recover.

Figure 2. Annualized Asset Class Returns in Crisis & Recovery



The annualized excess return during recovery is the benchmark return for each asset class over the six-year period from March 2009-March 2015, minus its long-term average (1988-2015). Annualized return during the crisis is the benchmark return for each asset class from October 2007- March 2009, which was annualized as if it occurred over a comparable six-year period.

Still, investors may take little comfort in knowing that the US equity market is *only* as expensive as it was prior to the crash, sporting a cyclically-adjusted price-earnings ratio (Shiller's CAPE) of 27. Bond markets, meanwhile, are considerably more expensive than they were then—the US 10-year Treasury yield remains below 2%, vs. 4.5% in the fall of 2007. Moreover, the interest rate spread between relatively safe US government debt, and riskier corporate and high-yield bonds, has never been narrower. As a result, the interest rate on high-yield bonds (formerly known as "junk") fell below 6% last summer—two percentage points lower than in 2007. In other words, investors are not being compensated appropriately for credit risks they bear.

Naturally, our clients want to know what all of this means for markets—and, most importantly, their portfolios. To assist them, we publish biannual *capital market assumptions*, which represent our best estimates of the potential risks and returns associated with various asset classes over the next 10 years. These assumptions are derived from the building blocks that historically have driven investor returns to equity and debt, and then adjusted for current valuations.

The upshot of this analysis is that market returns over the next decade are likely to be lower—perhaps considerably lower—than what investors have come to expect over the past thirty years. We anticipate that a combination of slower economic growth, persistent low inflation, and high starting valuations will restrain asset prices over the medium term (5-10 years). Our expected returns lie within the range of estimates provided by other investment experts. We are not pessimistic about markets, but realistic.

Capital Market Assumptions 2015-2025	**Historical Returns (1988-2014)**	**Expected Returns**					
		KPF Global	**BNY Mellon**	**Fidelity**	**J.P. Morgan**	**Research Affiliates**	**Sellwood Consulting**
Equity Investments	**8.2**	**6.9**	**7.3**	**8.4**	**6.8**	**4.5**	**5.8**
US Equity	10.7	6.0	7.4	8.6	6.5	2.3	5.0
International Equity	4.8	7.5	7.0	7.9	6.8	6.4	6.6
Emerging Market Equity	9.5	10.5	9.0	9.9	8.8	9.3	7.5
Fixed Income Investments	**5.7**	**3.3**	**2.8**	**3.2**	**3.7**	**3.1**	**2.5**
US Treasury Notes	2.6	2.0	2.0	1.6	4.0	2.2	2.3
US Treasury Bonds	7.5	2.5	2.1	2.0	2.8	2.5	1.8
Mortgage Bonds	7.0	3.3	2.7	3.0	3.3	2.3	2.6
Municipal Bonds	5.6	3.8	3.7	3.8	3.3	3.8	2.7
International Bonds	5.8	3.0	0.9	3.5	2.3	2.5	...
EM Sovereign Bonds	5.5	5.5	5.3	5.0	6.8	5.8	3.4
Real Assets/Inflation Hedges	**6.9**	**4.6**	**5.0**	**6.5**	**5.0**	**3.7**	**3.3**
US Inflation-linked Bonds	6.1	2.5	2.5	2.5	4.3	2.8	1.8
International Inflation-linked Bonds	6.8	3.0	...	...	...	...	...
Natural Resources	5.4	4.0	2.2	...	3.5	4.7	3.4
Domestic Real Estate	8.6	6.0	7.5	8.0	6.5	3.5	4.7
International Real Estate	7.4	7.5	7.6	9.0	5.8	...	...
Opportunistic Investments	**7.0**	**4.9**	**4.0**	**4.3**	**5.4**	**3.5**	**3.0**
Corporate Bonds	6.6	3.8	3.2	3.5	4.8	3.0	2.5
High Yield Bonds	8.7	4.5	4.8	5.0	6.0	3.9	3.4
Opportunistic Investments	5.7	6.5	...	...	...	...	...
Cash & Liquid Instruments	**3.4**	**1.8**	**2.0**	**1.6**	**2.0**	**1.9**	**1.4**

Over a 5-10 year horizon, the single most powerful predictor of an asset's future return is its starting value, or yield. For bonds, price is perfectly represented by yield (lower yields=higher prices) since these move inversely to one another. A stock's yield is similar: it is a combination of the dividend it pays, and its *earnings yield*, which is the inverse of its price-earnings ratio.

Figures 3 and 4 below show the correspondence between fixed income & equity yields and their subsequent 10-year returns since 1904. Not only do yields drive returns, the yields available in the US equity and debt markets have scarcely been lower than they are now; valuations have rarely been higher.

Thus, it is not realistic to expect US bonds to consistently post returns that are much above 3 percent. If the Fed raises short-term interest rates, it is not a given that long rates will rise; since 2000 the bond market has doubted the necessity and magnitude of Fed hikes, sending long-term rates lower whenever the central bank has tightened. Even if the Fed succeeds in driving bond yields higher, the move will hurt short-term returns even as it raises the prospect of higher long-term yields. Similarly, it is not realistic to expect US equity to deliver returns beyond 7-8%, compounded, over the next decade. The average return over the last century was 9.5%—and that was a period of exceptional US economic performance, which came to be known as the "American Century." US-oriented portfolio returns will likely fall in the 4-7% range, and could be lower over the next few years, given high current valuations.

Figure 3. Starting Yields (Valuations) Drive Future Bond Returns

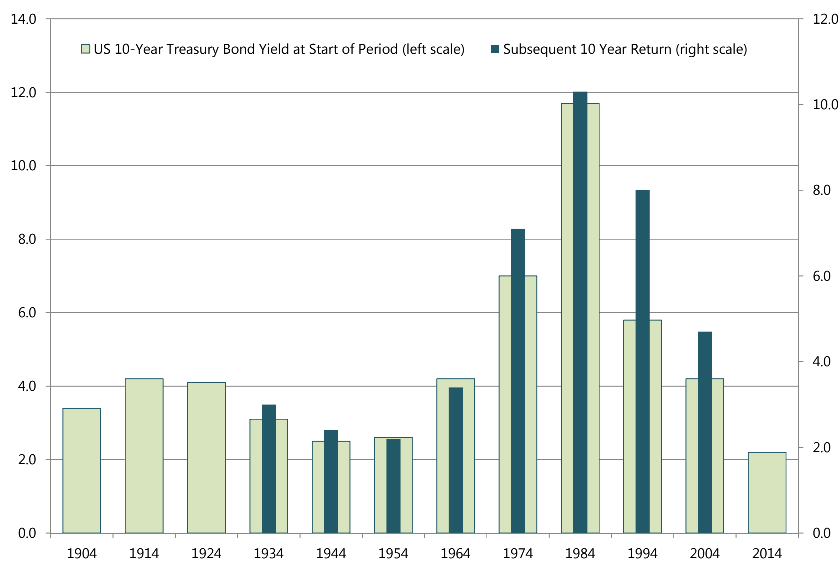
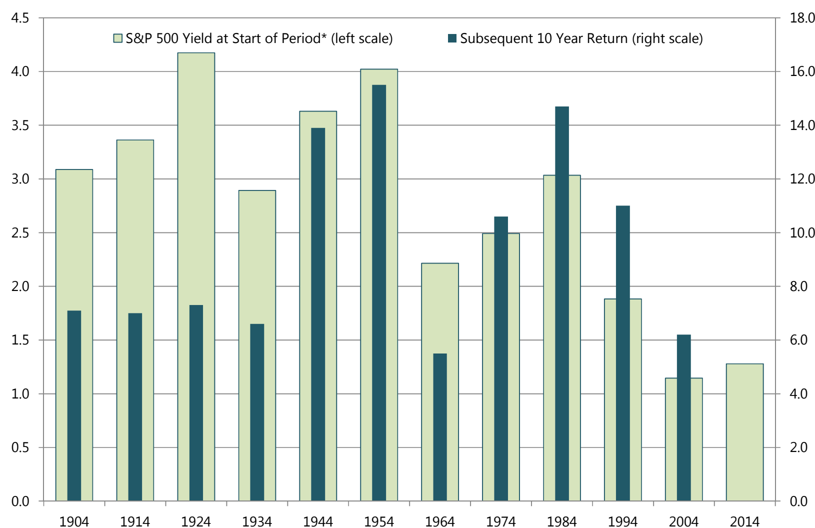


Figure 4. Starting Yields (Valuations) Drive Future Equity Returns



** The starting yield is the average of the S&P 500 dividend yield and its earnings yield (inverse of the price-earnings ratio)*

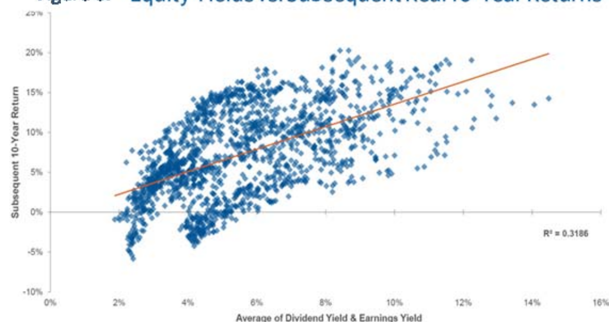
There are outliers, of course. The bond market did well after 1994 because the Fed jacked up interest rates, causing large losses to bondholders that set the stage for later gains. Similarly, the US stock market had an exceptionally good run in the 1990s due to the tech boom—but we all know how that ended!

Outliers notwithstanding, the correlation between starting valuations and future asset returns is not an artifact of the time intervals or markets chosen. Research Affiliates, a premier investment research firm, has published scatterplots that show the same relationship using monthly data for an array of global bond and stock markets (see Figures 5 and 6 below). These show that current yield and future return move very closely together for bonds—the current yield on the Barclays US Aggregate Bond index implies a 10-year average return of 2.5-3.0%. The relationship for equity markets is looser; nevertheless, the future return implied by the current equity yield (3%) ranges from 1% to 10%, with the bulk of the observations hovering in the 4-6% range.

Figure 5. Bond Valuations vs. Subsequent Nominal 10-Year Returns (1976–2014)*

*Barclays U.S. Aggregate for 1976–2014 and Barclays U.S. Treasury Index for 1990–2014.
Source: Research Affiliates based on data from Bloomberg.

Figure 6. Equity Yields vs. Subsequent Real 10-Year Returns*



*1915–2014 for the United States, 1969–2014 for Global Developed Markets, 1994–2014 for Emerging Markets.
Source: Research Affiliates based on data from Robert Shiller and Bloomberg.

Most experts agree that over shorter time horizons (i.e., under 5 years), market returns are essentially unpredictable. Therefore, we consider valuation to be the primary criterion guiding adjustments of our clients' asset allocations away from their long-term strategic targets. Unfortunately, the rewards from value investing can be slow in coming; markets may deviate from "fair value" (if that can be identified) for a very long time. Reversion to the mean return can take 5-10 years or more, so value investors had better be patient—and comfortable veering away from what's currently popular, and pricey. History suggests that they will be amply rewarded for their patience. Indeed, investors who seek out less expensive assets can achieve higher returns than the static projections shown above.

The waiting game can be nerve-wracking for all but the hardiest value investors. Overpriced assets commonly become more overpriced—driven by cyclical forces and/or momentum trading—before investor sentiment shifts. Similarly, undervalued assets may languish for years before a cyclical catalyst emerges that restores their attractiveness in the eyes of short-term investors. No one knows whether prices will adjust through an abrupt market correction (which could set the stage for higher returns down the line) or merely a long period of sub-par performance. Nor are these possibilities mutually exclusive. However, we do know that, eventually, value will out.

Fortunately for value investors, the US markets are not the only game in town. For those who are willing to look beyond US borders, who are willing to take the long view, and who can tolerate the higher volatility associated with overseas markets, attractive opportunities abound. Figure 7, courtesy of Research Affiliates, reports current Shiller P/Es for an array of developed and emerging equity markets. These data show that the US equity market is expensive not only in comparison with its own history, but relative to other countries (and their histories). Other global equity markets are more attractively priced.

Figure 7. *Research Affiliates* Identify Value (and Volatility) Overseas

	Shiller Cyclically-Adjusted Price-Earnings Ratios						
	Current	Max	Median	Min	Expected Return	Market Volatility %	Return/ Risk
Developed Equity Markets							
United States (large cap)	27.0	44.2	15.9	4.8	0.7	14.6	0.05
Australia	17.2	30.4	16.4	7.5	5.5	23.2	0.24
Canada	19.5	60.3	19.1	6.0	3.8	20.5	0.19
France	16.2	57.3	19.3	6.1	4.5	22.5	0.20
Germany	19.6	57.0	17.8	7.8	3.4	25.0	0.14
Hong Kong	18.0	32.4	18.1	8.2	4.0	20.7	0.19
Japan	26.8	91.6	38.0	15.4	3.1	15.8	0.20
United Kingdom	12.7	26.2	14.7	6.0	5.6	17.5	0.32
Emerging Equity Markets							
Brazil	8.9	28.5	16.4	8.7	12.2	35.5	0.34
China	14.6	48.6	18.0	10.6	6.8	25.8	0.26
India	20.5	48.8	22.9	16.0	6.4	30.1	0.21
Mexico	21.5	39.3	23.6	12.4	4.2	24.1	0.17
Poland	10.6	28.0	14.5	9.3	8.9	33.5	0.27
Russia	4.9	24.3	7.1	4.6	16.8	37.5	0.45
South Africa	21.8	26.9	18.9	14.5	6.2	25.9	0.24
South Korea	12.4	28.6	16.4	12.0	4.9	27.4	0.18

As of March 31, 2015. These indicators are calculated by Research Affiliates,using data provided by MSCI Inc. and Bloomberg.

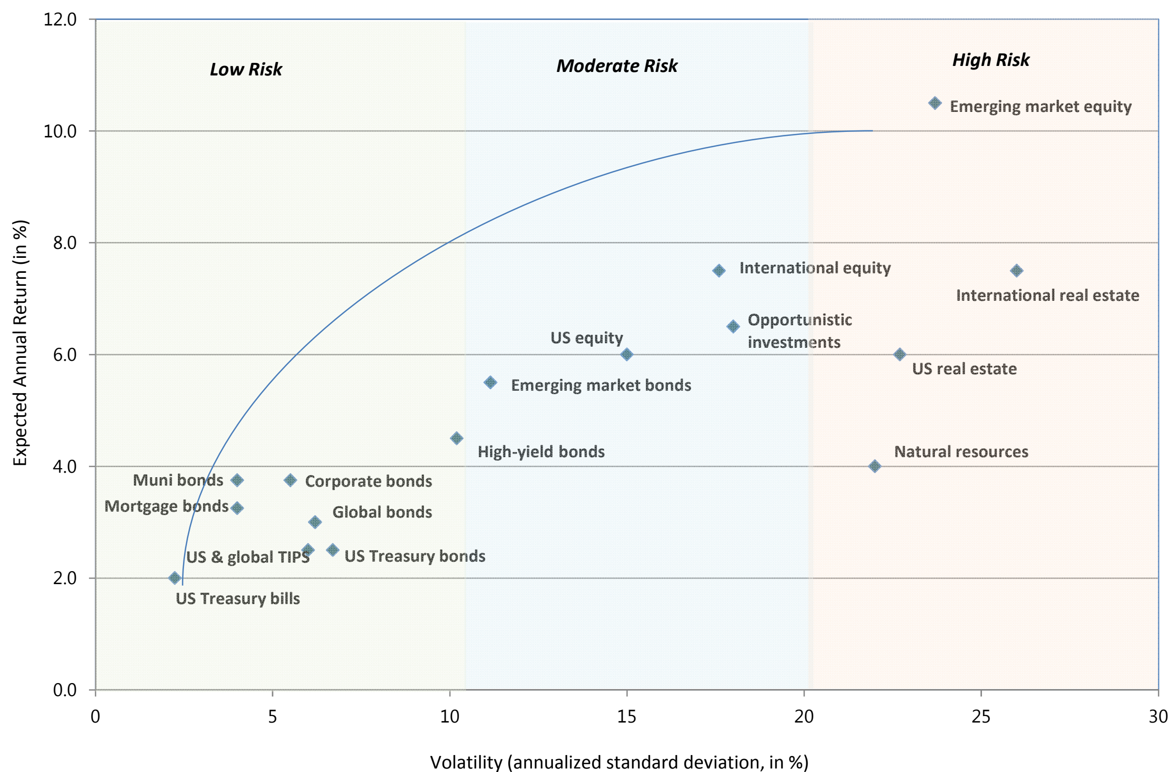
It is important to keep in mind, however, that price volatility is generally higher—often considerably so—in foreign markets. These sectors, especially the emerging markets, are more cyclically-sensitive and are typically less liquid than the US, with a smaller free float of shares. Moreover, US investors are subject to changing regulatory conditions and foreign currency fluctuations, which can add to volatility, as occurred in 2014. Therefore, foreign equity investments must be sized appropriately to the investor's risk tolerance.

Our return projections are not as gloomy as those offered by Research Associates and some others. Even so, we expect that lower returns in the future will be accompanied by increased volatility across global financial markets. It's been a scant 6 years since global markets bottomed in March 2009, yet many investors seem to have forgotten what volatility looks like.

Equity markets (and debt securities, for that matter) do not deliver expected returns in smooth and predictable increments. Stocks that deliver an average long-term return of 9% can nevertheless contain a 10-year sequence of annual returns that looks something like this: 11%, -8%, 4%, 14%, 19%, -14%, -26%, 37%, 24%, -7%, 7%; these were the S&P 500's actual returns from 1968 to 1977. The price of return is risk, and global central banks cannot underwrite market returns, while subduing risk, indefinitely. Investors who believe they have a high tolerance for risk based on the artificial context of the past six years may learn something new about themselves over the next decade.

Figure 8 summarizes our projections for asset class return and risk that will govern investment choices over the next decade. Higher-returning asset classes, such as emerging market equity, international equity and international real estate, entail commensurately greater volatility than "safer" (but more expensive) assets such as US equity and debt. By combining assets with different risk and return profiles, one can achieve a higher risk-adjusted return than is available from any one investment.

Figure 8. KPF Global's Projected Efficient Frontier, 2015-2025



Our goal is to construct portfolios of investments that maximize expected return for our clients' chosen level of risk; those portfolios should lie along the "efficient frontier" designated by the blue curve. By maintaining a value-oriented investment profile within portfolios that are broadly diversified, we believe we can push the efficient frontier up a bit and to the left, yielding somewhat higher returns, with less risk.

KPF Global Portfolio Strategy

As described in our last quarterly letter, we have reduced our clients' US equity and real estate exposures, after the strong run these sectors have had over the past several years. We are holding our international and emerging market equity positions, which are more attractively valued, but keeping an eye on the global economic situation. We have taken profit on our two opportunistic investments in China's local (A share) equity market, as well as a currency-hedged Japanese equity ETF, following large gains. Within the real assets category, as we have trimmed US real estate, we have been adding to clients' investments in international real estate, while rebalancing natural resource investments via our preferred fund. The net effect of these adjustments has been to increase our clients' cash positions, which we will deploy in the event that market volatility creates more attractive investment opportunities.