Quarterly Market Outlook & Strategy Letter

What I've Learned

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Executive Summary

- After a strong start in January, global financial markets became significantly more volatile over the first quarter of 2018, as investors began to digest the consequences of monetary tightening by the world's central banks. Most market segments delivered negative returns, with the exception of emerging market equities and foreign government bonds. These sectors were helped by the appreciation of foreign currencies against the US dollar.
- The synchronized global upswing has lost some momentum, as growth in Europe has moderated, and the Chinese authorities continued their efforts to restrain domestic credit expansion. However, the US economy remains firm and the Fed is on track to raise short-term interest rates further. More significant will be the increased issuance of US government debt as a result of fiscal stimulus and the Fed's decision to allow more securities to mature off its balance sheet. Rising US rates and a relatively flat yield curve point to renewed strength in the US dollar.
- At this mature stage of the economic cycle, given high market valuations and tightening liquidity, we have been trimming our clients' high-octane investments in overseas markets. We remain underweight US equity & real estate, and moderate- to short-duration in fixed income. We remain invested in relatively high-quality high-yield funds and have boosted portfolio cash into the 10-20 percent range.
- 2018 marks the tenth anniversary of this business, and what a decade it's been! This quarterly letter outlines ten lessons I've learned over the years—about portfolio management, this industry, the economy and markets:
    1. Real people are more fun
    2. Value investing works
    3. Volatility is a drag
    4. You can't be everything to everyone
    5. Talk is cheap
    6. AUM fees are appropriate for those who care about investment results
    7. Technology "solutions" are an oxymoron
    8. Small is beautiful
    9. Trust is everything
    10. You have to read everything to understand anything

What I've Learned

This spring marks the tenth anniversary of the founding of this business, and what a decade it's been! The world and financial markets have changed in myriad ways. Change promotes learning and adaptation. No less than Stephen Hawking defined intelligence as the ability to adapt to change. So here's what I've learned—ten lessons over ten years:

1. **Real people are more fun.** When I left a relatively lofty perch in the institutional investment world in early 2008, the move was seen as a step down by many of my peers. Why would I want to serve a bunch of individual clients, rather than large-scale institutional investors? And if I *were* going to manage money for families, why not seek those with more money to manage, rather than people who have "only" a few million dollars? After all, they reasoned, bigger clients allow a small business to scale more readily, and it's just as easy to manage the investments of a large client as a small one (and it's just as easy to love a rich man as a poor one!) Indeed, some argue that it's *easier* to manage money for the wealthy, since those clients enjoy a wider array of investment options, and are liable to be more knowledgeable on the subject.

   When it comes to investing, individuals have been described in academia and by the press as short-sighted, ignorant of risk, greedy, and/or fearful. They are supposedly prone to a litany of behavioral biases that cause them to overreact to market noise, ignore the signal, buy high and sell low. One well-known study of individual investors, Dalbar's Quantitative Analysis of Investor Behavior (QAIB), purports to show that individuals badly lag the markets, due to ill-timed shifts into and out of mutual funds.[1]

   All of this sounded condescending to me. Ten years in, I can confirm that individual investors have gotten a bad rap. The people with whom we work—without exception—are sensible, realistic and reasonable in their expectations. Larger clients can be more challenging than the smaller ones, but are still terrific. In comparison with many institutional investors I've known over the years, individuals take a longer AND broader view of the markets, being less pigeonholed by asset class parochialism, peer pressure, and the perils of decision making by committee. Far from being impulsive, individuals tend to look through the noise, and take market commentary (including that of their advisors!) with a large grain of salt. Inertia is a greater challenge than impulsiveness, since most people are busy with other priorities.

[1] See the brilliant QAIB takedown by investment advisor Michael Edesses in 2014. More recently, Wade Pfau.

Research shows that people who monitor their portfolio frequently tend to make worse investment decisions. It's the institutional investors, huddled before banks of computer screens—endlessly dissecting the trading day via recirculated emails, chat groups, investment committee meetings, and networking lunches—who reinforce each other's moods, interpretations, and decisions. Business incentives compound the challenge of independent thinking, since professional investors are typically evaluated on the basis of benchmark and peer comparisons, over relatively short review windows. In this light, the supposed ignorance of individual investors may not be such a liability—for themselves or others. After all, it wasn't individuals who blew up financial markets in the past!

The QAIB data do not support the inference that ordinary folks would be lost without professional guidance. Per Morningstar, the gap between individual investment results (i.e., dollar-weighted returns) and fund or benchmark returns (which are time-weighted) is now fairly modest—and probably has little to do with investment considerations.[2] Rather, it reflects net portfolio contributions that ebb and flow over the course of one's career. Portfolio distributions increase during a market downturn as investors lose jobs and/or income. By contrast, money comes into portfolios when the economy is in an upswing, labor markets are tight, and bonuses are paid. We know this, because we see these flows, day in and day out.

Legendary investor [Jeremy Grantham] brilliantly described how much easier it is to achieve good results when investing for one's own family. It is true. My former colleagues were right in thinking that this work would be challenging—involving, as it does, multiple accounts, complex tax issues, and intricate family dynamics. For the same reasons, it is also less profitable, and is certainly less glamorous! Even so, the work is truly rewarding. The rewards come from the intellectual stimulation of managing a multi-asset portfolio that is both responsive to market opportunities and faithful to our clients' long-range financial plans. There are fewer constraints on our strategies, and the risk-adjusted returns are consequently better. Even more rewarding is the warm appreciation our clients express for helping them navigate the complexity. In this increasingly impersonal world, where institutional trust has become an oxymoron, it's the personal relationships that matter—more than everything else.

Along the way, I also learned that it is easier (at least for me) to love a poor man. ☺

[2] See Morningstar, 2016.

2. **Value investing works.** I've always been inclined toward assets that are unloved and undervalued—probably a reflection of my contrarian, root-for-the-underdog attitude. I applied this approach successfully for many years to the management of foreign exchange portfolios. However I wasn't sure, when I became a registered investment advisor, that the same concepts could be used to manage a multi-asset portfolio. The criteria that define fair value vary across asset classes. Moreover, each responds differently to economic forces, and over varying timeframes. Determining whether an asset class offers good value—and how quickly that value will be realized—is an exercise in ambiguity. Nevertheless, I've learned that value-oriented allocation is a sustainable comparative advantage for our firm, because so few investors practice it. That's not because the concepts are analytically insurmountable, but because they demand psychological stamina from the investor. And patience.

   Research shows that momentum investing (adding to sectors or securities that have enjoyed relatively strong recent performance, while trimming those that lag) is a profitable strategy over one- to three-year horizons. By contrast, value-oriented investing (holding asset classes that are relatively cheap while eschewing those that have become expensive) is more profitable over the longer term (i.e., 7-10 years or more). At market extremes, these two approaches are diametrically opposed. The short horizon over which momentum strategies earn good returns is nested within the longer and more profitable value horizon. Thus, there must be some phenomenon that reconciles the conflict between the two, in favor of value. That would be known as a market crash!

   By avoiding the worst effects of market crashes, a value-oriented strategy allows portfolios to rebound and compound more quickly. This advantage more than compensates for the lag in performance that tends to come at the end of momentum-driven bull markets. However, to see the outperformance, one must give value investors the benefit of a full market cycle over which to compare results. Few investors have the patience for that. It's easier, and more congenial, to go along with the crowd in boom times, even if everyone is heading over the cliff together. As the analysts at Research Affiliates have shown, growth and momentum investing styles always dominate at the end of a bull market.[3] Even if value managers stick to their knitting, they generally have little money left to manage at that point, as impatient clients have gone elsewhere. We are lucky; most of ours instinctively understand the principles of value investing.

[3] Research Affiliates and Research Affiliates, 2015.

As Keynes wrote in his <u>*General Theory of Employment Interest and Money*</u>, *"...it is the long-term investor, he who most promotes the public interest, who will in practice come in for most criticism, wherever investment funds are managed by committees or boards of banks. For it is in the essence of his behaviour that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, he will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy. Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.*

To purchase an asset that is attractively valued (i.e., when markets are down) one must have some cash available. Unless the client is contributing to the portfolio, the cash must come from the prior sale of another investment. For value investors, the timing of asset sales and purchases do not always match, especially at the end of a bull market, when many sectors have become expensive. With individual clients, retaining cash is not difficult, since people generally feel more secure when they have plenty on hand. Indeed, research has shown that personal happiness is correlated with money in the bank, not net worth. For institutional investors, however, cash is scarce. Professional managers do not get paid for holding more than a token amount of cash; it's the four-letter word of finance. Most will do whatever they can to keep their clients invested at all times. Prudential steps that might preserve the value of an individual investor's assets are costly to the typical manager.

3. **Volatility is a drag.** The chief advantage of value investing lies in its effectiveness at curtailing portfolio drawdowns. After all, if an asset is already inexpensive, there is less room for it to fall—and more room for it to rise. On the other hand, if a stock declines by 50%, it must then rise by 100% to return to the same price. Stable portfolios compound more effectively, boosting long-term returns. "Volatility drag" is the phenomenon by which assets with the same average return produce different compound returns, in proportion to how much they fluctuate. When I started out in this business, I had no idea what volatility drag was, or how significant was its impact on long-term returns. Few investors do. However, we've seen its effects over time in the performance of our strategies. The sequential rotation of capital into investments with greater upside than downside risk has muted volatility and curbed drawdowns. Big returns may be episodic, but clients experience less downside risk while waiting for them. Of course, ordinary people don't care about volatility, and few understand what the term "risk-adjusted returns" even means. But everyone understands drawdowns. And they certainly know who won the race between the tortoise and the hare.

4. **You can't be everything to everyone.** Given the challenges associated with value investing, one is tempted to improve upon its time-honored principles. Why not, for example, deploy a momentum strategy in the short run, or at least use it to identify the ideal timing of your value strategy? Such an approach sounds appealing, and seems likely to attract a wider following. However, balancing two opposing strategies is fraught with risk. Portfolio diversification, which serves as a crucial buffer against the uncertainty associated with return to fair value, would be sacrificed in the service of momentum investing. Moreover, the switch from a collection of high-octane investments to those that offer good value—even if one were to make the pivot successfully—would likely entail a complete liquidation of the portfolio, with heavy tax costs. Naturally, if you care about your clients (and we do!) you want them to be satisfied at all times. However, if you try to please everyone, there's a good chance you'll end up pleasing no one. We've learned that a well-founded and carefully-articulated investment policy is helpful in navigating uncertain markets, and is respected by all who understand the challenge.

5. **Talk is cheap.** Every firm in this industry says they put clients first. Few do. For decades, investment advisors sought to conceal how they were paid for their services, and the conflicts of interest those compensation schemes entailed. Many large advisory firms (those who use soft-focus ads of attractive seniors to tout a sincere commitment to their clients) are seeking to derail legislation that would require them to put those clients' interests first. Even the unconflicted fee-only advisory community seeks to boost "productivity" through technologies that promote "mass customization." I've learned that actions speak louder than words. All you need to know about a firm's commitment to its clients can be found in its advisor-to-client ratio. That doesn't mean that every client needs or wants lavish attention. The happy medium is to give each client just the right amount of value-added service, and charge them accordingly.

6. **AUM-based fees are appropriate for those who care about investment results**. Advisory fees that are computed as a percentage of assets under management (AUM) have been standard in the investment industry for decades. It was nice work if you could get it during the twin stock-bond bull market that began in 1980—just ride the wave! In recent years, as market returns have shrunk, clients and advisors alike have begun questioning the AUM-based fee model. Many advisors who focus on planning services, who follow a passive strategy, and/or who have outsourced investment management to other firms, have adopted project fees and retainers. In such situations, flat fees make a great deal of sense, and we use them for planning work ourselves.

However, for firms like KPF Global who hold themselves accountable for clients' portfolio results, the AUM-based fee structure is what economists call *incentive-compatible*. That's a fancy way of saying it aligns our financial interests with those of our clients. If your portfolio does well, so do we—a task that may be increasingly challenging in the years ahead. The larger the portfolio, the more financial responsibility we assume, although our tiered fee structure accounts for economies of scale in client service. Several years ago we began discounting our first fee breakpoint for longstanding clients whose startup costs were fully amortized. It's our way of saying "thank you" for their loyalty.

7. **Technology "solutions" are an oxymoron.** There is no question that technology has brought great benefits for financial advisors and their clients. Investment research is far more convenient, given the wealth of information and data at one's fingertips. It's easier to share information with, and execute transactions on behalf of clients—often at a moment's notice. However, for every advantage technology brings, something else is lost: the close connection between advisors and clients that comes from an in-person meeting or phone call. Control over the privacy of one's personal data. Attention spans that promote long-term thinking about investment and financial results. Limited exposure to security risks and logistical challenges borne by others. Initially, innovation lowers costs—otherwise it would not be adopted. However, over time technology-related complexity creates layers of attendant expense, a result of Jevons Paradox. Back in 1851, British economist William Jevons observed that the cheaper (or more accessible) something becomes, the more people demand it (and of it)—until society winds up with a more burdensome cost structure than before the innovation was introduced.

   We see this daily in our interactions with regulators, technology providers, and the vendors who support them. I've learned that, more often than not, new technologies and software "upgrades" are designed to elicit monopoly rents and/or personal data from our clients, rather than genuine productivity benefits. New tools typically entail meaningful transition costs and additional processes, while provoking compatibility issues with existing tools and processes. Financial regulators seek to combat the downsides of new technology—cyberterrorism, privacy violations and excessive standardization—with additional compliance requirements. Increasingly these involve "proving the negative" (i.e. that the advisor has done nothing wrong). That Sysiphean task forces one to spend more time on documentation, rather than serving clients. The typical response to rising costs is to increase scale…but scale creates more complexity! Small advisors, those that are most likely to know and care about their clients, are under constant pressure to go big or go away. We will do neither.

8. **Small is beautiful**. I've worked in a variety of organizations (academic, public policy, non-profit, private and commercial) of all dimensions. One interesting thing I've learned is that size is more influential for corporate culture than is industry or sector. In other words, large organizations have more in common with each other (as do small firms) than firms of different sizes in the same industry. And small is almost always more enjoyable. Research shows that people at smaller companies make less money and enjoy fewer perks, but are nonetheless much more likely than big-company employees to describe themselves as "extremely satisfied" with their jobs. That's because they can see and be recognized for the results of their efforts. Our clients also like knowing that they can easily reach us by phone (voice prompts are turned off during business hours!) and that they are just one call or email away from the person who makes the decisions in their portfolio. We're planning to keep it that way.

9. **Trust is everything.** There's a good reason why people feel comfortable in smaller networks, and that reason is conceptualized in Dunbar's Number. It represents the cognitive limit on the number of individuals (150) with whom one can maintain stable social relationships. Beyond that number, postulated British anthropologist Robin Dunbar, it becomes substantially more challenging to coordinate group activities through mutual agreement, trust and reciprocity. Technology has enabled economies of scale that were previously unimaginable. The profits available in our globalized, winner-take-all markets are equally unimaginable, but come at a large social cost. In lieu of mutual trust, we see a proliferation of regulations to manage (and favor) large organizations, whether public or private—buttressed by increasingly burdensome enforcement mechanisms. The result has been concentration of wealth, a breakdown in interpersonal relationships and community support mechanisms, diminished entrepreneurship, and a backlash against those who are different from us.

   One of the reasons technology-enabled economies of scale have been so profitable is that their costs have been *externalized* to the rest of society. The loss of well-paying jobs, retirement savings and personal health that attends the modern economy is a drain on our national wealth. Bailouts of too-big-to-fail banks are costly to the taxpayer and stifling of competition. The depletion of fossil fuels due to the expansion of energy-intensive computational networks (autonomous vehicles being one conspicuous example, blockchain another) threatens the sustainability of modern society, even as it destroys the environment. I think it's fair to say that we've reached the limits of scale, and the analytical abstractions that are required to sustain it. At some point one must confront facts on the ground, and they're not too good.

From my PhD at Stanford to stints at the IMF and on Wall Street, I was well schooled in the neoliberal model of capitalism. Macroeconomics, and its analog in modern portfolio theory, relies on analytical abstractions that are conceptually useful, but which don't address many real problems in the economy and society. Externalities are not a sidebar to the story of modern economics; they ARE the story. And while competition is an important aspect of human behavior, so too are cooperation and collaboration. All three are challenged by scale. The past decade has taught me that too much abstraction can blind one to realities that should be obvious. We are paying a steep price for our inability to address large-scale problems—while continuing to scale up.

10. **You have to read everything in order to understand anything**. I've learned that the best way to learn is to listen. I have a plaque on my door with a quote from Eleanor Roosevelt, who advised: *Learn from the mistakes of others. You can't live long enough to make them all yourself.* It goes nicely with the plaque on my desk, which reads: *Isn't life simple when you know you're right all the time?*

    Books are the distillation of wisdom from the smartest people who have ever lived. Reading widely allows one to achieve a sense of perspective that would be hard to gain otherwise. You never know where that perspective will come from, so I read everything that looks interesting.[4] Which brought me unexpectedly to one of the best pieces of advice I have seen for these times: "*Consider the rights of others before your own feelings, and the feelings of others before your own rights.*" *- John Wooden*[5]

KPF Global Strategy

Despite the market's volatility in February and March, the Jerome Powell-led Fed is committed—appropriately—to hiking interest rates and reducing the bank's holdings of US Treasuries. Meanwhile, Treasury issuance and the US fiscal deficit are expanding rapidly. The resulting rise in US rates and strengthening dollar will further restrain global liquidity (conditions have already tightened materially), which will pressure debt-heavy corporate and government balance sheets. Higher interest rates are making bonds and cash more attractive relative to equities – at long last, there *is* an alternative! Rising rates and tighter liquidity will act as headwinds for equity valuations, which are already near all-time highs.

[4] You can find a collection of Munger's best quotes on reading here.

[5] Courtesy of Benjamin Lev, Founding Principal of the Hamilton Grange School.

Meanwhile, earnings expectations are at risk. We believe that the positive impact of tax cuts is now well-understood and reflected in analysts' forecasts. Less appreciated are the lagged economic impacts of tightening global liquidity, which are starting to appear in overseas data. We also observe that corporate margins have come under pressure in recent months, and bankruptcies have started to rise. According to business surveys, input prices and wages are picking up – anathema to margins. Even before factoring in the potential for a full-blown trade war, we think there is downside risk to earnings estimates for the remainder of 2018.

In summary, the current environment is characterized by elevated asset valuations, peaking global growth, tighter liquidity, rising inflation, and political event risk – not conducive to strong stock market returns. At this late stage of the cycle, we are trimming our clients' equity exposure more broadly, taking profits on both US and foreign investments. Our largest underweights remain in US equity and real estate, but our exposure to developed foreign markets has come down as well.

We are retaining our preferred investments in emerging market and Japanese equity, as well as short-duration high yield, all of which are more defensive than their respective benchmarks. We have made our remaining US equity exposure more defensive as well - our rotation into a covered-call strategy should allow clients to earn a healthy yield with better downside protection than a traditional equity investment. Call premiums (and therefore this strategy's yield) have grown in sympathy with the recent uptick in equity volatility.

We are deploying the remainder of the proceeds to a basket of portfolio hedges: cash, short/medium-duration fixed income, Treasury Inflation Protected Securities (TIPS) and the US dollar. This hedge basket allows clients to earn some yield while we wait for more reasonable equity valuations, and could outperform stocks in a departure from the "Goldilocks" market scenario of the past 8 years.