CLIFFORD SWAN

THE Investment Counselor

SECOND QUARTER 2017

WISDOM *for* GENERATIONS

MARKET OUTLOOK

By Anil Kapoor
CFA

The stock market, as measured by the S&P 500 Index (a broad stock market proxy), has *tripled* in price since the depths of the financial crisis in March 2009. Since the pre-crisis market peak of October 2007, the S&P 500 is up 57% and is up 16% over the past 12 months. Over almost any extended time frame over the past nine-plus years, equity investors have experienced positive returns. During this time period there have been numerous unnerving geopolitical events, technical market scares, and constant chatter about upcoming recessions. Stocks have gyrated up and down, yet, in aggregate, the market kept climbing this "wall of worry," and continued its upward ascent.

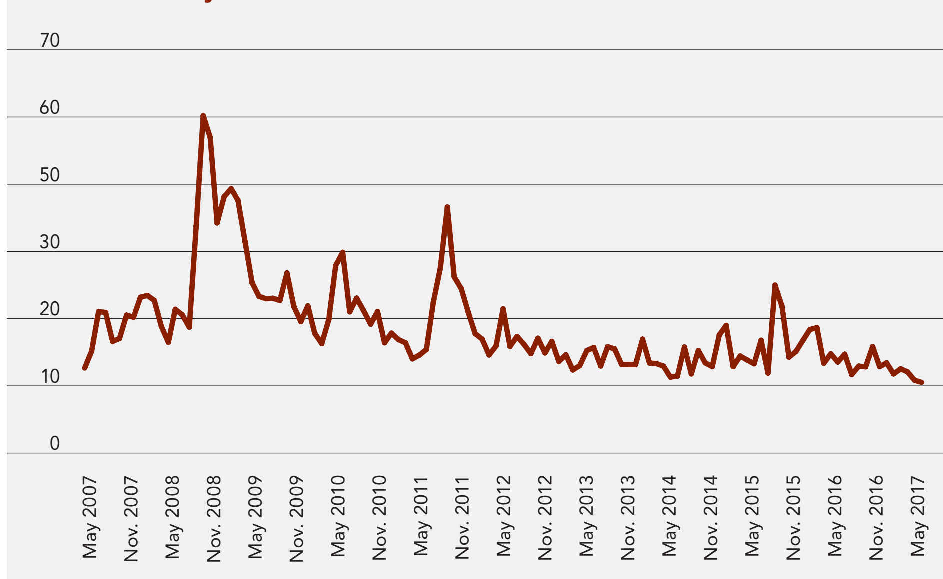
One of the most interesting aspects of the rally has been the lack of volatility. According to the Merriam-Webster dictionary, the simple definition of volatility is "characterized by or subject to rapid or unexpected change." There has been nothing either unexpected or rapid in the markets of late. It seems that every morning the atmosphere is quiet and calm. To quantify this serenity, we turn to a measure of volatility that many investment managers utilize: the CBOE Volatility Index, or VIX. As you can see from the chart below, the VIX is trading at 10-year lows. The volatility in the first quarter of 2017 was the lowest in 50 years.[1] The average absolute price change for each day in the quarter was 0.32% for the S&P 500 Index. That is the lowest average absolute percentage change for a quarter since the third quarter of 1967.

> "One of the most interesting aspects of the rally has been the lack of volatility."

Most news has been treated as positive by the market, and although earnings reports and growth forecasts appear satisfactory, one possible reason for the tame, orderly move up is Exchange Traded Fund (ETF) investing. Certain types of ETFs are funds that are structured to mimic the indexes. As an example, an ETF that mimics the S&P 500 Index might contain all 500 stocks in the index in the same weight and proportion as they comprise the index. The biggest companies represent the greatest percentage in the fund while the smaller ones are the smallest percentages.

Nowadays, many investors are purchasing the index ETFs without necessarily considering the underlying components' fundamentals and weight-

CBOE Volatility Index



Source: Thomson Reuters Baseline

1. Kim, Crystal. "The Least Volatile Quarter on Record Since the 1960s." *Barrons.com* 31 March 2017.

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ings. This is known as passive investing, as the investor *passively* buys the index with no analysis. En masse, this type of investing starts a chain reaction: monies pour into the larger companies, which results in their share prices going up, they become larger, there is more buying, their prices go up, they become larger, there is more buying, and on and on and on. As the big companies get bigger, the index slowly creeps up. This trend has led to a somewhat distorted weighting of the constituents of the S&P 500 Index as the top five component companies (Apple, Google, Microsoft, Amazon, and Facebook, respectively) are now almost equal, by market capitalization, to the bottom 250 companies combined in the index. Digest that for a second—five huge technology-oriented companies are close to equal in market capitalization to 250 companies within many varying industries serving hundreds of end markets. Keep in mind that the Information Technology sector is at the greatest risk of displacement as these companies face technological risk (obsolescence from rapid change) and that these huge weights could, therefore, be dangerous to the performance of the index.

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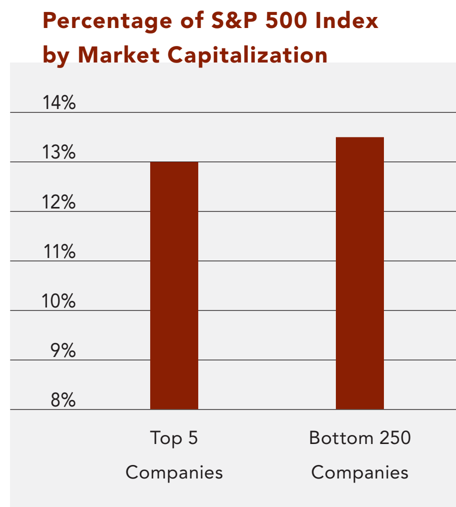
This data is not presented as a prediction that the prices of these leading technology companies will decline but rather to illustrate that they have increased in relation to the entire marketplace. This phenomenon can continue for long periods of time until, eventually, the valuations become absurdly high and a correction occurs. The timing of this is difficult to predict.

Percentage of S&P 500 Index by Market Capitalization



Source: Thomson Reuters Eikon, 5/31/17.

In addition to lack of volatility due to ETF investing, the current market environment also has many underlying moving parts which we feel may be underappreciated. Although there is an appearance of strength across broad market indices, when the onion is peeled back, there is divergence within sector returns. The Energy sector has been under pressure the last several years, as have many areas of Consumer Discretionary, namely Media and Retail. On the surface, the overall market might seem like a smooth ride up, but there are lots of internal dynamics presenting opportunities to both buy and to sell.

This is when the value of active management comes into play. Active management is the process of selecting individual securities rather than passively buying the index and inherently investing in some overvalued securities. Our team of analysts is able to examine each sector and associated subindustries to find undervalued areas of the market.

At Clifford Swan, careful due diligence and analysis is performed for each company—we know the fundamentals of each company intimately. Conversely, when investors buy a passive index there is no analysis. There is no understanding and differentiation between business models, no reading of financial statements, no discussions with management, and most importantly, no conviction in the unique investment metrics of the individual companies invested in. We buy businesses and companies that we believe will thrive in the future with lower risk. An index ETF is simply a piece of paper representing a collection of stock certificates. This is an investment in the overall trend of an index—the individual destiny of each company is not considered.

As markets rise for prolonged periods of time, speculation increases and ETF investing provides easy returns. There is no need to conduct any fundamental investigation—the index may go up in a systematic manner with seemingly no worries. Unfortunately, we think this game cannot end well. Market cycles are unavoidable; eventually, there is a market downturn and the index starts to sell off rapidly. While active management allows investors to react on the individual company level to a downturn, ETF investing, by definition, does not accommodate investing on the individual company level—the overall trend of the index is one and the same as an investor's return.

There has not been a prolonged market downturn in quite some time. One of our primary goals is preservation of capital during market cycles, which inevitably include downturns. When the next downturn hits, we expect our clients to be well-positioned relative to passive investors. CSIC companies are some of the strongest, most stable, cash generative firms in the marketplace and are purchased at reasonable valuations. Combined with an appropriate asset allocation (see the article by my partner, Lloyd Wong), we aim to protect capital and grow it over the long term. We can tell you what you own and why you own it. We have done the fundamental work and are confident in our due diligence process. ◆

BACK TO BASICS: ASSET ALLOCATION

By Lloyd K. Wong
CFA

WHAT IS ASSET ALLOCATION?

Simply put, it is the strategic mix of asset classes in a portfolio. The universe of assets in which to invest is broad and the risk spectrum ranges from ultra-safe U.S. Treasuries to high-risk Emerging Market stocks. There is a distinct tradeoff between risk and return. Riskier assets have the potential to provide higher levels of returns, but at higher levels of return variability. The chart below shows some of the risk/return tradeoffs of various asset classes, with standard deviation used as the measure of risk. Standard deviation indicates how dispersed a data point is from its average. A low standard deviation means that data points are scattered relatively close to their average (lower risk); conversely, a high standard deviation means that data points are scattered relatively farther away from their average (higher risk). Assuming that data points are randomly distributed in a normal way, one standard deviation denotes the probability that a data point will fall within a range of its average plus or minus its standard deviation 68% of the time.

As the chart below illustrates, U.S. Treasuries provided an average return of 1.39% with a standard deviation of 0.75%. Developed Market International Stocks provided a similar average return to U.S. Treasuries of 1.53%; however, its much higher standard deviation of 18.66% means that there was a much broader range of returns. As you can see, for this 10-year period one could get almost the same return of just over 1% on U.S. Treasuries for a much narrower range of variability (lower risk) compared with Developed Market International Stocks (higher risk).

There are many ways to gain exposure to an asset class. Among the variety of vehicles that can be used are individual securities, such as stocks and bonds, as well as mutual funds and exchange-traded funds (ETFs). The latter two are essentially pooled investments of individual securities. For instance, one can gain exposure to stocks, whether they are domestic U.S. stocks or international stocks, through individual securities, mutual funds, or ETFs. One can access the Real Estate asset class through real estate investment trusts (REITs), limited partnerships (LPs) or physical real estate properties. The vehicles through which one gains exposure to these asset classes can be passive (indexes accessed through ETFs) or active (individual securities). We here at Clifford Swan espouse an active approach to investing. Security selection within an asset class is in and of itself a broad topic and beyond the scope of this article.

Determining the asset classes in which to invest and the exposure levels to those asset classes is largely influenced by each investor's unique circumstances and situations. While one might have encountered the general advice that one should allocate one's age to bonds (e.g. a 40-year old ought to have 40% allocated to bonds), this view is too simplistic. While one's **age** (something that is often referred to in investment terms as **"time horizon"**) can be one of the determinants of asset allocation, it alone cannot wholly dictate it. For instance, **goals-based factors** are also important when determining one's asset allocation. Funds earmarked for shorter-term goals such as home purchases and vacations should be exposed to less risk while funds earmarked for longer-term goals such as college tuition and retirement can withstand relatively more risk. Additionally, some investors may wish to leave a legacy for their heirs while others may have specific philanthropic goals in mind.

Liquidity is also an essential factor. In addition to the general rule of keeping three to six months of living expenses as a cash reserve, one's liquidity or cash needs, in conjunction with the goals-based factors mentioned above, are

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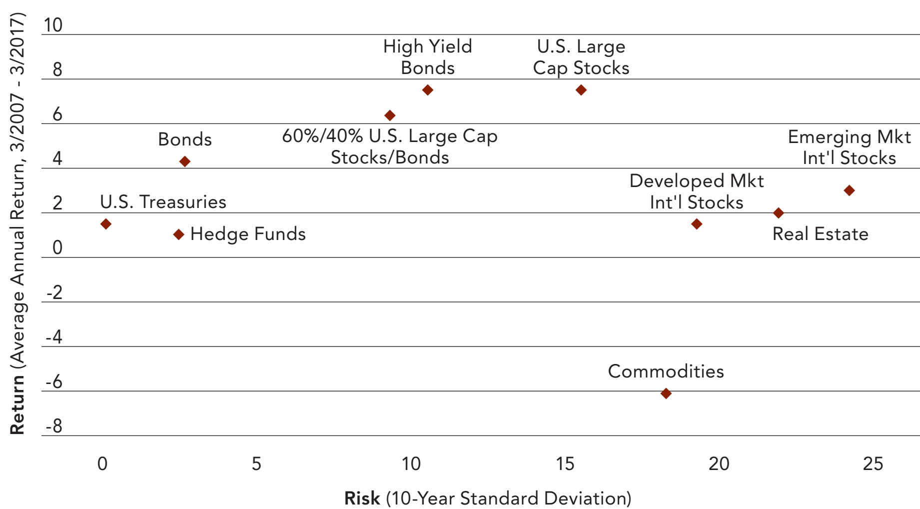
Historical Risk vs. Return by Asset Class



Source: Morningstar, 3/31/07 – 3/31/17. Indexes used: U.S. Treasuries: Bloomberg Barclays US Government 1 Year; Bonds: Bloomberg Barclays Aggregate; Hedge Funds: Hedge Fund Research Inc. Fund of Funds (Conservative) Index; High Yield Bonds: Bloomberg Barclays Corporate High Yield; U.S. Large Cap Stocks: S&P 500; Developed Mkt Int'l Stocks: MSCI EAFE; Commodities: Bloomberg Commodity Index; Real Estate: S&P Global Property Trust Index; Emerging Mkt Int'l Stocks: MSCI Emerging Markets.

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important determinants of asset allocation. Those who are still working have fewer liquidity needs than those who are retired. Some retirees who are actively withdrawing from their portfolios often cannot afford the higher variability of stock returns and may need more of the income stability that bonds can provide. However, there are no cookie cutter solutions to asset allocation. For example, more affluent retirees who do not need to make income withdrawals may wish to grow their portfolios as a legacy for future generations; their portfolios would be able to withstand higher risk.

Income tax considerations can be an element to consider when choosing asset classes. As an example, those in higher tax brackets will wish to maximize allocations to tax-free municipal bonds relative to taxable bonds in their taxable accounts.

One's **ability to tolerate risk** is also important. Each individual's temperament is different. Nervous Nellies and optimistic Pollyannas will react differently to market downturns; some may be able to withstand more variation in their investments than others. In general, one would expect to be compensated with relatively higher returns in exchange for the ability to stomach higher variability of returns. In a basic two asset portfolio invested in U.S. Large Cap Stocks and Bonds, simply varying the allocations to each asset produces different risk/return profiles as shown in the table below:

Although past performance is no guarantee of future results, as you can see, historically, increasing one's allocation to the riskier asset (U.S. Large Cap stocks) resulted in higher returns. At the same time, doing so also resulted in a wider range of returns due to higher standard deviations.

Ideally, one's asset allocation should be customized to reflect one's distinctive situation as the optimal path to reach one's specific financial goals with the appropriate amount of variability (volatility).

WHY IS ASSET ALLOCATION IMPORTANT?

How one allocates investments among different asset class choices will determine the variability of one's portfolio returns. While a higher allocation to riskier assets may result in higher returns relative to lower risk assets, it will also result in higher return variability. As one nears the end of one's time horizon or is close to achieving a specific financial goal such as retirement, one should be mindful that lower return variability may be favored as the need for stability and asset preservation outweighs the need to grow assets. Similarly, the mere uncertainty of life events can also warrant lower return variability, as unforeseen liabilities due to job loss or major illness can occur. Lower return variability lowers the likelihood of having to sell from an asset class at an inopportune time (e.g. when an asset class is experiencing a downswing). It is up to each individual to balance the preference for higher returns with the ability to tolerate the higher variability in returns intrinsic to riskier assets. Ultimately, one's portfolio's asset allocation should be customized to reflect one's distinctive financial profile and should be diversified in order to minimize return variability over time.

Historical Ranges of Returns for Varying Asset Allocations

U.S. Large Cap Stock Allocation	Bond Allocation	10-Year Weighted Average Return	10-Year Standard Deviation	Range of Returns (1 Standard Deviation)
35%	65%	5.4%	5.8%	-0.4% to 11.2%
60%	40%	6.2%	9.3%	-3.1% to 15.5%
85%	15%	7.0%	13.0%	-6.0% to 20.0%

Source: Morningstar, 3/31/07–3/31/17. Indexes used: Bonds: Bloomberg Barclays Aggregate; U.S. Large Cap Stocks: S&P 500.

DON'T PUT ALL OF YOUR EGGS IN ONE BASKET

Diversification of assets among a variety of asset classes can be helpful over the long term as asset class returns vary over time. Individual asset classes move up and down in different amounts at different times. The measure of how two assets move in relation to each other is called correlation. One simple example of this would be investing in umbrellas and beach balls. Umbrellas are basically a foul weather item while beach balls are a fair weather item. One would expect the demand for these items to move in opposite directions, or in a negatively correlated way.

When one diversifies by investing in asset classes that have little to no correlation with each other, there are long-term benefits in the form of relatively lower overall return variability of the portfolio over time. For example, as shown in the chart on the following page, a portfolio invested 100% in U.S. Large Cap Stocks would have returned on average 7.5% with a standard deviation of plus or minus 15.3% over the 10-year period ending 3/31/2017 (that means returns could have varied from -7.8% to +22.8%). Likewise, a portfolio invested 100% in Bonds would have returned on average 4.3% with a standard deviation of 3.3% (a return range of +1.0% to +7.6%) over the same time period. A portfolio weighted 60% in U.S. Large Cap Stocks and 40% in Bonds would have returned a weighted average 6.2% over this time period. The standard deviation of this portfolio, however, is not simply the weighted average of respective standard deviations for U.S. Large Cap Stocks and Bonds (which would be plus or minus 10.4% or a range of -4.2 to +16.6%). Instead, the low correlation of 3% between U.S. Large Cap stocks and Bonds dampens the volatility of the overall portfolio, lowering the standard deviation to 9.3% or a narrower range of -3.1% to +15.5%. Investing in asset classes that aren't correlated with each other increases portfolio diversification which can help mitigate risk over time.

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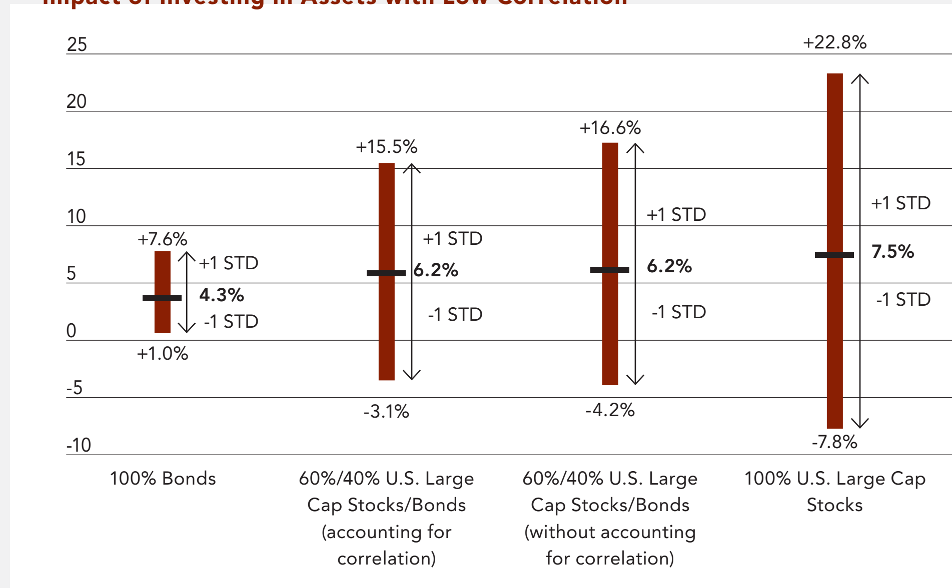
IS ASSET ALLOCATION SOMETHING I CAN SET AND FORGET?

No. Over time market fluctuations result in asset class over- and underweights relative to your original asset allocation and taking a disciplined approach of rebalancing to that original allocation may be in order. More importantly, life changes (marriage, family, retirement, death, etc.) will warrant revisiting your original asset allocation. We at Clifford Swan believe that it is essential to craft an asset allocation that reflects your own unique financial situation and stand ready to customize those allocations as your circumstances change. ◆

Impact of Investing in Assets with Low Correlation



Source: Morningstar, 3/31/07 – 3/31/17. Indexes used: Bonds: Bloomberg Barclays Aggregate; U.S. Large Cap Stocks: S&P 500.

THE FAMILY MISSION: WHAT DOES IT MEAN TO BE US?

By Linda Davis Taylor

"What about our family do you value most and hope never changes?"

This is one of several questions a family might ask itself as part of a process to develop a family mission statement. Why might a family want to define their mission? Consider what a mission statement achieves in a business setting—it clarifies an organization's identity and vision for the future.

A company's mission is a clear and concise statement about its purpose. What does it aim to do? What value is provided? The business world has come to appreciate that customers listen to a compelling message. Scott Bedbury, brand guru for Starbucks and Nike, defines great brands as stories that are never completely told. A galvanizing mission is the first chapter of the story for a business. The same can be true for a family that wants to create something of value that thrives for generations. The family's purpose should be stated and its story should be told.

Even before its legendary swoosh symbol, Nike's founders knew they wanted "to bring inspiration and innovation to every athlete in the world." This is their mission statement. To engage consumers in the story, they added a tag line: "If you have a body, you are an athlete." The appeal of contemporary brands such as Facebook and LinkedIn is that they connect people. Having a mission to connect the members of your family creates its own social network.

Businesses big and small understand how missions move people. The Humane Society taps our emotions with its promise "to create a humane and sustainable world for all animals." Disney's aim is "To Make People Happy." The TED organization only needs two words—"Spread Ideas"—to engage us in its cause. When a mission strikes a chord, everyone wants to be a part of the story.

In successful organizations, employees have a clear grasp of what the company is trying to accomplish. The stock boy may not own company stock but he certainly understands what his role is in fulfilling the company's mission. In a family, all the members are "stockholders"; no one should function in a vacuum. An unfocused company will lose customers as well as profits. If family members don't understand what they are trying to accomplish, they are bound to get off track.

A mission usually begins with the founders' vision. Founders are those with the drive and ambition to create something of lasting value, whether a family or a company. Passing on the founders' vision through a mission statement provides continuity for succeeding generations. Having a written statement helps them remember it. Remembering it makes it important.

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The old proverb “shirtsleeves to shirtsleeves in three generations” relates to the challenge of successfully transitioning wealth past the second generation. It predicts that the financial assets will be gone by the third generation. When that time comes, some family members may have never known the family’s founders. Perhaps they didn’t hear the poignant personal stories of the challenges that were overcome. More than likely they didn’t have the matriarch or the patriarch as a mentor.

This is when families need a mission statement. It instills the family’s most important message in the minds of succeeding generations. This can be a single sentence, or a more lengthy statement that sets out values. We aren’t accustomed to seeing mission statements in a family setting. They are often found in schools—places with a specific teaching job to do, but like a family in important ways. Both are there to educate the next generation, respecting the past while preparing for the future.

A family’s mission is more personal than a company’s. It often takes root as a daily maxim. It might be a slogan or byword that rings true to the family members. It’s something to turn to when times get tough. A family mission gives purpose to its members’ lives just like a company’s mission provides focus to its employees. It’s more than a statement on the wall. It’s a way of life.

When a company defines its mission, lots of people get involved. It isn’t only the corporate executives who set the direction. A special meeting is called to invite others into the mix. We can do the same with our families. The summer months or other holiday periods are ideal times because families are more likely to have get-togethers already in the works.

If meetings aren’t yet part of the family lexicon, this is the chance to begin a new healthy habit. We all like to be asked for our opinions, especially regarding something we care about. Let your family members know about the new project and schedule a few hours together at a favorite family spot to hold the family meeting.

If your family isn’t filled with verbal types, you may want to have a few warm-up questions ready to get the conversation going. Families are filled with stories, but rarely is there a collection of them in one place. Questions such the one at the beginning of this article and the two that follow encourage family members to reflect on the things they cherish, the genuine family jewels.

“Share a family story or tradition you love and want handed down to future generations.”

“What three adjectives complete the sentence, “Our family is . . .”?

If logistics prevent scheduling a family meeting in the near future, consider sending an email communication to begin the family conversation. For written communication, I have found asking the question, “What does it mean to be us?” to be pivotal because it touches on identity, values, and culture—literally the “glue” that holds a family together.

One family member told me recently that when she asked this question of her family members, she was overwhelmed with the insightful and meaningful answers. After the first ten or so responses, she noted a common thread; people were grateful to be a part of the family, and being part of the family was one of the most important parts of their lives. As she began sharing the individual answers with the entire family, it had a snowball effect. As family members read what other members had written, they wanted to add their perspective.

Shared values and shared stories lead to a shared mission. Think of a mission as a mantra that motivates. One family with whom I worked expressed its belief that everyone in the family is expected to make the family a priority with three simple words, “No Empty Chairs.” Whether you’re a family of one or of one hundred, what matters is developing the appropriate mind-set.

Your family’s mission is its promise to itself. The mission connects all the members to the family story. The story is like an epic tale with themes of new opportunities and chapters unfolding with each new generation. Each person lives his or her own version, but the core purpose is timeless.

The thoughts in this article are excerpted from Linda’s book, “The Business of Family: How to Stay Rich for Generations.” ◆

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