CLIFFORD SWAN
THE Investment Counselor
FIRST QUARTER 2018
WISDOM *for* GENERATIONS

BELIEVE SO THAT YOU MAY UNDERSTAND

By Kevin J. Cavanaugh

Stock market investors have experienced quite a volatile ride over the last two decades. As measured by the S&P 500 Index, the stock market tripled from 1995 to 2000. The ensuing bear market from 2000 to 2003 saw a decline of about 50%. The market recovered completely from 2003 to 2007 and then fell again almost 60% from 2007 to 2009. The current bull market phase has lasted for over eight years and the S&P 500 Index has risen from 666 to 2640, another increase of 300%. While the markets have been eerily calm over the last year, pushing ahead to new highs, historically-informed investors are anticipating renewed volatility.

Why so? Recent market action has taken on a more speculative tone. Individual investors have a rehabilitated appetite for stocks, especially the stocks of technology companies. Stocks are expensive by historical standards, as indicated by the median price-to-sales ratio shown to the right. How does the current market dynamic compare to the Dot-Com bubble experienced in the later part of the 1990's bull market? In 1996 our then Central Bank chief, Alan Greenspan, famously asserted that stock market investors were assuming an attitude of "irrational exuberance." This warning landed upon deaf ears, as the market skyrocketed higher over the next three-plus years. It was a very demanding environment for those of us who were managing client portfolios during that period. While investors' wealth increased at a fevered pace, we knew the risks of loss were increasing commensurately and required action. The

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conundrum was what to do with our investments in exceptional companies that were trading at very excessive valuations. Looking back from the current day, we can see that many outstanding franchises (the winners) proved to be sub-par investments over the ensuing period due to the high valuations being accorded in the late 1990's. Many of the stocks have yet to eclipse or have just recently eclipsed the prices paid during that bubble.

For the uninitiated, speculative market bursts are a joyful experience where easy money can be made and reputations burnished. The recent parabolic increases in the value of the crypto-currency Bitcoin and leading Chinese technology companies are good examples of just how "easy" it can be to manage money (sarcasm). For more disciplined investors, these speculative phases can cause existential crises, where our faith in investing as a rational enterprise is seriously tested. We find ourselves having to re-examine our foundational

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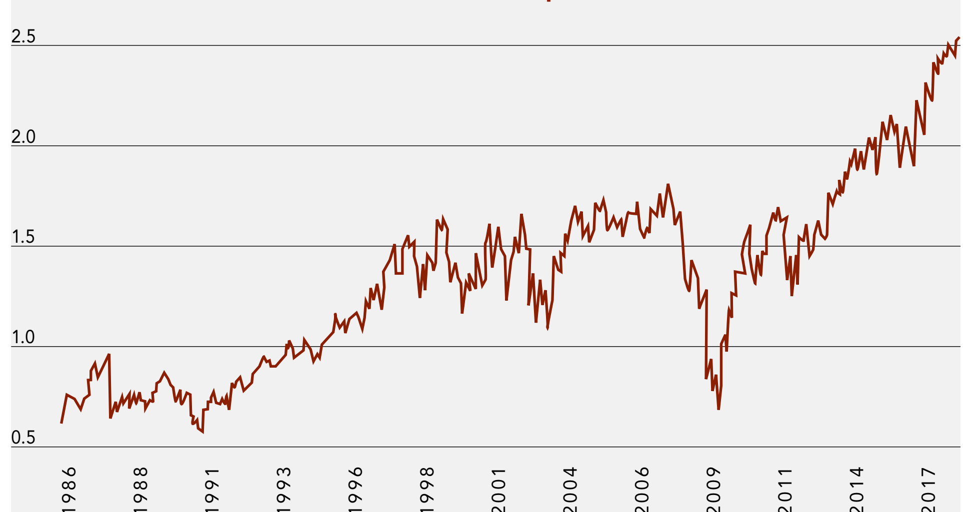
Price-To-Sales Ratio: Stocks Are at Their Most Expensive Level



Median price/revenue ratio of S&P 500 Index components. Source: Hussman Strategic Advisors

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principles. A speculative market phase will not provide evidence that a disciplined approach to investment is valid or even worthwhile. We are obliged to look back to market history, spanning both bear and bull markets, to find successful demonstrations of our principles in action.

Over the years, in our letters and newsletter articles, we have often reiterated the truism that market volatility is the disciplined investors' best friend. *Amen*. However, and quite frankly, upside volatility can be much more difficult to manage through. As valuations

"As valuations get pushed to extremes in a more speculative phase, investors' risk tolerances also change materially."

get pushed to extremes in a more speculative phase, investors' risk tolerances also change materially. The fear of *loss* is replaced by the fear of *missing out* and envy begins to drive investors to take unnecessary risks. For the uninitiated, the speculative phase will end in a vale of tears. For the disciplined investor, it is the ride up the mountain that proves to be the most challenging stage.

What causes this cyclicality in the stock market? *Human nature*. Bull and bear markets are caused by the interrelationship of two primary factors: **business fundamentals** and **investor sentiment**. In a bull market, **business fundamentals** are usually healthy and profit growth is strong or at least consistent. As sales and profits grow, confidence in the business cycle increases and investors tend to extrapolate profitable growth trends well into the future. As the market advances, investors can become increasingly focused on the potential for growth, whether sales or profits. In addition to this, **investor sentiment** (risk tolerance) evolves as well. As profits increase and the trends seem persistent, investors become increasingly willing to pay more for the potential profit stream. Over time, the current level of profitability becomes less significant and future profit potential more so. The stock prices of those companies with the best perceived growth potential become the most popular. In addition, companies whose profit streams appear unassailable (blue chips) become increasingly popular as well. As the bull market progresses, stock prices become divorced from the business fundamentals and the sheer popularity of certain companies attract more and more investment. These stocks' positive price momentum reinforces the trend and investors' confidence becomes increasingly tied to the price trend rather than the underlying business or the valuation of that business. Modern programmatic trading through the use of algorithms has added a new level of sophistication to momentum strategies. At this point, speculators are essentially just trading pieces of paper with the hope of selling that piece of paper to a greater fool. History shows that investing in these most popular stocks toward the end of a bull market turns out to be a sure path to wealth destruction.

"Bull and bear markets are caused by the interrelationship of two primary factors: **business fundamentals** and **investor sentiment.**"

Bear markets are the reversal of these trends. In many cases, the speculative advance in the stock market eventually has a negative effect on business fundamentals. Management teams feel increasingly pressured to justify the elevated stock prices of their respective companies and adopt riskier business strategies to drive profit growth. The increasing capital investment or acquisitive growth strategies tend to backfire, as the business cycle has nearly run its course. At this juncture, many companies' stock prices are radically over-valued and the expectations for growth sadly misplaced. The business cycle turns negative (recession) and profits begin to shrink for

"History shows that investing in these most popular stocks toward the end of a bull market turns out to be a sure path to wealth destruction."

many companies. And, just as in the bull market phase, investors tend to extrapolate the (in this case, negative) profit trend well into the future as confidence fades and the level of fear increases. Those companies without significant profits but with perceived growth potential begin to come under more scrutiny. The stocks lose the positive price momentum, which was the primary driver of appreciation to that point. Surprised momentum investors become more and more aware of the illusions on which their speculations subsist.

Bear markets tend to be shorter-lived as stock prices become quickly aligned with business values, or even trade at a discount to fair value, and more disciplined investors reenter the market. Many of the companies that were bid up on the potential of future profits cease to exist.

We are currently in a bull market phase, and business fundamentals and investor sentiment are both positively aligned. Expectations are high and stock prices are, generally, reflecting the high expectations. Popular stocks,

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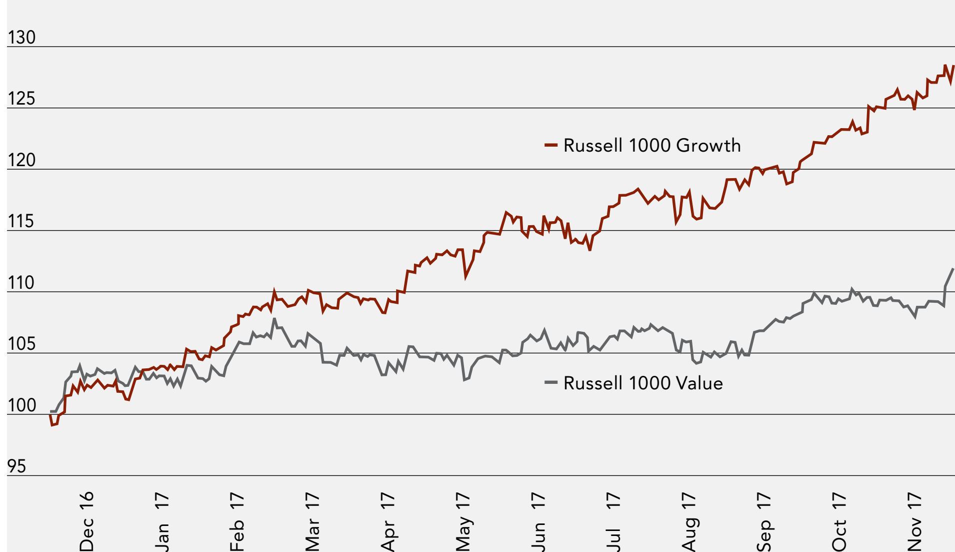
mostly technology companies, with well-established price trends and positive price momentum are leading the stock market higher. Investment strategies that are based on price momentum have been highly successful this year. More disciplined approaches that are based upon value-oriented principles are out of favor. The differential in investment returns of these two contrasting investment styles over the last twelve months are about as extreme as we have experienced since the Dot-Com bubble (see the chart below). Consequently, investment dollars are flowing toward momentum-oriented strategies and the more disciplined, value-oriented strategies are seeing redemptions. For now, these money flows have established a self-reinforcing cycle as is typical in the later stages of a bull market.

At Clifford Swan we take a rational, disciplined approach to investment. As the stock market moves higher, valuations are extended, and popular stocks with positive price momentum take the floor, we continuously revisit our foundational investing principles. What are these principles? First, we invest for a long-term time horizon and believe that this orientation will help generate excess returns. Our advantage is derived from the argument that, as most investors are so focused on generating short-term returns, we have a better chance to harvest longer-term investment opportunities. In a sense, we are playing a different game, with less competition. Our conservatism is derived, in large part, from the universe of high quality securities in which we concentrate investment. The businesses we invest in are inherently less risky. We define high-quality as those companies that possess a competitive advantage which allows them to earn superior returns on invested capital for sustained time periods. These typically industry-leading companies compete in growing addressable markets with competent managements focused on growing the profits and intrinsic value of the businesses over the long term. These companies' strong balance sheets and consistent, high levels of profitability allow them to self-finance any attractive growth opportunities. Second, but equally important, we take a valuation-driven approach to security selection. Clifford Swan has developed a specialized competence in assessing credits and pricing assets. We aim to generate excess returns by adhering to our valuation discipline and taking advantage of the shorter-term investment orientation of others. All of our investment decisions, whether to buy, sell or hold a security (common stocks) are made as long-term owners of the respective businesses. We assess risk on a security-by-security basis and attempt to balance risk through investment in a diversified portfolio of securities. Our ultimate goal is to construct portfolios to meet the specific investment objectives of our clients. We maintain an informed perspective toward the financial markets, including the potential risks as well as returns. A secondary goal is to communicate these sometimes complex ideas and circumstances clearly to our clients.

> "In a sense, we are playing a different game, with less competition."

Growth Stocks Have Momentum



Russell 1000 Growth and Value Indices, Rebased to 100. Source: Thomson Reuters Datastream

This disciplined approach allows us to earn competitive investment returns in upward trending markets as the companies that our clients own possess attractive growth characteristics. Importantly, the high quality characteristics of these businesses and the careful, valuation-driven approach to investment results in portfolios that tend to better hold their value in down markets. As the markets trend higher, we tend to lean against the wind somewhat, with an increasing focus on preserving capital. While the markets will again test our faith, we have conviction in the investing principles that have served our clients over the previous market cycles; we will continue to trust in the process.

"You would like to attain faith, and do not know the way; you would like to cure yourself of unbelief, and ask the remedy for it. Learn of those who have been bound like you, and who now stake all their possessions. These are people who know the way which you would follow, and who are cured of an ill of which you would be cured. Follow the way by which they began; by acting as if they believed…"
—Blaise Pascal, *Pensées*, No. 233 ◆

THE FAMILY BANK: A STRATEGY FOR PRESERVING WEALTH

“The generations of living things pass in a short time and, like runners, hand on the torch of life.” —Lucretius, Roman philosopher

By Linda Davis Taylor

What issue most worries families of means around the world? In our experience, families with significant wealth are focused not only on investment management of their financial assets; they also care deeply about the long-term welfare of their families. Their goal of “capital preservation” is often linked to family objectives and circumstances. The “capital” they care about is human as well as financial, and there is ample evidence that it is wise to have a strategy for preserving and growing both.

> “In our experience, families with significant wealth are focused not only on investment management of their financial assets; they also care deeply about the long-term welfare of their families.”

Despite all the effort that is put into earning wealth and investing it wisely, many families experience the unfortunate fate described by the famous Chinese proverb, *“shirtsleeves to shirtsleeves in three generations.”* Whether the wording is “rags to rags,” “clogs to clogs” or “rice paddy to rice paddy,” the meaning is universal.

When a family amasses financial wealth, it often disappears within three generations of its accumulation. Studies assert that this regrettable outcome occurs 70% of the time.[1]

WHY IS “SHIRTSLEEVES TO SHIRTSLEEVES” A BIG CHALLENGE FOR FAMILIES?

Consider what happens in the cycles of families. The first generation creates a family fortune. These industrious and often frugal people work hard, save wisely, but do not change their way of life and continue their economical habits even after they become wealthy.

The second generation then has the benefit of many advantages the first generation worked hard to provide them. They attain quality educations and other preparation that enables them to launch successful careers and enjoy a level of prominence in their communities. This successful path often leads to an expensive lifestyle commensurate with their greater earnings and civic profile. They, in turn, provide even more benefits to their own children.

The third generation, having become accustomed to many financial advantages, grows up without necessarily having a realistic understanding of the hard work and sacrifice required by their parents and grandparents to create the family’s wealth. The risk is that the third generation will consume the fortune they inherit because they have the money without experiencing what went into earning it. Unless this generation translates their own unique talents to productive outcomes, they may lack a sense of direction for their lives. The family fortune, no matter how great, will ultimately be consumed. Typically, this is due to not understanding the value of work; that is, a “calling” does not exist that can instill a sense of purpose and motivation as well as financial rewards.

INVEST IN THE FAMILY

Families who aspire to avoid this outcome and to ensure successful long-term preservation—both of their family as well as their wealth—should commit to the growth of their human assets as well as their financial assets, and can designate a portion of their wealth as a tool to achieve both results. This necessitates implementing a sound long-term oriented investment philosophy to preserve and grow the financial capital, using strategies described by my colleagues in this periodic newsletter. It also requires a long-term *family* strategy focused on the growth and development of family members themselves, who possess the family’s human capital in the form of their varied skills, talents, and abilities.

Such a commitment is a high calling because it requires the family to believe that the *preservation of the family itself* is a worthwhile endeavor, and both time and money should be prudently dedicated to this purpose. This core

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value should be communicated to family members as intentionally as its other capital preservation principles, such as spending and investing wisely. This approach frames family wealth as a resource that unites the family rather than dividing it.

In tangible terms, this means that part of the family's wealth is used to support in constructive ways the development of each individual family member. To survive and thrive, a family needs to enhance the growth of its members' abilities—its human and intellectual capital—to the highest capacity. Without this development, family members will not have the human assets to take advantage of new opportunities the future will offer, and to counter the threats that will naturally occur.

> "To survive and thrive, a family needs to enhance the growth of its members' abilities—its human and intellectual capital—to the highest capacity."

ENCOURAGING EMPOWERMENT NOT ENTITLEMENT

For many families of some affluence, investing in the next generation's growth and development is a natural process. Children are nurtured, educated and encouraged. Parents and grandparents take pride in contributing significant amounts of their own human and financial capital to launch the next generation through commitments to academic and extra-curricular activities. Tuitions are funded; athletic events are boosted; vacations are enjoyed.

It becomes more challenging, though, to answer the question of how and how much to support the next generation once they are beyond the teenage years. Though his resources greatly exceed those of most families, Warren Buffett describes the challenge in this way: "A wealthy person should leave his or her kids enough to do anything but not enough to do nothing." While the dollars will differ from one family to the next, the goal is one many families share.

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ONE WEALTH PRESERVATION STRATEGY: THE FAMILY BANK

To help with this vexing question of how to support family members' growth and development without creating a sense of entitlement, some families have used a concept known as the "family bank." A family bank is not a "bank" in the formal sense. It is an arrangement where parents or grandparents form a trust that designates a portion of the family's wealth for loans to family members. The purpose of the "family bank" is to foster responsible money behaviors and encourage productive endeavors. Young people may not otherwise be able to qualify for these loans from external sources, so the "family bank" may be uniquely suited to serve this niche.

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A family would make such loans because they would seem low-risk in relation to their contribution to the family's long-term wealth preservation plan. Instead of *giving* money to children or grandchildren, and face the possibility of the money being lost or not being used productively, the family *loans* money to children and grandchildren through a formal process to be used in ways that will contribute to their success and independence, lessening the risk of creating dependency on gifts.

WHAT PROJECTS SHOULD BE FUNDED?

Two types of loans might be considered. An *Investment Loan* is one whose purpose is to ultimately increase the family's wealth by supporting financially remunerative efforts such as starting a new business. Loans for educational purposes that augment professional skills and capabilities might also be considered *Investment Loans* if the case can be made that they are likely to increase members' earning power. Examples might be graduate school, professional certifications, or career development programs.

> "An *Investment Loan* is one whose purpose is to ultimately increase the family's wealth by supporting financially remunerative efforts such as starting a new business."

An *Enhancement Loan* supports the family's long-term capital preservation strategy if it increases the family's human or intellectual capital. These loans have a more indirect impact on the family's goal of wealth preservation, but can be extremely valuable if they

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> "An *Enhancement Loan* supports the family's long-term capital preservation strategy if it increases the family's human or intellectual capital."

contribute to fostering an independent lifestyle and sense of purpose in the member. For example, some educational or self-improvement programs may not directly increase financial earning power but they may provide a much needed catalyst to finding the path to greater well-being.

Basic Rules for Administering Loans Could Include:

- The borrower provides a written plan and loan application with information similar to what any commercial lender would request.
- The borrower discusses the project's feasibility and outcome with the family bank trustees.
- If the loan is granted, the borrower provides periodic reports on the investment.
- The borrower ultimately repays the loan, and terms should be well-defined.

Sometimes family bank trustees have difficulty with *Enhancement Loans* because they seem too much like subsidies. Subsidies are to be avoided because they actually increase dependency, which is counter to the purpose of the family bank. Financial dependency diminishes the family's financial assets and thwarts the individual's motivation. To avoid inadvertent subsidies, *Enhancement Loans* should be made with the same discipline of evaluating their long-term potential for positive outcomes for the individual and the family.

Possible Evaluation Metrics for Enhancement Loans:

- The borrower states in writing how the loan will increase his or her independence by proposing how the loan will provide the borrower with tools, both practical and psychological, for independent, non-subsidized living.
- The borrower states how the loan will increase his or her intellectual or human capital and therefore benefit the family.
- The family bank trustees should determine whether repayment of the loan may be in the form of demonstrated increased independence of the borrower or must be through financial repayment only.

HOW DOES THE FAMILY BANK WORK?

In consultation with the family's legal and tax advisors, a separate trust should be set up to serve as the family bank. As with any trust, one or more trustees are needed to manage the process and make decisions. Most likely trustees will be family members and/or outside advisers who are knowledgeable and can be helpful in decision-making and administering loans. Rules are needed for such things as whether loans can be forgiven and what happens if a family member defaults on the loan.

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Practices That Families Have Adopted When Setting Up the Family Bank Include:

- *State the Purpose:* All family members, both lenders (family trustees or decision-makers) and borrowers, should understand the family bank's fundamental purpose—to provide loans to family members that may be higher risk with lower interest rates to support productive activities.
- *Privacy*: Family bank processes and activities should remain private within the family and its trusted advisers.
- *Governance*: Each family has its own culture and therefore should decide how it wishes to manage its family bank. In order to communicate its purpose and philosophy to family members, it should have a written *Mission Statement*.
- *Formal Processes:* The family bank should have formal meetings with clear procedures for receiving and processing loan applications.
- *Transparency:* Loan application materials are generally shared with other family members; certain financial information about the borrower may remain confidential, but the purpose and amount of the loan should be disclosed. This provides a certain accountability on the part of the applicant when considering their request, and communicates a sense of fairness to all family members about how family resources are made available.

WHAT ARE THE PROS AND CONS OF THE FAMILY BANK?

Given the need for a trust and trustees to administer the loans, a family bank does add complexity. If not administered well, the family bank can create disharmony if decision-making is perceived to be inequitable. If repayment or forgiveness plans are inconsistent, ongoing dependency on a family's financial resources can reduce family wealth. Repayment or forgiveness plans should be reviewed and monitored with your tax adviser to avoid unintended gift tax consequences.

A well-conceived and run family bank provides excellent financial education for family members. It can also pro-

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> “A well-conceived and run family bank provides excellent financial education for family members.”

tect assets that children and grandchildren might otherwise lose through poor choices. Transparent communication throughout the family about the family bank’s purpose, processes, and decisions encourages dialogue about the family’s wealth and its philosophy regarding the purpose of money.

Perhaps most importantly, individual members learn from each other as different projects are proposed and completed. One member’s idea may be just the catalyst another member

> “Family wealth and family bonds can grow together.”

needs to launch her own new venture. Family wealth and family bonds can grow together. ◆

SOURCES

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1. Williams, Roy and Vic Preisser. *Preparing Heirs: Five Steps to a Successful Transition of Family Wealth and Values.* Robert Reed Publishers, 2010.

REMEMBERING PHILIP V. SWAN

Philip V. Swan
March 25, 1929 - December 7, 2017

It is with great sadness that we share the loss of our visionary co-founder and friend Philip V. Swan, who passed away peacefully on December 7, 2017 in Pasadena. We honor him for his impact on the investment counsel profession over his career of more than forty years in the industry. We are grateful for his leadership in launching his own advisory firm in 1984, which merged with Clifford Associates in 2007 to become Clifford Swan Investment Counselors. The two companies joined together based upon a shared heritage and common values of independent advice, rigorous investment research, and commitment to clients.

Born in Pasadena on March 25, 1929, Phil grew up in San Marino. He was a graduate of Pomona College and Stanford University School of Business. After 54 years in South Pasadena, Phil most recently resided in Pasadena.

Phil began his career in the investment management industry in 1955 as a securities analyst with Clifford Associates. For 23 years, he was associated with the national firm, Lionel D. Edie & Co., where he managed Southern California operations and served as an officer and director of the company. Throughout his career, Phil was passionately dedicated to providing exceptional investment counsel to individuals, families, and charitable entities.

Beyond his professional endeavors, Phil was very involved in the community. He dedicated his time and leadership to the South Pasadena Community Redevelopment Association, The Oneonta Club Scholarship Committee, Oneonta Congregational Church, Los Angeles Rotary, The Economic Roundtable, The Huntington Library Board of Overseers, The Braille Institute and Forest Lawn Boards of Directors, and Scripps College, where he served on the Board of Trustees.

Phil had a great enthusiasm for life and had many hobbies and passions. These included a particular interest in history and his collection of autographed pictures of U.S. political and business leaders. He was also well-known as a dedicated baseball and USC football fan. Phil will be remembered for his strong work ethic, boundless energy, dedication to family, generosity, sense of humor, and as a dispenser of advice and wisdom. To all of us at Clifford Swan, Phil personified the Clifford Swan mission to instill *Wisdom for Generations.*

A memorial service was held on Tuesday, December 19th at San Marino Community Church, followed by a reception at the Valley Hunt Club in Pasadena. ◆

MARKET OUTLOOK

By Randall L. Zaharia
CFA, CAIA®

As investors entering 2018, we are experiencing a nine-year-old bull market in domestic equities, with many of the major technology companies leading the way. In addition, many other asset classes have increased in valuations (for example, in the art market, a Leonardo da Vinci painting recently sold for $450 million). Easy central bank policies have been reversed by the U.S., Canadian, and British central banks; the European central bank may not be far behind. Global economic growth in 2018 is projected to be at its highest levels in over five years. Geopolitically, there are a number of hot spots: North Korea; the Middle East; Russia; and terrorism, to name just a few. We see a lot of similarities between today's confluence of risks and those of the 1970s. In any event, we believe there is a heightened risk environment which requires special attention.

With this backdrop, we are actively monitoring two key factors. First, as of December 20, 2017, domestic stock markets continued the strong advance of the past nine years (since March 2009), and we are concerned that the equity markets may experience significantly higher price volatility compared to the lower volatility of recent years. Second, the Federal Reserve continues to increase short-term interest rates and decrease its over $4 trillion investment portfolio. This reversal of the easy monetary policies of the past decade is significant because the availability of easy money may have underpinned the strong advance in the financial markets. There are a lot of moving pieces—including the Fed, central banks' policies, and uncertainty on what to anticipate in the markets—to consider.

> "This reversal of the easy monetary policies of the past decade is significant because the availability of easy money may have underpinned the strong advance in the financial markets."

The last few years have been highly unusual with respect to U.S. and international monetary policies (see the Clifford Swan article published in September 2016, *Negative Interest Rates: The Imaginary Has Become Reality*). We have seen extremely low, and even negative, interest rates globally. The Federal Reserve has been the first to reverse these easy money policies, given a solid, albeit subdued, 2%+ GDP growth rate. Since the situation is without recent precedent, most of us do not know what to expect as rates continue to increase, especially given the inexperience of the reconstituted Federal Open Market Committee (FOMC) board.

President Trump has nominated Jerome Powell, a current FOMC member and the first non-economist in nearly 40 years (since G. William Miller), to be Chair of the FOMC board, replacing Janet Yellen in February 2018. As a result, Dr. Yellen will step down from the board, joining Vice Chair Stanley Fischer (stepping down mid-year 2018) as departures from the board. In addition, the President has and will be nominating several additional members for the FOMC board, putting his strong mark on the helm of the U.S. central bank. One economist noted that there has been substantial turnover and a reduction in the FOMC economic staff, as well as shorter tenures by FOMC board members.[1] So, as monetary policy continues to be reversed by the Fed, a relatively novice board and staff are steering the boat.

> "We believe that the Fed's policy of gradually increasing rates will continue."

We believe that the Fed's policy of gradually increasing rates will continue. The FOMC has posed a terminal level for short rates at just under 3% several years out. The most recent December increase brings short rates up to nearly 1.5%, suggesting at least five more interest rate increases over the next two to three years. We anticipate that rates may top out around 2.25% to 2.50%, with a relatively flat yield curve. A flat yield curve occurs when short-term interest rates are the same as long-term rates; for example, the 2-year U.S. Treasury yield at 2.5% and the 10-year U.S. Treasury rate at 2.5%. Flat yield curves, and especially inverted curves (short-term interest rates higher than longer-term interest rates), may suggest an economic downturn is looming. However, given the less experienced FOMC and its staff, it is plausible that policy could well overshoot that 2.75% to 3.00% goal as there may be misreads on economic data and trends, including inflation trends, especially if GDP growth comes in at a much stronger 2.5% to 3.0% (vs. 2%+ over the last nine years). In this situation, the yield curve may indeed become inverted.

Clifford Swan noted in a first quarter 2017 article (*Inflation: Is This the Inflection Point?*) that a modest increase in inflation may occur over the next couple of years. Combined with an increase of GDP growth to over 2.5%, the FOMC may be led to push rates higher. And given this unusual context, that action raises questions on how markets will react. If the yield curve flattens or even inverts so that short-term rates

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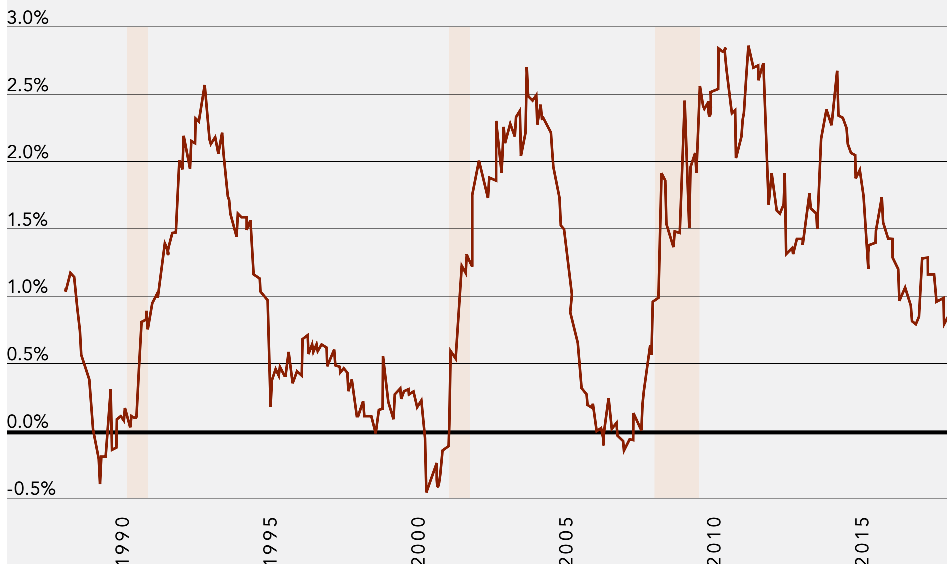
are higher than longer rates, will this flattening of rates actually predict an economic downturn? Historically, an inverted curve has been a very strong indicator of a potential economic downturn. While not all inverted yield curves lead to a recession, recent recessions have been preceded by an inversion (see the graph above; points where the curve falls below the thick black line indicate an inversion and precede a recession). According to the chart, we are gradually moving towards a flat curve as the difference between short-term (2-year) and long-term (10-year) Treasury rates moves towards zero (the thick black line). Therefore, the question may arise sooner rather than later. Given the unusual monetary conditions, we are not sure what to expect—it is unclear whether historic indicators will apply. Figuratively speaking, sailing out of a fog can be just as uncertain as sailing into it.

10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity



Shaded areas indicate U.S. recessions. Source: Federal Reserve Bank of St. Louis

Given the unpredictable situation in the financial and monetary markets, both domestically and globally (remember, global markets have also been subjected to unprecedented monetary policy), Clifford Swan is not sure an inverted yield curve will indicate anything at these low interest rate levels. In general, many economists and analysts appear to be only modestly concerned about the flattening of the yield curve. One economic analyst noted that every recession since 1980 has been preceded by an inverted yield curve. He did not foresee such a yield curve in the near future and cautions that the Fed needs "to be careful," lest it enter the danger zone of an inverted yield curve.[2] Another economic analyst notes that even if there is a yield curve inversion, a recession—if one occurs—is typically one year off.[3]

> "Finally, is the so-called ***Yellen*** (and earlier, ***Bernanke***) ***put*** likely adding more interest rate distortions to the financial markets?"

Finally, is the so-called ***Yellen*** (and earlier, ***Bernanke***) ***put*** likely adding more interest rate distortions to the financial markets? This colloquial term signifies the expectation that the Fed will always protect against a major financial sell-off (as seen in the 2008/2009 Great Recession). Christopher Whalen, a financial analyst and a previous member of the Federal Reserve Bank of New York staff, noted emphatically that the Fed would always be there to backstop the markets; that is, the Fed will always provide liquidity and support to financial markets to hold off a massive correction and panic, in an effort to protect the integrity of the financial system. Mr. Whalen went so far as to say that this was the primary (yet unstated) policy mandate of the Fed. The two overtly stated Fed objectives are full employment and stable, non-inflationary monetary policy. Whalen notes that this is especially true in the context of managing an ever increasing debt load and interest payments by the U.S. Treasury.[4] We would argue that if the Fed, indeed, is providing a continuing backstop, unintended consequences will eventually emerge. What those might be are, of course, uncertain.

> "We would argue that if the Fed, indeed, is providing a continuing backstop, unintended consequences will eventually emerge."

Nonetheless, Clifford Swan has sailed through many different environments over the last 102 years. We have generally taken a defensive, wealth preservation approach; going into the next few years, we anticipate that conservative orientation will serve us and our clients well in what we think will be much more volatile markets. ◆

1. *US Economic Update*. www.capitaleconomics.com. 14 November 2017.
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WHAT'S ALL THE FUSS ABOUT A FIDUCIARY STANDARD?

By Peter J. Boyle
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Much has been written in the last couple of years regarding the "fiduciary rule" rekindled by the 2015 announcement by the Department of Labor (DOL) of a seemingly straightforward and reasonable proposal which would require all firms and individuals who provide investment advice to retirement plans and IRAs to abide by a "fiduciary" standard. To be a fiduciary requires putting clients' best interests before one's own interests. This set off intense opposition by providers who claim they would need to adjust their offering and compensation structures to comply, resulting in the current delay in the rule's implementation. For example, brokers and insurance agents—who have been regulated under the less-lofty "suitability" standard—would need to demonstrate and document that the products they sell are truly in the best interests of their clients. Despite the delay, some aspects of the industry have already begun to react; for example, mutual fund companies have voluntarily reduced their fees—good news for current and future retirees.

Having spent the past 25 years with a firm that helped define the investment counseling profession and now wrapping up my nine-year term on the Board of Governors of the Investment Adviser Association, the 80-year-old organization representing our industry, I find myself questioning the recent fuss. The "fiduciary standard" is a simple concept which has been deeply-rooted in Clifford Swan's and the investment counseling industry's DNA from its very founding.

In 1921, thirteen years before the creation of our regulating body, the Securities and Exchange Commission, and only eight years after the Department of Labor was established, A.M. Clifford proclaimed in the *Los Angeles Times* that he was "…prepared to act solely in an advisory capacity from an impartial, independent and disinterested position…" This was a radical departure in an era of commission-based, sales-driven brokers.

In 1937, the then-named Investment Counsel Association of America adopted its *Code of Professional Practice*, which included the following principle: "neither the firm nor any partner, executive or employee thereof should directly or indirectly engage

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in any activity which may jeopardize the firm's ability to render unbiased investment advice." While this Code has evolved to include the term "fiduciary," what has not changed is the notion that the "investment adviser stands in a special relationship of trust and confidence with, and therefore is a fiduciary to, its clients."

Formal regulation of our industry finally caught up in 1940, thanks to the enactment of the *Investment Advisers Act of 1940*. In the section titled *Standard of Conduct*, the Act directs the SEC to "promulgate rules" ensuring advisers "act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice."

Many retirement investors are left awaiting the DOL's rule implementation and, longer-term, a potential universal fiduciary standard which would apply to *all* who provide investment advice. Meanwhile, our fellow investment counselors and their firms, guided by the *Investment Advisers Act of 1940* and represented by the Investment Adviser Association, have and will continue to espouse these fiduciary principles: clients first, transparency, and confidentiality. These principles have provided the foundation we have stood upon since the industry's creation. ◆

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