CLIFFORD SWAN

THE Investment Counselor

FIRST QUARTER 2019

WISDOM *for* GENERATIONS

WAS THE FOURTH QUARTER REALLY JUST A GLITCH?

By Kevin J. Cavanaugh

It has been reported that 90% of asset classes suffered losses in 2018. There were few places to hide, even for well-diversified investors. As we will explain, this was an unusual outcome.

The losses were undoubtedly far reaching. In the face of a stronger U.S. dollar, international equity markets struggled. Small and mid-capitalized companies experienced especially bad losses both domestically and abroad. Domestic and global bond markets were not much help either. Continuing this theme, publicly held real estate in the form of REITS (real estate investment trusts) and even less conventional assets like commodities and precious metals produced negative annual results. The best annual performance from a major global asset class came from U.S. Treasury Bills at 1.86%. This is a historical rarity: the last time that T-Bills took first prize was in 1981 when they were up 15%.

What happened is puzzling. It is not evident that any speculative bubble burst. Nor were there any financial crises such as we experienced in 2008. If anything, 2018 should have provided a good fundamental backdrop for equity investment. Global economic growth was the strongest generated in about eight years. In the U.S. and most other developed countries, inflation is well under control. U.S. corporate earnings grew at a robust 25%.

We think the following factors contributed to the challenging year.

RISING INTEREST RATES

Coming into 2018, we observed that stock valuations were quite high and believed there was a strong probability that interest rates would increase, introducing volatility to global markets. In fact, the U.S. Federal Reserve Board increased the federal funds rate four times in 2018. While higher interest rates can be viewed as a deterrent to investment, they are not necessarily so. It is perfectly normal and possibly even advisable for a central bank to increase rates as the domestic economy picks up steam. Moreover, interest rates moving higher from a historically depressed level is a signal of economic and financial health, and a path towards "normalization" is desirable. Yet, twice last year (in late January and then again in the fourth quarter), equity markets reacted negatively as 10-year U.S. Treasury yields neared 3%. In both cases, as rates retreated, the S&P 500 Index eventually stabilized. It is interesting to note, however, that after the first episode at the end of January 2018, large-capitalization stocks in the U.S. resumed their climb until the fourth quarter. Other asset classes, such as domestic small and mid-capitalization stocks and international equity markets, began to roll over and never recovered from the peaks hit early in 2018.

> ". . . interest rates moving higher from a historically depressed level is a signal of economic and financial health, and a path towards 'normalization' is desirable."

RECESSION RISK

As we progressed through 2018, investors began to focus on the "threat" of an inverted yield curve. This is viewed with concern because past inverted yield curves have proven an accurate predic-

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tor of an economic recession, typically occurring within 12-24 months. Why does the yield curve invert and why has this worked as an economic indicator? An inverted yield curve occurs when short-term government interest rates are higher than long-term rates. Historically, as economic expansions begin to show signs of over-heating, the Central Bank increases interest rates to help moderate growth and the possibility of higher inflation. Eventually, higher short-term rates succeed in slowing economic growth, and this may be reflected in lower long-term rates, which anticipate the slowdown. The chart below shows long-term trends in both short (red) and long (gray) government bond yields. The yield curve is not inverted at present (the gray line is still above the red line). There have been other periods where the yield curve has been flat, such as today, and the economy did not fall into recession.

POLITICAL ANGST

Reflecting uncertainty surrounding the current political climate, market volatility spiked at the conclusion of the November 2018 U.S. election cycle. Normally, the markets favor gridlock in Washington as it has the potential to reduce the range of outcomes, lessening uncertainty. It is possible that investors began to look forward to the next election cycle and did not like what they envisioned.

SLOWING GLOBAL ECONOMIC GROWTH

Coming into 2018, investors were generally optimistic about economic conditions and signs pointed to the continuation of a synchronized global economic upswing. However, as the year progressed, evidence began to accumulate that global economic growth is slowing. The explanations for the slowdown were higher interest rates, a stronger U.S. Dollar, growing pains in China, increasing trade-related roadblocks, less stable political conditions, and the record length of the economic cycle itself. In the U.S., economic conditions remained more robust than those of most of our major trading partners. Still, increased interest rates may have negatively impacted certain parts of our economy such as housing and auto sales. During the summer months, there was talk about an over-heating economy and the potential for seriously higher levels of price inflation. By the time the year ended, the narrative had changed to economic recession as the foremost risk.

SLUMP IN OIL PRICES

This distinctive reversal of fortunes was no more apparent than in the oil markets. The negative price action in the oil markets during the fourth quarter of 2018 was unprecedented. Oil prices peaked in September and declined virtually every day for two months straight. We believe that the dramatic nature of this reversal caught many investors off guard and served to reinforce the new narrative of a possible recession.

Ultimately, it may be said that expectations were too high coming into 2018, with prices in the stock market reflecting near perfect conditions of growth and stability. Circumstances last year were set up for negative surprises—and they arrived as the year progressed and were reflected in prices in the fourth quarter.

However, coming into 2019, expectations appear realistic and maybe even overly pessimistic.

LOW RISK OF RECESSION

We do not see the probability of a recession as high at this point. We expect the U.S. economy to grow at a healthy, albeit slower pace in 2019 and probably 2020 as well. Due to the very tight labor

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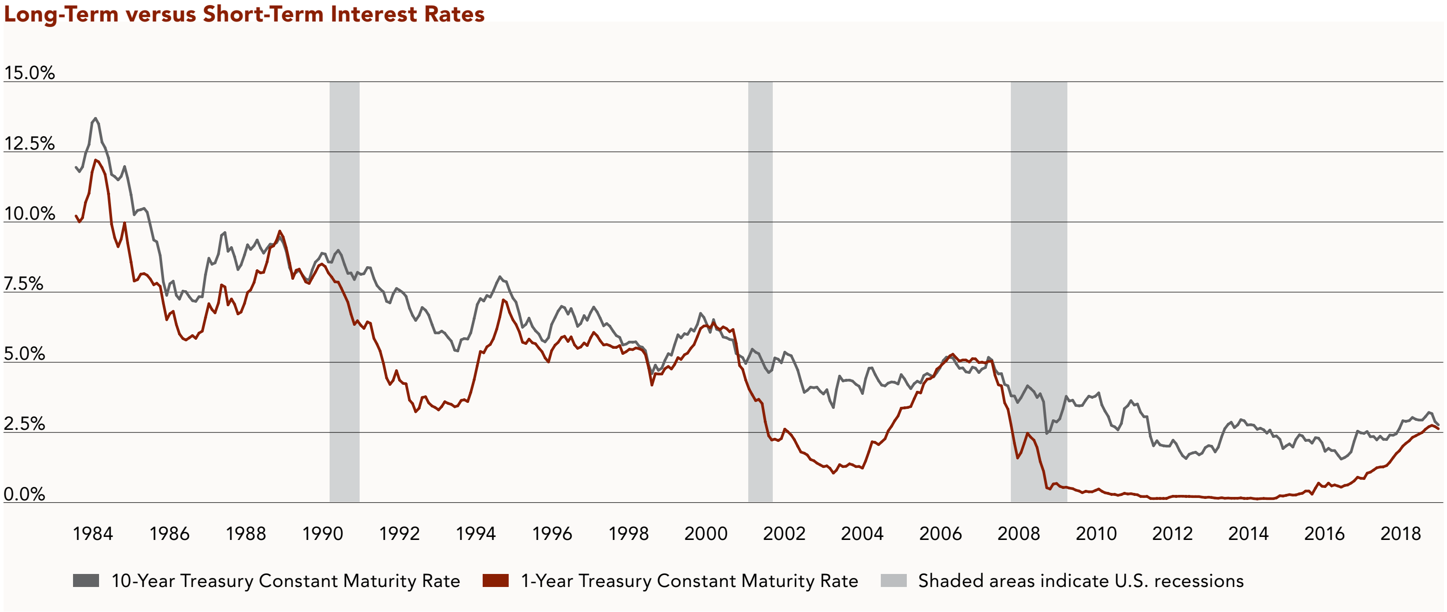
Long-Term versus Short-Term Interest Rates



Source: The Federal Reserve Bank of St. Louis

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markets domestically, we anticipate that wage inflation will continue to climb over the next few years as the benefits of the stronger economy are more broadly shared within the populace. The general level of inflation could also trend higher once we get past the effects of the recent abrupt decline in oil prices. Additionally, price inflation could be stoked by persisting trade tensions and any tariffs that might come about.

CONTINUING ROLE OF INTEREST RATES

While the slowing pace of global economic growth may diminish the chance of materially higher interest rates, we expect the direction will remain toward higher rates in 2019, and, consequently, continued market volatility. One reason for our negative view is that the supply of bonds should increase materially in 2019.

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The U.S. Treasury is expected to issue a record amount of bonds this year, with more Treasury bonds being issued as a percent of GDP than at any point since World War II. On top of this, unlike 2018, this year will see a large amount of corporate bonds maturing, leading to more issuance. Television character Gomer Pyle used to say, "Surprise! Surprise! Surprise!" This year, there should be no surprise that fixed income markets will need to deal with supply, supply, and more supply. Borrowers will need to entice global investors with higher yields for this surplus of debt. The large Treasury issuance has the potential to "crowd out" other markets, causing concerns about global liquidity.

Interestingly, the futures markets are pricing in zero U.S. Central Bank interest rate increases this year and a rate cut for next year. The Central Bank, while backing off its stricter rhetoric, still indicates two bumps in rates for 2019. Given moderate U.S. economic growth, one to two more rate increases seems appropriate to us.

The low level of interest rates for the last decade has been a mammoth tailwind for investors in stocks and other risky assets. In the U.S., the tailwind has ceased for now. This does not mean that a bear market is imminent, but it could lead to choppier markets. As the chart on the previous page displays, both short- and long-term rates were headed higher in the 1998-2000 period, and all the while, as we recall, the stock market exploded higher. Valuations on stocks have declined significantly from this time last year and the opportunity set for our clients is therefore much improved. President Trump described the stock market pullback in the fourth quarter as a "glitch." If the glitchy oil market is any indication, the recent +15% rebound in prices points toward growth in demand for that resource and fair economic growth ahead.

KEEP AN EYE ON CORPORATE EARNINGS

Without the tailwind of low interest rates, corporate earnings will be a more important contributor to stock returns. Corporate earnings are expected to grow nicely (5% to 6%) in 2019 after a record year in 2018. So far in 2019, earnings reports support these growth expectations. However, if this growth does come about as estimated, corporate profits will be at their highest level relative to GDP in modern history, which may not be sustainable for long.

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While the chance of a market drop due to high valuations has decreased, we will need to be careful about the prices paid for stocks. Tax cuts, low interest rates, and depressed wages have supported today's higher profit margins. Over time, these contributors will likely revert to normal levels. Market conditions such as we have described should be conducive to long-term oriented investors. We believe our focus on profitable franchises and strong balance sheets should help preserve capital in volatile markets while our careful approach to investment and prices paid should improve our chances for superior returns over the long run. ◆

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HOW TO BUILD YOUR FINANCIAL SKILLS AND TAKE YOUR SEAT AT THE TABLE:

A financial toolkit for young adults who want to embrace the power of money and grow their impact

By Linda Davis Taylor

We are living in a time when young people have more access than ever before to the knowledge and skills to become impactful leaders—in their communities, professions and families. While those now commonly referred to as "millennials" or "Generation Z" are often encouraged to use their voices to speak up about causes they care about most, nothing wields the capacity to change our world like financial strength. When those in the early stages of building their experience are also financially healthy, they have greater flexibility to seize new opportunities and try new things. Good financial habits paired with sound professional skills gives our next generations a leg up.

Yet this goal can feel daunting.

Often, attention revolves around more immediate concerns like how to fund an urban lifestyle on an entry-level salary, manage debt from student loans or credit cards, and the distant prospect of saving for retirement. To begin saving and investing as early as college to be prepared for "life after school," young people can utilize practical tips to help get the ball rolling when it comes to managing finances. As these steps become second nature, it becomes easier to understand the implications of having sound financial skills as crucial to having impact in the world.

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If you would like to build your financial skills, the following toolkit provides actionable steps that can catalyze your financial journey and equip you with the tools needed to become financially competent and confident. For many, tackling finances can feel overwhelming, confusing and provoke real emotion. This guide cuts through the clutter and offers a place to start.

For those on the go, here are some marching orders:

- Embrace the transition from "student to worker" as a milestone in your financial journey.
- Plan your budget and financial roadmap ASAP—creating these financial boundaries will help you feel grounded and make reaching your financial goals possible.
- Start saving, full stop.
- Invest your money in companies or funds that you care about and learn first-hand how the stock market works.
- Set out your current and future life goals, and start making your dreams come true.
- Finally, seek a mentor to help you use your financial influence to take your seat at the table.

STEP 1: MAKE FRIENDS WITH YOUR FINANCES

When faced with the realities of leaving college and finding a job, managing one's finances may seem irrelevant and unattainable. Yet the opposite is true. Instead of viewing our financial situation as a weight on our shoulders, we need to reshape the narrative of our finances as a natural part of our journey. Just as a promising but still young company needs a sound financial strategy to ensure its future growth and success, we need to invest in our own financial health as we do in other personal assets such as physical health and career skills.

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Even daunting responsibilities such as repaying student loans can be managed. With sound financial habits and a grasp on the different options available, graduates can pay back their loans faster and deepen their financial independence. Education[1] and proactive planning are key to effective repayment. For some personal context, *The Cut*[2] shares stories of real students and their loan journey: “Once I finished, I was so proud. I’ve been shouting it from the rooftops. I think it’s an important message to spread—that it’s possible, and we can help each other by talking about it. People have more agency than they think.”

> “Three phrases sum up the challenge: Understand what you own, know what you earn, and manage what you spend.”

Three phrases sum up the challenge: Understand what you own, know what you earn, and manage what you spend. Do you have a savings account, a 401(k), a car? What will your paycheck be after taxes are deducted? How much money will it take to fund the things you need to keep you going in the world?

STEP 2: CREATE A BUDGET AND A FINANCIAL ROADMAP

If you’ve never created a budget before, now’s the time to start. Track the fixed monthly expenses you can expect each month like rent, a gym membership or your Spotify subscription. Then, estimate additional monthly costs like groceries, eating out, leisure, etc. Take a good, hard look at your spending from previous months. Make sure that when you create estimations, they reflect your *actual* spending habits. If last month’s totals alarm you (like the amount you spent on takeout in a week) then it’s time to craft a budget that will help you plan, as well as keep spending realistic for your income.

Many rules of thumb exist for how to categorize your budget. One approach is the 50/30/20[3] budget guide where you spend roughly 50% of your after-tax dollars on necessities, no more than 30% on wants, and at least 20% on savings and perhaps supporting a cause you care about through charitable donations.

> “One approach is the 50/30/20 budget guide . . .”

After you’ve created a budget, it’s just as important to measure its effectiveness. There are many ways to monitor and track your monthly budget, including building a spreadsheet and using real-time apps[4] such as Mint or Acorns.

STEP 3: START SAVING, EVEN JUST $10/MONTH

As a young professional, chances are you grew up watching the realities of an economic recession unfold. Without realizing it, some of your fears and anxiety around money might be tied to both the anecdotal and very real accounts of 2008.

> “After you’ve created a budget, it’s just as important to measure its effectiveness.”

Saving proactively is a great way to prepare for the future’s unknowns. Establishing a “nest egg” as early as possible is key to releasing some of the unease related to money and feeling more comfortable making financial decisions.

It’s especially important for young people to prioritize creating an emergency fund—a certain amount of money that is not used except in cases of a true emergency. If you’re just starting out, *Money Under 30*[5] suggests creating a minimum emergency fund of $1,000 or two week’s pay, whichever is greater. Having this amount readily available will help enable you to pay for a minor unplanned expense—such as a car repair, unanticipated travel or a veterinary emergency—without needing to borrow money.

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Here’s a rule of thumb: for professionals entering the workforce, aim to set aside three months’ of your monthly expenses at a pace that makes

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sense for your current income. For a less predictable income source, like freelancing, consider saving six to nine months of your expenses. The sooner you start saving, the sooner you will reach these goals. But don't despair if you haven't reached this goal within your first year in the workforce. Saving is a priority, but so is paying your bills on time.

STEP 4: MAKE THAT MONEY GROW!

As a young person, you benefit from an advantage that can't be taught, paid for or gained later in life: *TIME.* Investing for your future and retirement does not have to be a mountainous task. Despite money seeming more scarce, the small contributions you can make now will have a much higher payout in the future.

How valuable is the benefit of time? Let's consider an earner that initially invests $1,000 when she starts working at age 21 and adds $200 each month until age 65. Over those 44 years, she will have contributed $106,600. Yet, thanks to the power of compound interest, if she were to earn a total annual rate of return of 5%, with accumulated interest and dividends reinvested semiannually, her investment would grow to over $382,000 by the time she turned 65 years old. Waiting 10 years until age 31 to start investing would reduce the account's final value to around $214,000—a difference of $168,000!

> "As a young person, you benefit from an advantage that can't be taught, paid for or gained later in life: *TIME.*"

Imagine how much your money can grow by making consistent, manageable investments each year—such is the beauty of compound interest.

> "Managing your finances is an opportunity to connect your dreams to a reality."

STEP 5: CONNECT YOUR FINANCES TO YOUR DREAMS

Managing your finances is an opportunity to connect your dreams to a reality. It's also an opportunity to be direct about your goals. Planning for your financial future requires taking stock of your plans for both the present and future. Want to travel the world? Attend grad school? Start a business? Money is a place where you can (and should!) speak up for the things you care about. Set goals for three "dream" life experiences, plus a budget and timeline for doing them.

STEP 6: FIND A MENTOR

Meeting with a trusted family member, informed colleague at work, or a professional financial advisor is a great way to organize your various financial goals and receive advice. Don't be afraid to raise your hand and ask questions. If you don't know the difference between a 401(k) and IRA, ask someone who does! While "investment portfolio" might sound like a feature only wealthy executives get to experience, understand that financial tools are available to everyone. Clifford Swan Investment Counselors are always available to listen, brainstorm, and help.

> "Don't be afraid to raise your hand and ask questions. If you don't know the difference between a 401(k) and IRA, ask someone who does!"

Once you've prioritized saving, learned the basics of investing, and found a mentor to encourage you on your path, you'll begin to see that learning financial skills is just like any other subject—you get better at it with practice.

The more you ask questions, do research and manage your finances, the more your money (and power) grows. As future leaders, your financial influence can considerably shape the type of world you want to inhabit. Taking control of your finances is not only a source of personal empowerment, but also a multiplier to positively impact the world. ◆

> "The more you ask questions, do research and manage your finances, the more your money (and power) grows."

Clifford Swan does not endorse any of the third party resources named in this article and recommends you conduct your own due diligence or consult with your investment counselor before using any referenced investment tools or advice.

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HOW TO INVEST WHEN COMPANY LIFESPANS ARE SHRINKING

By David Y. Lin
CFA

In 1965, a company in the S&P 500 Index had an average life of 33 years. Incredibly, that number is now down to 18 years and falling.

What's driving the change?

Technology has a lot to do with it as entire industries have been reshaped, from the way we shop for clothes to how we power our cars. If that weren't already enough, businesses have had to fight off competition from global trade flows and easing regulations. Important in all of this is that the composition of businesses has changed, with many lacking the cash flows to survive. Consider that in 2018 over 80% of companies that went public in the U.S. were unprofitable, higher than even at the peak of the tech bubble in 2000.

While there's noise in how corporate lifespans are calculated (e.g., some don't die, they get acquired), the fact remains: investors have their work cut out for them. After all, it can be said that investing is the practice of predicting business outcomes. More central to the prudent investor's goals of wealth preservation and long-term growth of capital, it's figuring out where the pitfalls are so that we can avoid them. These days, it feels like those pitfalls have widened, with business disruption accelerating and more speculative companies cropping up.

With how quickly the corporate landscape is evolving, we think it's more critical than ever to bring meaningful insight to business analysis. And that's no easy feat. Getting to the heart of complicated business questions takes patience, a lot of deliberation, and searing intellectual honesty. It means figuring out what truly matters against an ocean of data points, each calling for our attention. For instance, while the market may be captivated by a startup's rate of growth, we need to remember that trees don't grow to the sky. It is more important to wonder what a business looks like in a steady state—after motivated competitors have entered and the market is closer to saturation—and whether, in that stage, the business can even cover its costs. Better insight also comes from seeking out opposing viewpoints, especially when we feel most confident—or worst yet, when we have spent so much time with a subject matter that our opinion has become fossilized.

> "It is more important to wonder what a business looks like in a steady state—after motivated competitors have entered and the market is closer to saturation . . ."

But in an always-connected world, it can be very hard to maintain discipline. How do we stay focused when a firehose of data hits us from our phones and monitors throughout the day? How do we think calmly with media outlets racing to see who can form the fastest and loudest opinions?

While knowing there aren't easy answers, our investment team adheres to two principles in our analysis of companies.

First, maintain an investment identity. Identity allows us to stay the course while responding gracefully to the winds of change. Without one, investors risk losing their way, blown around by market fads and a constant torrent of news. At Clifford Swan, we're exacting in the types of securities we'll consider. We look for companies with resilient business models—ones that don't have to undergo constant reinvention—and strong balance sheets that enable them to withstand shocks, whether from recession or unpredictable industry cycles. We also consider whether these businesses have a path for sustainable growth, not with a roll of the dice but through tangible means, whether through leadership in a consolidating industry or by applying existing strengths (e.g., brand power) in related markets.

> "We look for companies with resilient business models—ones that don't have to undergo constant reinvention—and strong balance sheets that enable them to withstand shocks, whether from recession or unpredictable industry cycles."

Maintaining our identity means we embrace innovation without losing sight of business fundamentals. For instance, we recognize the power of intangible assets—networks, smart algorithms, and customer lists—while realizing that as quickly as "idea companies" can scale, they may just as quickly be replaced.

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> “Maintaining our identity means we embrace innovation without losing sight of business fundamentals.”

And out of our long-term discipline, we avoid chasing headline-grabbing companies, opting instead for businesses that may be overlooked but have proven ways of accruing value.

Take the example of daily deal sites (e.g., Groupon), which are matchmakers between customers looking for deals and businesses that need more customers. At the outset, that model generated tremendous buzz and drove valuations to incredible levels. Less talked about was whether they actually made both parties better off in the long run (which time has shown to be a resounding “no”). We would much sooner take interest in an operating model like that of business process outsourcers, which though unremarkable on the surface offers a stronger value proposition. They can be deeply entrenched in their customers’ operations—providing essential services like payroll processing and benefits management—with ways to grow an already resilient cash stream.

Our second principle is to promote a culture of rigorous and open dialogue, leaving no stone unturned when considering an investment. To be sure, strong dialogue doesn’t assure us of an easy path to success. That path is more likely to be filled with false starts and dead ends. But it’s in spirited dialogue that we can begin to uncover the questions that really matter to a company’s inherent worth and thus uncover potential pitfalls. Instead of spending significant research resources trying to predict next year’s margins to the precise decimal, a team may realize the better question to ask is: *Does this business actually offer something valuable to customers?* And if the answer is yes: *How might that eventually change?*

> “ . . . the better question to ask is: *Does this business actually offer something valuable to customers?* And if the answer is yes: *How might that eventually change?*”

As an extension of the principle of open dialogue, we favor corporate management teams who spend as much time thinking about what can go wrong as they do what can go right. Great managers speak comfortably about their business’s weaknesses, have respect for their competitors, and acknowledge their own missteps. It’s with a deep appreciation for both risk and opportunity that they can feel sure-footed in difficult times and make prudent decisions.

> “As an extension of the principle of open dialogue, we favor corporate management teams who spend as much time thinking about what can go wrong as they do what can go right. ”

At Clifford Swan, we reflect often on the adage: “go slow to go fast.” Adding our own take, it means that to make real progress, move deliberately and with purpose. Those are sage words for the business environment that we’re in—filled with promise and also increased danger. To this end, we think maintaining an investment identity and promoting relentlessly honest dialogue are important pursuits—ones that permeate every corner of an organization and anchor us in trying times. In an age of business disruption that’s showing no signs of slowing, they help us steer towards calmer waters and stay in command of our clients’ investment goals. ◆

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