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EATING AND SLEEPING ON A CHALLENGING JOURNEY

It has been said that in the context of an investment portfolio, equities afford clients the opportunity to eat well while bonds provide the comfort of sleeping well, analogous to their ability to provide the pillars of a long and healthy lifestyle. But, at certain stages of an economic cycle, challenges arise that can undermine these benefits in a traditionally constructed portfolio.

As the "new, new normal" environment of higher volatility and market uncertainty continues into early 2019, investor optimism has once again turned to heightened concern as the 10-year to three-month (10y-3m) portion of the U.S. Treasury yield curve inverted for the first time since 2007, concluding the longest period since the early 1960s without an inversion.

Every recession since the mid-1960s has been preceded by an inverted yield curve, but not every inverted yield curve has resulted in a recession. If the bond markets are to be believed, the likelihood of a global economic slowdown increases significantly as longer-term bond yields trade inside those on the shorter end of the fixed income curve.

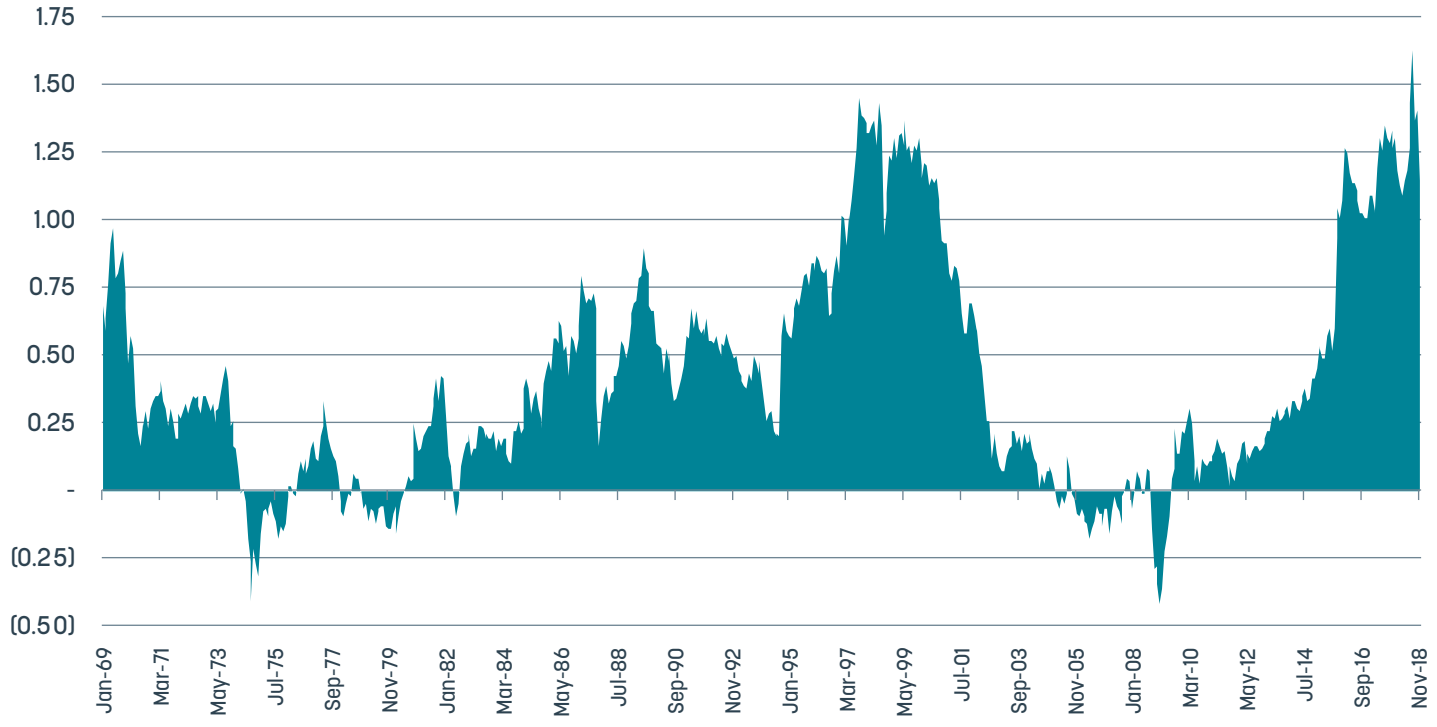
Another development in the bond market has received a bit less attention but is equally important. Bloomberg recently published an article[1] entitled The $10 Trillion Pool of Negative Debt Is a Late-Cycle Reckoning, highlighting that "the stockpile of global bonds with below-zero yields just hit $10 trillion, intensifying the conundrum for investors hungry for returns while fretting the brewing economic slowdown." The author goes on to point out how this phenomenon can lead to questionable investor behavior, as the reach for yield leads to the increased risk of diminishing return. Considering that fixed income exposure is designed to provide some level of capital protection within a diversified portfolio, negative yields in global bonds and deteriorating risk/reward opportunities in speculative debt can erode the downside risk mitigation that has historically been the primary objective of the fixed income investor.

This "reach for yield" has implications beyond the wealth preservation portion of a client's portfolio, as equities' ability to drive returns can be impacted as well. One needs to look no further than the last several years of Index performance against a historical market cycle for the S&P 500 to see the massive cyclicality of risk-adjusted performance.

The following chart shows the rolling 7-year, risk-adjusted performance of the S&P 500 Index over the past 50 years, as measured by its Sharpe Ratio.[2] Domestic equities have experienced several peaks and valleys over the years, with risk-adjusted performance peaking in the late 1960s,[3] again in the late 1990s,[4] and most recently at the end of 2018.[5]

Unsurprisingly, each historical peak was followed by a multi-year period of disappointing returns for the Index. Following the peak risk-adjusted performance of the late 1960s, the S&P 500 produced a negative annualized return of (-3%)

S&P 500 Index Sharpe Ratio (1969 – 2018)



Source: Federal Reserve Economic Data, Evestment

over the subsequent 5+ years. During the bull market of the late 1990s, the risk-adjusted performance peaked in mid-1998, roughly 18 months before the market top in early 2000. Here too, forward performance was massively disappointing for investors as the Index generated a negative annualized return of (-5%) over the next decade. Given the tremendous environment for equities over the past 10 years — abnormally high returns, coupled with historically low levels of volatility with effectively zero interest rates, a reversion to the "risk-adjusted mean" appears exceedingly reasonable.

Given the low return environment for traditional bonds, and potential downside risk in long-only equities, the need to introduce alternative debt and hedged strategies to capture the benefits of market inefficiencies is increasing in importance. Even a moderate shift from traditional to alternative strategies (e.g. structured credit, catalyst-driven equities, dynamic multi-asset class investing, etc.), can make a huge difference in a client's risk-adjusted performance over time. Considering what traditional markets are telling us about future returns and increasing risks associated with the status quo, the time to develop a prudent, strategic plan is now.

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END NOTES

[1] https://www.bloomberg.com/news/articles/2019-03-25/the-10-trillion-pool-of-negative-debt-is-a-late-cycle-reckoning

[2] Sharpe Ratio is the average return earned in excess of the risk-free rate per unit of volatility.

[3] Rolling S&P 500 Sharpe Ratio of 1.0 in June 1969.

[4] Rolling S&P 500 Sharpe Ratio of 1.4 in June 1998.

[5] Rolling S&P 500 Sharpe Ratio of 1.6 in Sept. 2018.

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