Independence | Asset Advisors

2019 - A Great Year To Be An Investor

What About 2020?

Economic & Market Overview

Congratulations, we just made history! The 2010's marked the first decade in recorded U.S. history when a recession did not begin (or end). Sure, the decade started from a low point after the global financial crisis of 2008-2009, so the first several years of growth just got us back to 2007 levels, but since then, the U.S. and world economies have continued to expand at a slow but healthy pace.

Historically, business cycles have been shorter and more frequent. Over time, as the structure of the economy evolved, business cycles have become extended. Of course, the "glass is half empty" crowd will view this as evidence that an economic comeuppance is near. Our view: Relax and enjoy the recent run. It has been an entire decade of sustained, moderate economic growth, low inflation, and falling unemployment. Sure, economic problems remain, but we'll take the progress.

2019 does offer a few clues for 2020. While most strong, one-year stock gains are followed by another up year, the course of future years isn't very predictable. Although, since the Great Depression, no 30% gain was followed by a down year. While fears of complacency have some investors nervous, the economic backdrop for 2020 has improved. For markets to move higher, the cyclical and value laggards of 2019 may need to become leaders.

Valuations today are high by most historic measures. But there are few signs that valuations are in a bubble-like state. It is safe to say that assets aren't cheap and annualized returns on the horizon will be less than the last decade. However, with investment grade bonds yielding less than 3% and cash returning less than 2%, returns from equities may still be the best game in town.

Thus, looking at 2020 we see:

1. Positives are consistent economic growth, and the likelihood that earnings growth will expand, perhaps meaningfully - likely with less headwind from a strong dollar.
    - Growth in services is offsetting manufacturing weakness.
    - Economic growth and inflation remain muted globally.
    - Monetary and fiscal stimulus should postpone a recession.
    - Elections years tend to come with additional fiscal stimulus – especially with an incumbent running for a second term.
    - Cyclicals and value as style/factors are inexpensive; defensive stocks, U.S. tech and communications services are expensive.
2. The fundamental risks are that rising wages will pull inflation and interest rates higher than subdued forecasts.
3. Geopolitical risks and trade policy remain a wildcard to potential outcomes - expect volatility.

Ten-Year Total Returns by Asset Class

2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Energy Infrastructure 35.9%	Energy Infrastructure 13.9%	U.S. SMID Equity 17.9%	U.S. SMID Equity 36.8%	U.S. REITs 32.0%	U.S. REITs 4.5%	Energy Infrastructure 18.3%	Developed Foreign Equity 25.0%	$CAD Investment Grade Bonds 2.1%	U.S. Large Cap Equity 31.5%
U.S. REITs 28.1%	U.S. REITs 9.4%	Developed Foreign Equity 17.3%	U.S. Large Cap Equity 32.4%	U.S. Large Cap Equity 13.7%	$CAD Investment Grade Bonds 3.1%	U.S. SMID Equity 17.6%	U.S. Large Cap Equity 21.8%	U.S. Cash & Reserves 1.9%	U.S. SMID Equity 27.8%
U.S. SMID Equity 26.7%	U.S. Investment Grade Bonds 7.8%	U.S. REITs 17.1%	Energy Infrastructure 27.6%	60%/40% Blend 10.6%	U.S. Large Cap Equity 1.4%	U.S. High Yield 17.1%	U.S. SMID Equity 16.8%	Bank Loans 0.4%	U.S. REITs 23.1%
U.S. High Yield 15.1%	$CAD Investment Grade Bonds 6.3%	U.S. Large Cap Equity 16.0%	Developed Foreign Equity 22.8%	40%/60% Blend 9.1%	60%/40% Blend 1.3%	U.S. Large Cap Equity 12.0%	60%/40% Blend 14.2%	U.S. Investment Grade Bonds 0.0%	60%/40% Blend 22.4%
U.S. Large Cap Equity 15.1%	40%/60% Blend 5.8%	U.S. High Yield 15.8%	60%/40% Blend 17.6%	U.S. SMID Equity 7.1%	40%/60% Blend 1.1%	Bank Loans 10.2%	40%/60% Blend 10.6%	40%/60% Blend -1.5%	Developed Foreign Equity 22.0%
60%/40% Blend 12.1%	U.S. High Yield 5.0%	60%/40% Blend 11.3%	40%/60% Blend 10.7%	U.S. Investment Grade Bonds 6.0%	U.S. Investment Grade Bonds 0.6%	60%/40% Blend 8.3%	U.S. High Yield 7.5%	U.S. High Yield -2.1%	40%/60% Blend 17.8%
40%/60% Blend 10.4%	60%/40% Blend 4.7%	Bank Loans 9.7%	U.S. High Yield 7.4%	Energy Infrastructure 4.8%	U.S. Cash & Reserves 0.1%	U.S. REITs 6.7%	Bank Loans 4.1%	60%/40% Blend -2.4%	U.S. High Yield 14.3%
Bank Loans 10.1%	U.S. Large Cap Equity 2.1%	40%/60% Blend 9.0%	Bank Loans 5.3%	$CAD Investment Grade Bonds 3.9%	Bank Loans -0.7%	40%/60% Blend 6.4%	U.S. REITs 3.8%	U.S. REITs -4.2%	U.S. Investment Grade Bonds 8.7%
Developed Foreign Equity 7.8%	Bank Loans 1.5%	Energy Infrastructure 4.8%	U.S. REITs 1.2%	U.S. High Yield 2.5%	Developed Foreign Equity -0.8%	U.S. Investment Grade Bonds 2.7%	U.S. Investment Grade Bonds 3.5%	U.S. Large Cap Equity -4.4%	Bank Loans 8.6%
U.S. Investment Grade Bonds 6.5%	U.S. Cash & Reserves 0.1%	U.S. Investment Grade Bonds 4.2%	$CAD Investment Grade Bonds 0.3%	Bank Loans 1.6%	U.S. SMID Equity -2.9%	Developed Foreign Equity 1.0%	U.S. Cash & Reserves 0.9%	U.S. SMID Equity -10.0%	Energy Infrastructure 6.6%
$CAD Investment Grade Bonds 3.9%	U.S. SMID Equity -2.5%	$CAD Investment Grade Bonds 1.4%	U.S. Cash & Reserves 0.1%	U.S. Cash & Reserves 0.0%	U.S. High Yield -4.5%	U.S. Cash & Reserves 0.3%	$CAD Investment Grade Bonds -0.8%	Energy Infrastructure -12.4%	U.S. Cash & Reserves 2.3%
U.S. Cash & Reserves 0.1%	Developed Foreign Equity -12.1%	U.S. Cash & Reserves 0.1%	U.S. Investment Grade Bonds -2.0%	Developed Foreign Equity -4.9%	Energy Infrastructure -32.6%	$CAD Investment Grade Bonds -0.3%	Energy Infrastructure -6.5%	Developed Foreign Equity -13.8%	$CAD Investment Grade Bonds 2.1%

Source: eVestment and Black Diamond

In honor of my beloved father-in-law and founder of Vanguard, John C. Bogle, who passed away last January, I have taken some of his most sage advice and put it in the context of today's investment environment. For 38 years he was a generous mentor and I never tired of discussing (sometimes debating) investing with him. Simplifying the complex and educating investors was his passion, not just his profession. The following pearls of his wisdom seem apropos for investors today.

The Power of Persistence

"The idea that a bell rings to signal when an investor should get out or back into the stock market is simply not credible. …I don't know anybody who has done it successfully and consistently. And I don't know anybody who knows anybody who has…" John C. Bogle, "Common Sense on Mutual Funds", 1999.

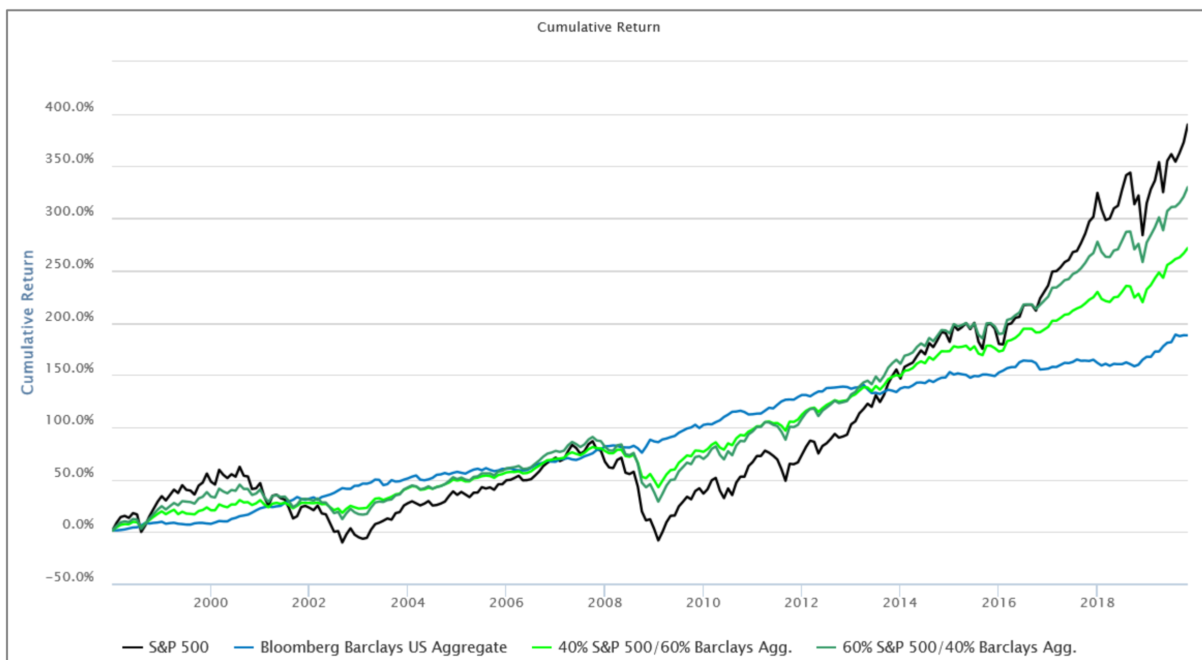
In fact, Wall Street and large bank economists are notoriously bad at forecasting the next calendar year's stock market return. Since 2000, the consensus forecast has predicted positive market (S&P 500) returns every year for the last 20 years, but they actually fell six times – a directional error ratio of 30%. Bespoke Investment Group calculated the median 20-year consensus calendar year forecast for stocks to rise 9.8%. In fact, the S&P 500 rose 5.5% on average. The gap between the median forecast and the market return points to a magnitude error of 44%. Interestingly, the consensus forecast for 2008, the year the market fell 39%, was for an 11% gain!

What can we conclude? Forget stock market forecasts.

Trying to time the next market, as Bogle would say, "is a fool's errand." The best approach is to determine your long-term investment allocation and "Stay the Course," another favorite Bogle admonishment.

With that in mind, we charted the last 20 years of market returns to demonstrate to power of picking an asset allocation and sticking with it.

Not surprisingly, investors that stayed the course and held through the last market downturn earned an attractive 8.4% compounded annual gain from the S&P 500 pre-crash high in October 2008.



Source: eVestment

It is also interesting to note what more diversified investors would have earned with a more conservative 60% stock and 40% bond (60/40) allocation, or capital preservation-oriented 40% stock and 60% bond (40/60) allocation over the same time period. In the table below, we chose October 2007 to start a second data series range since this was the pre-crisis market high. Diversified investors also did well in both the 12-year (peak to current) and the 22-year periods, earning nearly identical returns of 7% for the 60/40 investor and 6.2% for the 40/60 investor.

Index	Range	Cumulative	Annualized	Range	Cumulative	Annualized
S&P 500	Jan 1998 to Nov 2019	390%	7.5%	Oct 2007 to Nov 2019	167%	8.4%
BB Agg.		188%	4.9%		66%	4.3%
60/40 Blend		330%	6.9%		128%	7.0%
40/60 Blend		272%	6.2%		108%	6.2%

Source: eVestment

So why invest in anything but stocks?

It depends on your time horizon and risk tolerance.

“In a world of boxcar total returns on stocks, risk is often ignored, bonds deemed irrelevant, and income old-fashioned, but when the going gets tough, all three – risk, bonds, and income – will come into their own again.” John C. Bogle, Bogle on Investing: The First Fifty Years, speech from April 2000.

We do not consider volatility as risk, but as stock market noise created by fear and greed and short-termism. We consider the risk of loss as the most important risk investors should consider. 15% volatility over a long investment horizon doesn’t sounds so bad, but how would you like to experience the 51% peak to trough drawdown that U.S. stocks experienced in 2008-2009 again? The chart below shows market risk measures for stocks and bonds and simple U.S. stock/bond diversified portfolios.

2007 – 2019 (Peak-to-Peak) Risk Measures
(The 20-Year numbers are nearly identical.)
Stocks………… Volatility 14.9%................Drawdown (51.0%)
Bonds…………. Volatility 3.3%..................Drawdown (1.3%)
60/40………….. Volatility 9.0%..................Drawdown (32.5%)
40/60………….. Volatility 6.3%..................Drawdown (21.3%)
Source: eVestment

We believe most investors with less than a 20-year time horizon should have a diversified portfolio. Your asset allocation is best set by considering both your investment time horizon and your tolerance for mark-to-market drawdowns. Generally, the shorter your time horizon, the more you need to diversify away equity risk with an increasingly high-quality bond allocation. In other words, if you can’t hold through a major drawdown, diversify to minimize that risk.

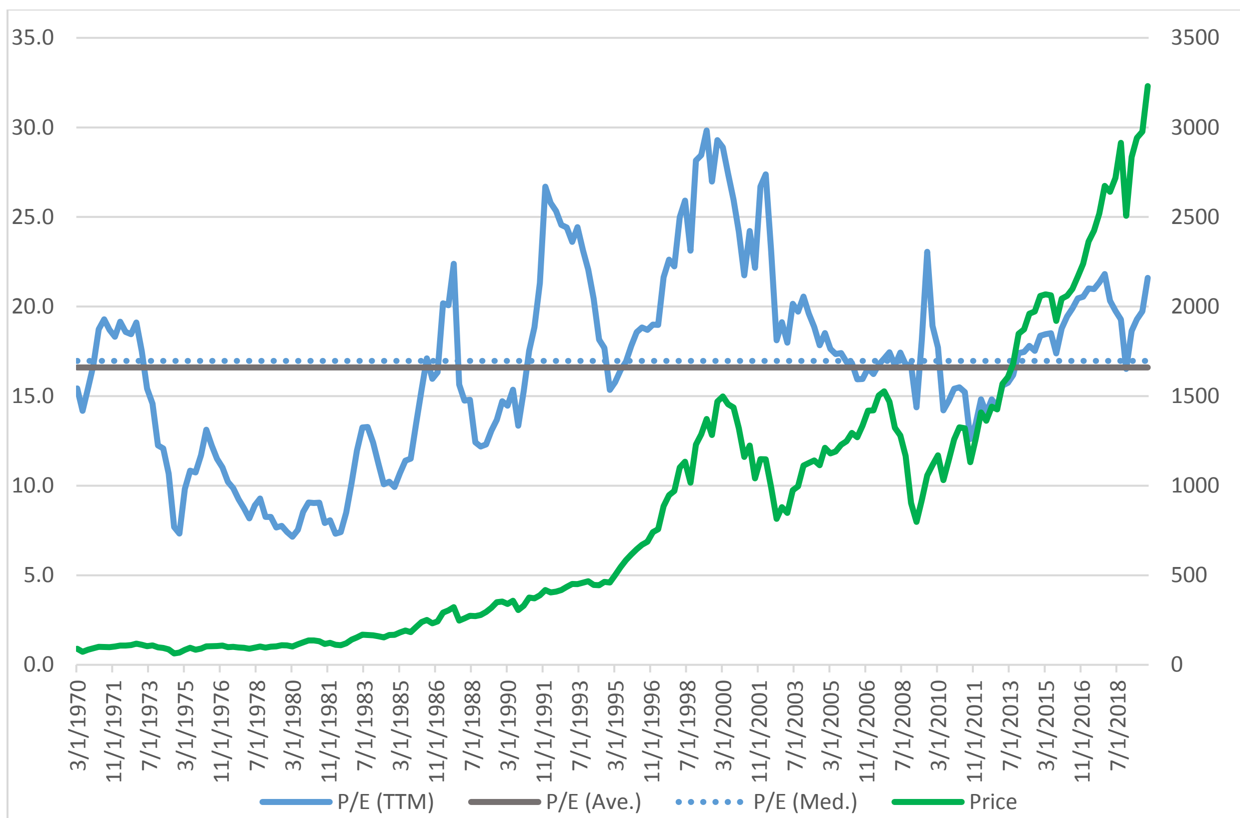
What was true in early 2000 and again in 2008 will be true again in the next major downturn. Bonds are the ballast to keep a portfolio upright and to provide liquidity in tough times.

Price matters

This bull market started when the S&P 500 Price to Earnings (P/E) ratio was at 12 to 14 times earnings. The current P/E ratio is 21.5x vs. a historic average of 16.6x. Better to add to equities when valuations (P/E) are low than when they are high.

Of course, Bogle might argue about active management vs. indexing, but not about how much price matters. He was known to invest in index funds other than the Vanguard 500, including Total Stock Market (more diversification), and Dividend Growth and Dividend Appreciation funds (higher quality value oriented). He even invested in actively managed funds like Windsor Fund during John Neff's management and Vanguard's PrimeCap Fund more recently. He acknowledges that there are some persistently good active managers, but believed the average investor could not consistently find them or would find them late and buy yesterday's winners. The important message Bogle delivered to me at an institutional level was not passive over active, but that cost matters – don't over pay for active management.

The graph below shows the S&P 500 index in green (right scale) against the Price-to-Earnings ratio in blue (left scale) since 1970. Dotted & grey lines show historic average and median P/E.



Source: Bloomberg

At today's valuations, with tech stocks at over 23x forward earnings (one-standard deviation high), we advise that investors avoid the tech-heavy S&P 500 index and invest in high quality stocks with lower valuations, because price matters.

Cost matters

"Investors need to understand not only the magic of compounding long-term returns, but (also) the tyranny of compounding costs; costs that ultimately overwhelm that magic." John C. Bogle, "The Clash of Cultures", 2012.

Every penny (basis point) paid in fees reduces return. "Watch the pennies and the dollars (pounds) will take care of themselves", William Lowndes (1652-1724).

Avoid Complexity

"My judgement and long experience have persuaded me that complex investment strategies are (often) doomed to failure. Investment success, it turns out, lies in simplicity as basic as the virtues of thrift, independence of thought, realistic expectations, and common sense. The one great secret of investing is that there is no secret." John C. Bogle, The Clash of Cultures speech, February 1999.

Enough said.

In Closing

I am optimistic about the U.S. and global economy and financial markets in 2020. That optimism is tempered by high starting asset valuations that portend lower than average market returns over the next decade. 2019 was a fantastic year to be an investor. There are not many reasons outside of a significant policy mistake or geopolitical events that 2020 will not reward investors with reasonable positive returns.

As Jack would say, just "Stay the Course".

As always, we are here to discuss any questions you might have about the year ahead or your portfolio. We are grateful for the opportunity to partner with you.

Best wishes for a happy, healthy year.

Scott

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