NOTTINGHAMADVISORS
ASSET MANAGEMENT

LIFE IN INVESTMENT PURGATORY
2016 Q2 Review

pur·ga·to·ry
ˈpərgəˌtôrē/
noun

1. *(in Roman Catholic doctrine) a place or state of suffering inhabited by the souls of sinners who are expiating their sins before going to heaven.*

For those of us that received the bulk of their early education from the likes of Sister Mary Payattention!, not to mention the brilliant but stern Jesuits of my high school years, the concepts of Heaven, Hell and Purgatory are firmly established in our collective psyche. Heaven and hell were easy enough to grasp – strive for one, definitely avoid the other, but purgatory was always sort of that nebulous place where we all knew we had to spend some time, but wasn't so bad. Kind of like a Comfort Inn when you're on a family road trip with the kids. There may even be an indoor pool to help pass a couple hours, not to mention the "free" breakfast.

As the more formal ("formal" meaning the first hit I got on the internet) definition above states, purgatory is that place where we atone for our sins before meeting up with St Peter at the pearly gates, when our true fate will be revealed. It could be that we're in this temporary holding area for a few weeks, months, maybe even years. It all depends on how much we learned and lived the teachings of Sister Mary and others. Unfortunately, I may be in for an extended stay.

My early Catholic school challenges aside, I think it an apt metaphor for where we find ourselves on the investment landscape today. It's definitely not a great environment to make money, but far from the worst. We're likely to be here for a while, but not permanently. And where we ultimately end up probably depends more on what we do now as opposed to what we've done in the past (unlike the real purgatory).

The challenges investors face today primarily include uncertainties around Brexit, the Fed and China. These are three huge macro variables that could each determine our near-term investment fates, and collectively likely will. The tough thing is that there is no easy or quick resolution to these issues and truly only time will tell. That's a pretty tough pill to swallow for investors with money on the line, not to mention retirements, college educations or homes to buy. So, what should one do while biding their time in this investment purgatory?

In our view, the three most critical choices investors can make today in order to improve their chances of passing through St Peter's gates are: 1) Be patient, 2) Be realistic, and 3) Be opportunistic. I know it sounds simple, but when your neighbor is bragging to you about how his utility stocks are up 24% this year (but doesn't mention their ridiculous valuations), it will be hard

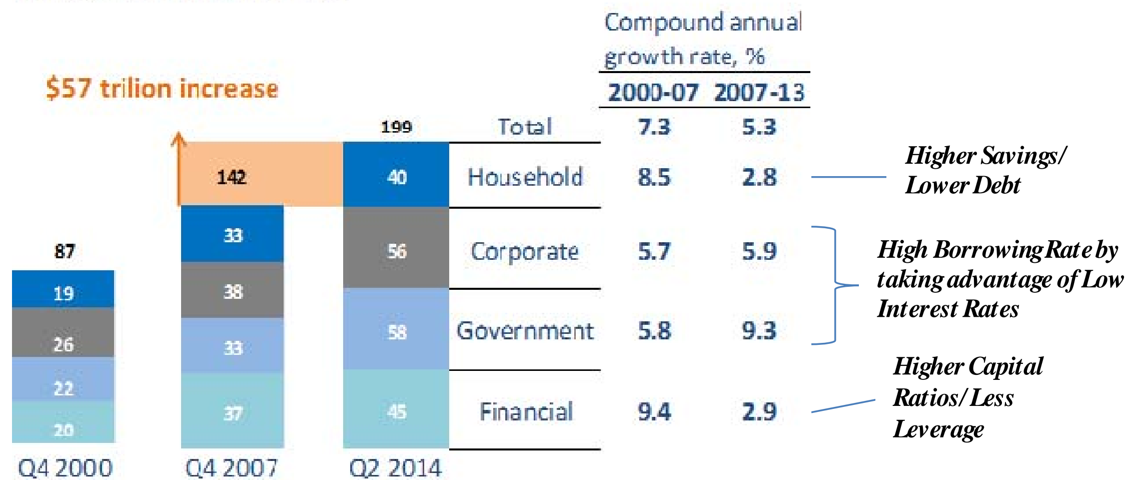
not to want to jump on that train. And if you're a pension fund trustee banking on an 8% annual return from your 60/40 portfolio over the next 7 years, all we can say is good luck! But don't check out completely because with volatility comes opportunity, and the successful investors over the next few years will need to be ready to take advantage of market dislocations and mispricing's.

Patience

The idea behind the Christian purgatory is to atone for one's sins. The investment sins we're atoning for involve excessive borrowing over the past 20 years and pulling too much spending from the future back to today. Hence, the weak economic growth we're experiencing now. Following the bursting of the credit bubble in 2008, household debt has declined as savings rates have increased (a negative for GDP), while both corporate and government borrowing rates have increased.

Since the Great Recession, global debt has increased by $57 trillion, outpacing world GDP growth.

Global stock of debt outstanding,
$ trillion, constant 2013 exchange rates



Source: Bank for International Settlements; Haver Analytics; International Monetary Fund World Economic Outlook; national sources; McKinsey Global Institute Analysis

It would appear that the cure for too much debt in 2008 has been more debt. Granted governments are generally better equipped to handle excessive debt versus ordinary individuals; however, the debt/GDP levels in many countries (i.e. China & Japan) are alarming. While we don't anticipate another '08-like crisis, the "secular stagnation" thesis is becoming more base case than previously thought. Investors will likely be rewarded for resisting the temptation to reach for return while sticking with their long-term plan. No overnight fortunes will be made in this environment, though many investors will be just fine.

Be Realistic (or Penitent)

Since 2008 investors have bid up the prices of virtually all financial assets to a point where future returns are bound to lag. Equities, bonds, real estate and collectibles are all expensive by historical comparison. At Nottingham, we steadfastly believe that starting point matters. What you pay for an asset today has a huge impact on the future return one receives from that asset. Take the table below for example. Using the Shiller P/E (a price/earnings ratio is a rough valuation measure for equities – what an investor is willing to pay for a $1's worth of earnings. The Shiller P/E looks at earnings over a 10-year period rather than the current or trailing year's earnings.), we can see that

future returns are very likely to trail historical norms. Although investors aren't necessarily fated to poor equity returns over the next 7-10 years, odds are they will trail the longer term averages

Results For S&P 500 From Different Starting Shiller P/Es 1926-2012

Starting P/E		Average Real	Worst Real	Best Real	Standard
Low	High	10 Year Return	10 Year Return	10 Year Return	Deviation
5.2	9.6	10.3%	4.8%	17.5%	2.5%
9.6	10.8	10.4%	3.8%	17.0%	3.5%
10.8	11.9	10.4%	2.8%	15.1%	3.3%
11.9	13.8	9.1%	1.2%	14.3%	3.8%
13.8	15.7	8.0%	-0.9%	15.1%	4.6%
15.7	17.3	5.6%	-2.3%	15.1%	5.0%
17.3	18.9	5.3%	-3.9%	13.8%	5.1%
18.9	21.1	3.9%	-3.2%	9.9%	3.9%
21.1	**25.1**	**0.9%**	**-4.4%**	**8.3%**	**3.8%**
25.1	46.1	0.5%	-6.1%	6.3%	3.6%

Source: Robert Shiller's Website & AQR Analysis

As suggested above, many institutional retirement plans have an assumed rate of return built in to their asset/liability equation. Given that 10-year bonds yield less than 2.0% currently, and the chart above would indicate equities may return 3% to 5% (nominal), assumptions of 7% to 8% annual returns for a blended portfolio seem out of reach. While anything can happen, and often does, today's low interest rate environment (courtesy of global central bank financial repression policies) will continue to penalize savers of all stripes.

Be Opportunistic

Despite the less than stellar backdrop for today's investor, all is not lost. With market volatility comes opportunity. There are, and will continue to be, asset classes and sectors within asset classes that are for one reason or another mispriced. The patient, analytical investor can avail themselves of these opportunities (as we endeavor to do every day here at Nottingham) when they present themselves. This may mean selling out of a position when prices get ahead of themselves, or diving into a once-dreaded asset class when it gets sufficiently cheap.

We're watching a few things today that have piqued our interest and should they cheapen up a little more, one may find them in their portfolio. If I were an owner of utilities, or heavily weighted towards the consumer staples sector, I would be very cautious right now – perhaps even to the point of booking some profits. Valuations have become a bit frothy in these sectors and while many of the companies represented here are world class, they remain just too expensive given the low growth environment we're in. In a mean-reverting world, areas such as Europe and emerging markets look very attractive right now.

Interest Rates

We touched all-time lows on both the Treasury 10-year note and 30-year bond recently. The reasons for this include global central bank quantitative easing, little global growth, low to no inflation and a flight to safety triggered by Brexit and other geopolitical issues. During most of my time as a bond trader, the 30yr Treasury yielded between 5% and 8%. Never would I have believed the yield would drop as low as 2.1%! Then again, with over 40% of the world's sovereign debt

sporting negative yields right now, 2% must seem like a king's ransom to investors in Japan and the Eurozone.

Our last letter touched on the limits of monetary policy and our belief that we have effectively reached them. It will now be up to Congress to enact some fiscal policy – whether it be infrastructure spending or tax reform – in order to revive growth here in the US. The bond market is currently priced for perfection and any hint of inflation or stronger than expected growth will likely be met by higher interest rates and material losses on longer-dated bonds. Investors should resist the temptation to chase yield and stay patient, focusing on municipal bonds in the 5-7 year range.

Conclusion

Low return environments can be extremely frustrating for investors, especially after 7 years of a bull market. Right now, both US bonds and stocks are near all-time highs, yet investor enthusiasm appears non-existent. Too many macro concerns I guess. With unemployment at 4.9% here in the US, the housing market looking up, and a hint of modest wage inflation in the offing, the US remains the cleanest shirt in a hamper full of dirty ones. Some of the other dirty shirts, however, just might prove more wearable over the next 5 years, but for today, we suggest sticking with the US.

The summer months are notoriously volatile given vacation schedules, thinly traded markets and trading desks staffed by junior associates. At Nottingham, we've banned our staff from summer vacations. Just kidding, they're actually allowed a day or so. Nonetheless, our efforts are geared toward finding that price dislocation or alpha opportunity wherever it may exist. We owe it to our clients. So as we muddle through this investment purgatory, remember to be patient, remember what got us to this point, and look to embrace volatility. Our fate has yet to be determined, and despite the rhetoric and rancor around the November election, don't for a minute believe all the negativity. The U.S is as strong economically, militarily and technologically as it has ever been and will continue to be a world leader for generations to come. Invest accordingly.

Happy summer,

Larry Whistler, CFA
President/Chief Investment Officer
July 2016

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