HIGHLAND

# CAPITAL MARKETS QUARTERLY

*4th Quarter 2014*

## UNCONVENTIONAL SUCCESS

### INTRODUCTION

Divergence is quickly becoming the financial word du jour. This idea dominates the quarterly updates we receive from managers across the industry. It seems to be plastered across all media types from newspapers to the daily cable news networks. What does it mean exactly? The idea is that growth in the U.S. is further along than most other nations around the globe. This divergence is not just an economic occurrence, but rather it permeates through to performance in capital markets, monetary policy decisions, fiscal policy decisions, etc.

Conventional wisdom pursues higher growth and surging capital markets in countries that are experiencing elevated growth. This type of thought would over allocate capital to the U.S. due to the recent strength in its economy and stock markets. Highland does not subscribe to conventional wisdom. We seek reality. Searching for reality and investing based on this view often times leads us to areas that can be labeled contrarian. We are comfortable with this unconventional wisdom. In fact we embrace it. We believe this puts us, and our clients, in the best possible position to succeed. Why? Because we spend a great deal of time searching for where the returns will be in the future instead of studying where the returns were in the past.

## THE CASE FOR GLOBAL EQUITY

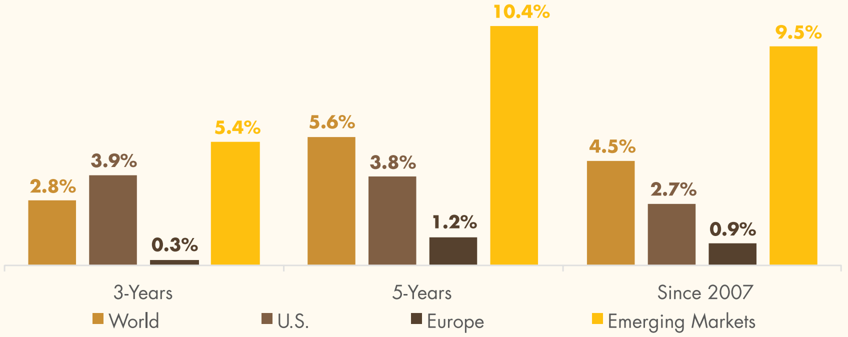
### WHAT IS THE CURRENT ENVIRONMENT?

Coming out of the "Great Recession" has not been even across all countries, as each region of the world is working through issues (see **Figure 1**). The U.S. is experiencing one of the better recoveries compared to other developed nations. The Federal Reserve's unprecedented accommodative policy measures are injecting liquidity in capital markets and propping up economic growth. Other developed nations embraced austerity during the early stages of the recovery, which has put them behind. The emerging world is still outpacing the developed nations, but the growth gap has shrunk considerably.

FIGURE 1

ECONOMIC GROWTH RATES

Nominal Growth Collected By IMF (October 2014 World Economic Outlook)



SOURCE IMF

## OUR SERVICES

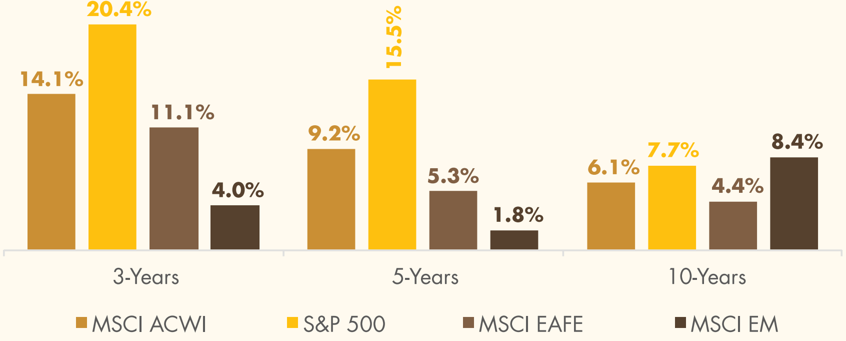
1. DEVELOPMENT OF INVESTMENT POLICY, OBJECTIVES AND GUIDELINES
2. ASSET ALLOCATION STUDIES
3. INVESTMENT MANAGER SEARCH
4. DEVELOPMENT OF INVESTMENT MANAGER PERFORMANCE STANDARDS/GUIDELINES
5. GENERAL CONSULTING SERVICES
6. PERFORMANCE MEASUREMENT & MONITORING
7. ASSIST IN FUND DIVERSIFICATION
8. RESEARCH
9. COMMUNICATIONS WITH MANAGERS
10. MANAGEMENT SUPPORT

## INVESTING FOR THE TOTAL CLIENT

- *Investment services*
- *Reporting services*
- *General support*

This divergent growth path combined with differing monetary policies produced a global equity market that experienced a large dispersion in returns. **Figure 2** shows the total returns of the global stock markets broken down by region. The U.S. (represented by the S&P 500) is clearly benefiting from easy monetary policy and higher relative (to other developed nations) economic growth. The international developed world (MSCI EAFE) is trailing the U.S. and outpacing emerging markets (MSCI EM). This shows that in an uneven recovery, the U.S. stock market is the proverbial safe haven, thus experiencing accelerated returns.

FIGURE 2 TOTAL ANNUALIZED RETURNS (AS OF 12/31/14)



SOURCES: S&P; MSCI; FACTSET

Investors who were able to determine the nature of the recovery took an overweight position to the U.S. stock market and benefited tremendously. While most U.S. investors have an overweight position in the U.S., their positioning was not determined by the nature of the recovery, rather it was determined by a phenomenon called home country bias. This means that investors naturally gravitate to their home country when investing because they are familiar with it. A report issued by Vanguard shows that U.S.-based investors invested 73% of their equity allocation in U.S. equities (Philips, 2014).

While home bias benefited most U.S. investors, the most important question is whether this positioning will pay off in the future. At Highland, we strive to invest in ways that will be the most beneficial going forward. We subscribe to the philosophy of Walter Gretzky. When teaching his son, Wayne, Walter often told him "a good hockey player plays where the puck is. A great hockey player plays where the puck is going to be." Wayne embraced his father's wisdom and became a Hall of Fame hockey player. We also embrace this wisdom and apply it to investing. We do this by sifting through the information available in order to understand the true drivers of future returns. Once we understand this, we can apply rigorous analysis to determine our next move.

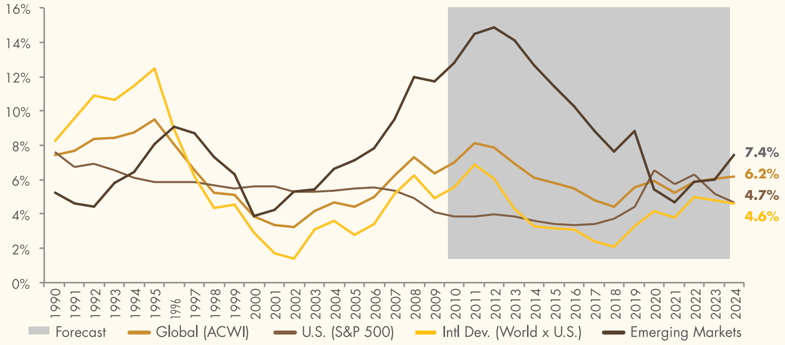
## HIGHLAND'S PHILOSOPHY: RETURN DRIVERS MATTER

If you ever listen to industry experts explain equity market returns, you will most likely hear the terms investor sentiment, earnings surprise, momentum, supply/demand, resistance, support, etc. While all of these things play into intraday price movements, Highland believes that equity markets are driven by three factors: (1) the dividends received, (2) the growth rate of earnings, and (3) the price you pay. We focus on these three drivers of return in order to determine our future expectations. Once these expectations are calculated, we understand that the absolute number is not that important. Rather the number's relation to its own history and the expected returns for other asset classes is what ultimately drives the asset allocation process.

## EARNINGS AND DIVIDENDS

When forecasting returns, Highland uses a variety of models to estimate future value. We believe this gives us a more complete picture and allows us to avoid mistakes. As for earnings and dividends (earnings growth ultimately determines future dividends), Highland utilizes two different models. First, we estimate earnings based on future economic growth rates. We believe the overall economy ultimately drives the earnings of the underlying companies. **Figure 3** shows the rolling ten-year nominal economic growth rates as provided by the International Monetary Fund (IMF). This model shows that global growth is in a downward trend and that the U.S.' higher growth is not expected to continue.

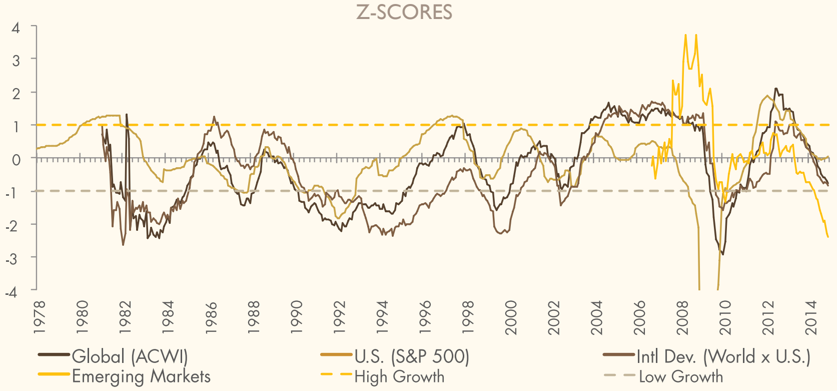
FIGURE 3 IMF ECONOMIC GROWTH 10-YEAR HISTORICAL AND FORECASTED



SOURCE IMF S&P, BLS:MSCI;FACTSET;HIGHLAND ASSOCIATES

The second model used examines long-term earnings growth rates and assumes that for a variety of reasons they are mean reverting (or earnings growth eventually moves back towards the average). **Figure 4** is a chart that shows the historical growth rate z-scores. Z-scores are the number of standard deviations away from the

FIGURE 4 ROLLING 10-YEAR EPS GROWTH RATES Z-SCORES



SOURCES: SHILLER; S&P; BLS; MSCI; FACTSET; HIGHLAND ASSOCIATES

mean a number is currently. For example, a z-score of +1 means that the current number is one standard deviation above the mean. This shows that the U.S. is currently at the average, while international markets (both developed and emerging) are below average.

## VALUATION

Although earnings and dividends are important, the price one pays plays a significant role in future returns. Just as with earnings and dividend growth, Highland uses two different models to forecast valuation. **Figure 5** graphs the z-scores for the price-to-earnings ratios using the last twelve months of earnings. This shows that the U.S. is slightly above average and that international (both developed and emerging) are below average.

The second model used is a long-term price-to-earnings ratio that was popularized by Robert Shiller in his book *Irrational Exuberance* (Shiller, 2000). This ratio uses normalized real price-to-earnings ratios in order to remove cyclicality caused by business cycles. **Figure 6** graphs the z-scores of these ratios and gives us a far different result. The graph shows that the U.S. is overvalued, international developed is slightly undervalued, and the emerging markets are extremely undervalued.

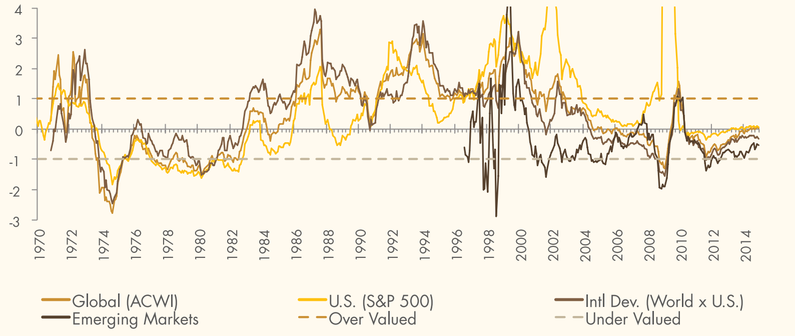
Combining all of these factors, Highland comes up with a return expectation for U.S., International Developed, Emerging Markets, and Global (which combines the three previous pieces). The absolute number is not that important; rather the number in relation to its history and the others is what is really important.

Based on our analysis, we believe each of the markets will experience below average total returns for the next ten years and the ranking from best to worst will be:

1. Emerging Markets
2. International Developed
3. Global (combination of the regions)
4. U.S.

Conventional wisdom or a good player (in Walter Gretzky's eyes) has an overweight to the U.S. market because of home country bias and it's the market that has performed the best lately. Highland's philosophy is to allocate where the returns will be higher in the future. This is why we favor a global approach that gives us exposure to markets outside the U.S., which we believe will perform better over the long-term. While this is a compelling reason to favor global, it is not the only reason. We also believe that a global orientation offers investors a larger opportunity set, less efficient markets, better diversification, and more flexibility to react to changing economic/market conditions.

FIGURE 5 TRAILING TWELVE MONTHS PRICE-TO-EARNINGS RATIOS Z-SCORES



SOURCES: SHILLER; S&P; BLS; MSCI; FACTSET; HIGHLAND ASSOCIATES

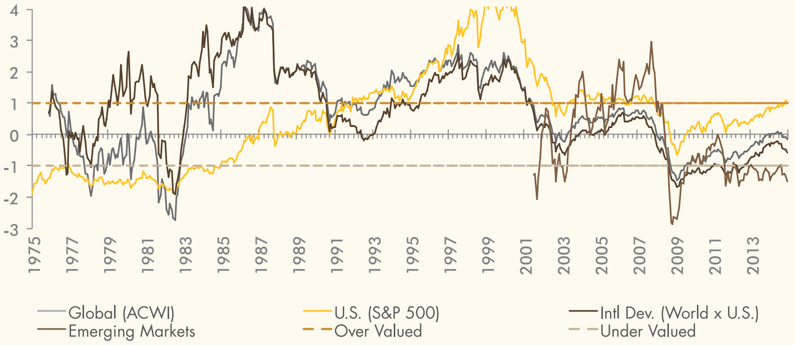
## HIGHLAND'S PHILOSOPHY APPLIED

Highland's case for global equity is just one of the ways we are using independent analysis to position portfolios for success. We use the same thought process and philosophy in every asset class in which we invest. While the individual drivers of returns are different, the overarching rigorous analysis and independent judgment based on healthy skepticism are the same.

## FIXED INCOME

The recent interest rate environment is causing much debate. Many argue over when rates will rise and by how much. These debates have made investors nervous over their bond allocations and conventional wisdom has led many to reduce core bond allocations in favor of lower duration[1] mandates (i.e. enhanced cash or unconstrained bond). Just as in equities, we analyze the drivers of return, which are the current yield and the future interest rate environment.

FIGURE 6 CYCLICALLY ADJUST PRICE TO EARNINGS RATIOS Z-SCORES



SOURCES: SHILLER; S&P; BLS; MSCI; FACTSET; HIGHLAND ASSOCIATES

In 2010 and 2011, Highland examined the future of the U.S. bond market in two different publications. "The Future of the U.S. Bond Market" studied the length of low interest rate environments post financial recessions. The conclusion was that financial recessions cause extremely long time periods of low interest rates and investors would benefit from underweighting (or allocating away from) bonds (Graham, 2010). "The Future of the U.S. Bond Market Part II" determined the optimal positioning of bond portfolios during difficult interest rate environments and determined that investors would benefit from longer duration bonds (Graham, 2011). This conclusion was completely different from the crowd and seemed unconventional; however, our analysis allowed us to position portfolios in a way we believed would reward our clients.

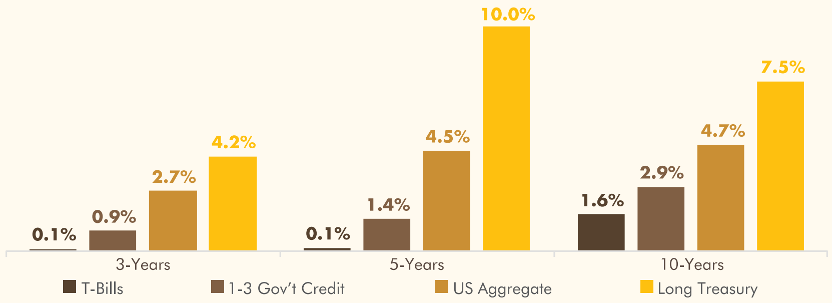
**Figure 7** shows the annualized total returns of different duration bond strategies over various time frames. In the graph, the columns are ordered from left-to-right from shortest duration to longest duration (i.e. shortest is T-bills and longest is Long Treasury). This shows that since 2010 (five years ago), the longer duration bonds have outperformed the shorter duration bonds.

The same conventional wisdom that dominates today was dominating in 2010, as yields reached levels many had never witnessed. Everyone was certain that interest rates were surely going to rise; therefore, lower duration was better. Highland was not entirely on our own in our conclusion, but our opinion was far from mainstream. Mebane Faber came to the same conclusion by examining the returns of cash versus longer duration bonds during the rising interest rate environment of 1973-1981 (Faber, Spring 2007). Applying this unconventional wisdom has allowed our clients' portfolios to benefit substantially.

## HEDGED EQUITY

Due to the recent equity bull market, many are questioning the viability of using hedged equity strategies. The crowd believes that these strategies no longer add value, so they are allocating more and more of their portfolios to traditional equity strategies. Our belief in these strategies ties into our expectation of future equity returns combined with the unexpected nature of market corrections and the ability of down markets to persist. As discussed earlier, we believe that equity markets face headwinds that could turn into difficult markets. We also believe that the current monetary policies pursued by central banks around the world are pulling forward growth in such a manner that can produce increased volatility in markets in the future. Not knowing when the increase in volatility will manifest makes investing in hedged products difficult. However, Highland believes that these types of strategies offer protection in difficult equity markets and provide diversification for a portfolio.

FIGURE 7 FIXED INCOME RETURNS
Total Returns (As of 12/31/14)



SOURCES: BARCLAYS CAPITAL; FACTSET

## INFLATION SENSITIVE ASSETS

The current environment can be categorized by low growth and low inflation. If we are in a low inflation environment, why would investors need inflation sensitive assets? We believe that investors should hold these types of assets for several reasons. First, most investor liabilities increase with inflation whether it is retirement income, medical equipment, or charitable distributions. This makes inflation a real risk to investors and many portfolios only contain assets that do poorly during times of inflation. Second, inflation is not just one number and it often occurs in pockets. Lastly, the time to add or hold inflation sensitive assets is when inflation is low. Just like the best time to purchase fire insurance is before the fire, not as your home is in flames.

We choose to allocate to these assets in a regimented approach which allows our clients to capture changing inflation rather than the absolute number. This means we allocate to a basket of investments that benefit from various types of inflation environments: real estate (rising inflation due to rising growth), commodities (inflation shocks), and inflation-linked bonds (rising inflation combined with low/declining growth – a.k.a. stagflation). While inflation is not a concern at this time, we believe that the amount of accommodative monetary policy utilized today could produce inflation in the future. Therefore, we continue to strategically use inflation sensitive assets.

## TIME HORIZON

All of the points discussed have the same underlying themes. First, we sift through the information available in order to base investment decisions on a realistic view of the world. Second, we maintain a long-term horizon. The idea of a long-term time horizon is a nebulous concept that can produce different definitions, depending on who you ask. Almost everyone believes they are long-term oriented, but what does that mean? Most investors will tell you that long-term is ten plus years, but they will evaluate their performance over three to five years.

Cliff Asness at AQR Capital Management published a report examining financial theory and time horizon. He illustrated that financial theory states that one must get a higher return when taking higher risk. He illustrated the effect of time horizon by examining returns for bonds (low risk), stocks (high risk), and commodities (high risk) over rolling five year periods from 1970 through 2014. The results showed that anything can happen over a five year period. When examining the entire period, the risk/return trade-off settles into what we all generally expect (Asness, 2014). **Figure 8** shows the results of Asness' conclusions.

Highland agrees with Asness and his assessment of time horizon. That is why we build our portfolios with an eye on the true long-term. We know that shorter time periods can cause us to question our decisions and lose our focus on how to add value. We must always remind ourselves that investing is a marathon and not a sprint; therefore, we must pace ourselves and know when and where we need to take risks.

## CONCLUSION

Success in investing requires hard work. It is not necessarily difficult, but it takes determination, resolve, attention to detail, and above all else, the willingness to put in the effort to succeed. Many are not up to the task which is why you see "rules of thumb" or conventional wisdom. Highland believes in hard work and putting in the effort in order to see the reality in the world, instead of taking the popular opinion. We believe that this is the only way to succeed, even though it is sometimes unconventional and unpopular. We are fine with that because we're not willing to settle for good. We demand great.

FIGURE 8

ORDERED BY AVERAGE RETURN

| TIME PERIOD | LOWEST | MID | HIGHEST |
|---|---|---|---|
| 1970-74 | Stocks | Bonds | Commodities |
| 1975-79 | Bonds | Commodities | Stocks |
| 1980-84 | Commodities | Bonds | Stocks |
| 1985-89 | Bonds | Commodities | Stocks |
| 1990-94 | Commodities | Bonds | Stocks |
| 1995-99 | Commodities | Bonds | Stocks |
| 2000-04 | Stocks | Bonds | Commodities |
| 2005-09 | Commodities | Stocks | Bonds |
| 2010-14 | Commodities | Bonds | Stocks |
| Full Period | Bonds | Commodities | Stocks |

SOURCE: AQR CAPITAL MANAGEMENT

[1] Duration measures a bond's interest rate sensitivity. Bonds that have a higher duration are more sensitive to changes in interest rates. Typically, a bond with a higher duration will suffer larger losses than lower duration bonds during a period of rising interest rates.

## References

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