NEWTON'S 1ST LAW AND YIELD-SEEKING BEHAVIOR

HIGHLIGHTS

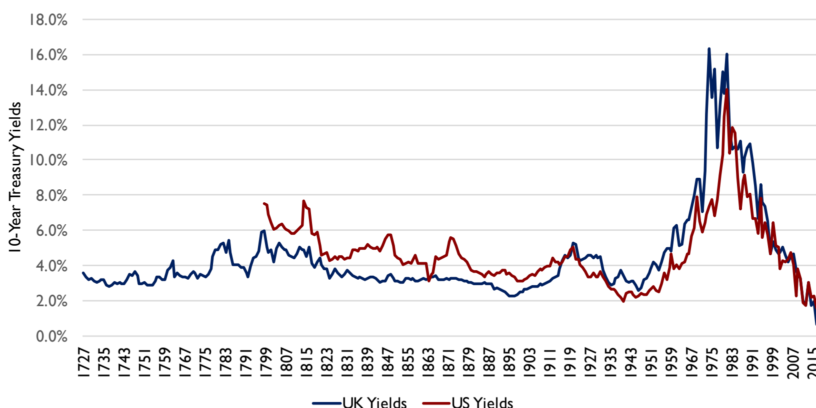
- An investor's desire for income in a world with minimal yield has given rise to yield-seeking behavior.
- Many investors are ignoring fundamentals and blindly searching for income, which is drawing them into risky investments.
- The safety of higher yields masks the risk characteristics of these bond proxies.
- Highland's asset allocation process emphasizes total return and risk mitigation over income only.

In the 17th century English physicist and mathematician Sir Isaac Newton formulated his 1st law of motion, which states that "An object at rest stays at rest, and an object in motion stays in motion unless acted upon by a force." An example of this law can be seen in the winter sport of curling, when the curler slides a stone on the ice, it will remain in motion until either the friction of the ice stops it or it hits another stone, causing it to stop abruptly.

The markets have witnessed a similar phenomenon as a constant force has driven yields lower since the Global Financial Crisis: unprecedented monetary policy. One of the intended consequences of central bank actions was to lower yields in safe assets in order to entice investors to take more risk. Central bankers have been successful in this undertaking as sovereign bond yields are at historical lows (**see Figure 1**). Central banks globally have purchased more than $25 trillion in assets since 2008. In addition, there is over $12 trillion in global sovereign debt with negative yields. With more than 70% of global government bonds yielding less than 1%, foreign buyers have flocked to higher yielding U.S. treasuries, thus driving yields lower in the U.S.

FIGURE 1

LONG-TERM YIELDS



SOURCES: GLOBAL FINANCIAL DATA; FACTSET; HIGHLAND ASSOCIATES; 10-YEAR YIELDS FOR UNITED KINGDOM AND UNITED STATES THROUGH SEPTEMBER 30, 2016

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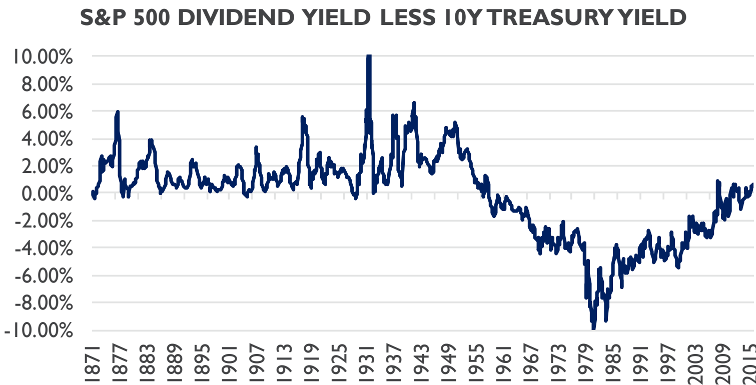
An investor's desire for income in a world with minimal yield has given rise to yield-seeking behavior. Many investors are ignoring fundamentals and blindly searching for income, which is drawing them into risky investments. Fund flows support this notion that investors are moving out on the risk spectrum with increasing allocations to high yield and emerging market debt as they continue this hunt for yield. This has resulted in a substantial decline in yields in both of these asset classes since the beginning of the year. Investors have expanded their search for income to the equity markets. With a substantial decline in the 10-year US Treasury, dividend yields on equities are comparable to bond yields (**see Figure 2**). The current spread between the equity and treasury yield is at its highest level since 1958.

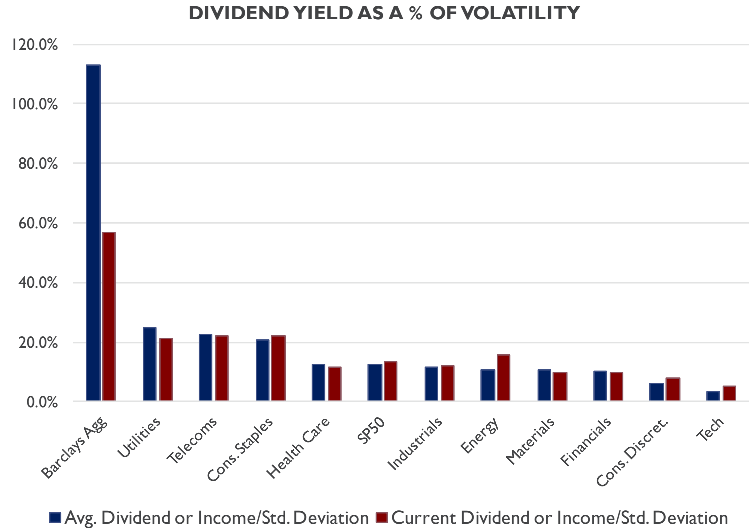
FIGURE 2



SOURCES: EMPIRICAL RESEARCH PARTNERS; SHILLER; HIGHLAND ASSOCIATES

Specifically, in U.S. equity markets, investors have sought higher-yielding sectors, such as utilities, telecommunications, and consumer staples. These historically lower-volatility sectors have lured investors based on their higher income. Investors often look at these sectors as bond substitutes due to their steady yields. However, the inherent risk in these securities is far different from in fixed income. Utilities, telecommunications, and consumer staples are five times more volatile than bonds. When measured by income per unit of risk, these bond proxies are much riskier than bonds (**see Figure 3**, higher number signals less risk). Interesting to note, as prices of these sectors have been bid up by yield-seekers, dividend yields have steadily declined, thereby decreasing investors' margin of safety.

FIGURE 3



SOURCES: FACTSET; HIGHLAND ASSOCIATES; AVERAGE AND CURRENT DIVIDEND YIELD AND STANDARD DEVIATION OF RETURNS FOR EACH SECTOR FROM DEC. 31, 1999 - AUG. 31, 2016. AVERAGE AND CURRENT YIELD TO MATURITY AND STANDARD DEVIATION FOR THE BARCLAYS AGGREGATE.

HIGHLAND'S VIEW

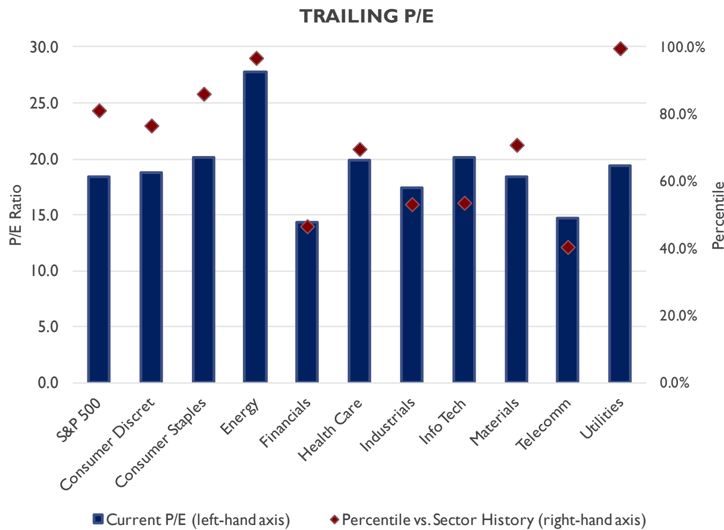
As Newton explained in his famous law, an object will stay in motion unless acted upon. Just as the curling stone eventually stopped, so too will the downward force on yields. What could cause this "motion" to meet resistance? We believe the following could put a stop to this downward trend with yields and yield-seeking behavior:

- Risk vs. reward becomes unattractive
- Rates rise
- Effectiveness of monetary policy is questioned
- Source of sustainable growth is identified

RISK VS. REWARD

With valuations at historic highs and dividend yields moving lower, Highland sees plenty of room for downside risk going forward (**see Figure 4**). Consumer staples and utilities Price-to-Earnings multiples are extremely expensive, ranked in the 90th and 100th percentiles since 1999, respectively. When valuations reach these excesses, lower returns going forward are highly probable. In fact, once valuations reach these levels, the average return for the following 1-year period is 3% for consumer staples and -1% for utilities. In addition, during those time periods of extreme valuations, consumer staples and utilities experienced double digit declines twice during the subsequent 1-year period.

FIGURE 4



SOURCES: FACTSET; HIGHLAND ASSOCIATES; S&P 500 SECTOR TRAILING P/E RATIOS FROM DEC. 31, 1999 THROUGH AUG. 31, 2016

RATES RISE

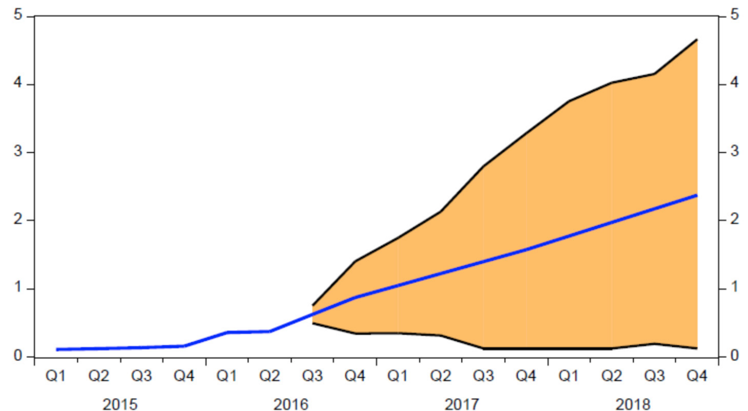
If central banks are the main reason for such low yields, then it is conceivable that their actions could also be the catalyst to drive yields higher. The U.S. is eight years removed from the financial crisis, yet we continue to question the Federal Reserve's ("Fed") usage of extreme measures typically set aside for deep recessions (***see Highland Capital Markets Quarterly 2Q16***). Since 2008, the economy has added close to 10 million jobs, leading to an unemployment rate below 5%. With the average business cycle lasting seven years, the current recovery is longer than average. Consequently, the Fed wants to get interest rates higher so they have levers to use in the face of another economic downturn. If the Fed were to raise rates, then bond proxies in particular could experience weakness.

EFFECTIVENESS OF MONETARY POLICY

Monetary policy effectiveness appears to be reaching its limits as the supply of cheap credit is plentiful, but the demand from borrowers to spend or invest is lacking. Previously when central banks enacted new monetary policy, the country's currency weakened. Equity markets reacted positively on expectations of higher exports leading to earnings growth. Lately, we have witnessed a different reaction from markets. Since announcing negative interest rates ("NIRP") in Europe and Japan, neither country's equity market is positive. Additionally, compared to the U.S. dollar, the euro has been flat since its latest cut, whereas the Japanese yen has strengthened 18%, the exact opposite of its intended effects. Further, NIRP is pressuring banks profitability, making it more difficult for banks to extend credit. The equity markets are discounting this pressure on bank earnings as Eurozone and Japanese banks are down 33% and 16%, respectively, since announcing NIRP. Monetary policy no longer yields the desired result.

Janet Yellen, Federal Reserve chairwoman, recently shared at the annual Jackson Hole conference the Fed's possible outcomes for interest rates. In her speech, she showed that there is a 70% probability that the Fed funds rate will be between 0 and 4.5% by the end of 2018. This admission to investors that the Fed can only place a 70% probability of that wide range of outcomes has investors questioning its abilities (**see Figure 5**). As investors become less certain of central banks' adeptness, then bond yields will be driven more by fundamentals and less by central bank activity.

FIGURE 5



SUSTAINABLE GROWTH IDENTIFIED

There is a growing chorus from economists and politicians that the U.S. needs to enact structural reforms to make the U.S. more competitive globally. Both Presidential candidates are calling for an overhaul in the tax code. In addition, both candidates believe we need to find a solution to getting U.S. firms' cash being held overseas back to the U.S. There have been more calls for fiscal expansion through infrastructure spending. By engaging the

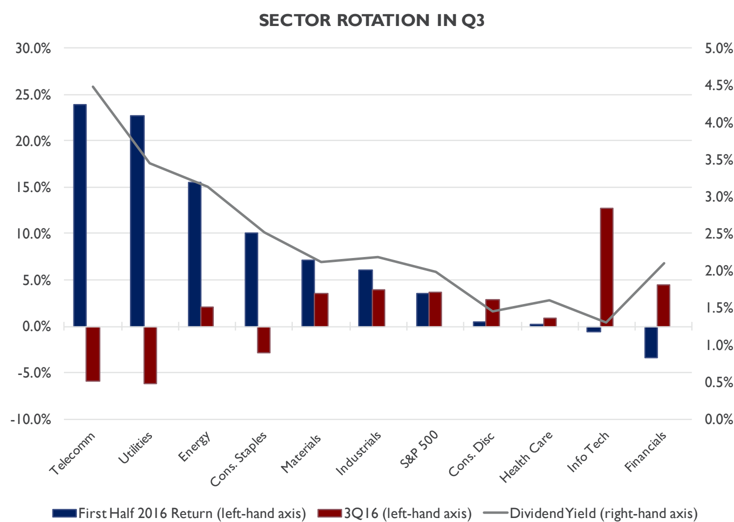
private sector to complete these projects, it is possible we could see higher business investment and an increase in productivity. If fiscal spending were to increase, this very well could result in a rise in growth and inflation, thus hurting bonds and bond proxies.

MARKET ACTION

Sector returns in the first half of 2016 had a strong relationship with the dividend yield (**see Figure 6**). Although the S&P 500 generated positive returns during that time period, it was primarily driven by utilities, telecommunications, and consumer staples. These sectors collectively only account for 16% of the S&P 500, yet they had an outsized impact on the market.

However, the chase for yield that dominated the first half of 2016 has begun to reverse in the third quarter. Telecom and utilities, which led the market the first half of this year, each declined 6% in the quarter. The safety of higher yields masks the risk characteristics of these bond proxies. With valuations stretched and as earnings outlooks become increasingly subdued later in the year, returns from income may be overshadowed. Investors appear to be rotating out of the income substitutes and into more cyclical sectors, such as information technology and financials. This rotation could place more pressure on bond proxies going forward.

FIGURE 6



SOURCES: FACTSET; HIGHLAND ASSOCIATES; S&P 500 SECTOR RETURNS AND DIVIDEND YIELDS THROUGH AUG. 31, 2016

In this ***Triple L*** Environment of ***low*** growth, ***low*** yields for a ***long*** time, Highland's view is to avoid following the fads du jour. We feel the current "income fad" carries more downside risk than upside for investors. Income is just one component of returns. The price you pay is the most important factor in your expected return. A vital risk measure is whether owning a certain investment can result in a permanent impairment of capital. With valuations in bond proxies approaching historical highs, Highland feels these risks are elevated.

Institutional investors are faced with meeting a long-term, total return objective. Whether it is covering the cost of debt, meeting an actuarial return assumption, or targeting a spending policy, all objectives are total return in nature. Therefore, Highland's asset allocation process emphasizes total return and risk mitigation over income only. The overarching goal is to invest in a group of assets that will outperform in any type of market environment. For example, even with bond yields at historical lows, it is prudent to still own them as they remain a good source of protection in any type of "risk-off" environment. In addition, we recommend having a strategic allocation to equites. These are held for growing the portfolio, not for their income. We also favor equity managers that focus on the fundamentals and avoid overpaying for companies. We feel this orientation leads to long-term value creation. Lastly, we believe it is prudent to own assets that will benefit from a change in inflation and thus protect the portfolio's future purchasing power. By taking a holistic approach to investing, this prevents trend-following follies and provides investors multiple sources of long-term returns.

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