Colony Market Perspectives

In This Report

Brian Katz, CFA
Chief Investment Officer

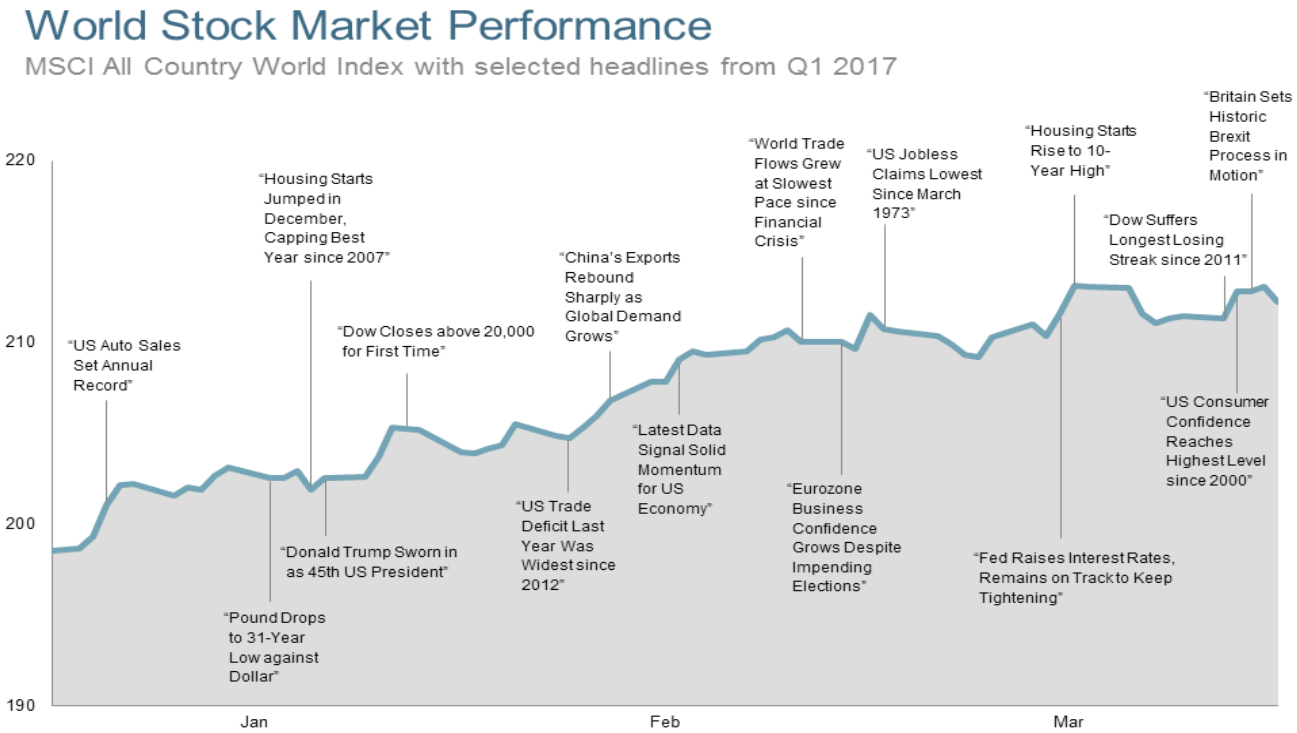
Introduction

The positive momentum in the markets that began following the November 2016 presidential election continued through the first quarter of 2017 as the S&P 500 returned 6.1%, its strongest quarter since the end of 2015. Interestingly, many of the sectors and stocks that performed well at the end of last year – those that were perceived to benefit from President Trump's agenda – were among the worst performers during the first quarter. This phenomenon may reflect investors' fading optimism regarding the new administration's ability to pass its legislative agenda. International equities, which lagged during the fourth quarter of 2016, outperformed U.S. stocks, with the MSCI All Country World Excluding U.S. Index returning 7.9%, its best performance since the first quarter of 2013.

Fixed-income ended the first quarter with muted gains, a modest improvement from the negative returns reported last quarter. Long-term interest rates generally were unchanged during the quarter despite the Federal Reserve raising short-term interest rates in early March, only the third hike since the financial crisis ended. Investors continue to watch the Federal Reserve closely, searching for clues as to how aggressively the Fed will raise rates this cycle.

Active vs. Passive – Why Settle for Only One?

There are few investment topics that are as polarizing as the decision to use active or passive investment



These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

Graph Source: MSCI ACWI Index [net div.]. MSCI data © MSCI 2017, all rights reserved.
It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. **Past performance is not a guarantee of future results.**

strategies. The debate between whether to invest with a manager that aims to beat an index benchmark (active) versus one that intends to match it (passive) has reached a fevered pitch following a period of underperformance by some active managers that has led a subset of investors to conclude that active management is dead.

We believe that the novel and unorthodox policies put in place following the financial crisis created an environment that sustained some passive managers. The uncertainty surrounding these policies caused investors to become hypersensitive to communication from policy makers and trends in economic data. This created a binary investment landscape, commonly referred to as risk-on/risk-off, which manifested itself through uniform, often forceful fluctuations in risk assets. As the Bank for International Settlements (BIS) noted in its March 2017 Quarterly Review, "In a global environment devoid of growth but plentiful in liquidity, central bank decisions appear to draw investors into common, successive phases of buying or selling risk." Indeed, during the last seven years, correlations across and within asset classes have been abnormally high.

As time passed, the proliferation of passively managed strategies became a self-fulfilling prophecy. Since 2008, investors have net redeemed nearly $2 trillion from active managers (cumulative net flows) while adding more than $750 billion to passive managers. As passive managers invested this cash flow, the price of securities within the index were pushed higher. Conversely, redemptions from active managers depressed the price of stocks commonly held by active managers. This exacerbated the performance advantage for passive investing as more investors chased performance and capitulated on active management.

While The Colony Group selectively utilizes both strategies, we believe that the environment moving forward may generally favor active management. The most widely used index funds are capitalization weighted, which means that the largest companies receive the greatest weight in the index. The result is a momentum bias within the index caused by managers allocating more capital to stocks that experience the greatest relative price increases. This, in turn, can lead to the price of select stocks within (or excluded from) the index to become mispriced relative to their fundamental value, creating an exploitable opportunity for active managers to outperform.

What this means – We believe that a hybrid approach using both active and passive strategies is ideal and see benefits from allocating to both strategies. Most obviously, passive funds remain less expensive than active funds. Yet, the relative performance of active managers versus passive managers appears to be cyclical. A recent study by the Hartford Funds showed that over the past 32 years (1985 – 2016) active large blend funds, considered by many to be among the most efficient segments of the domestic equity markets, outperformed S&P 500 index funds 47% of the time. The period was marked by long winning streaks followed by losing streaks. For example, from 2000 to 2009 active outperformed nine out of ten years, followed by the most recent period of underperformance that saw passive outperform six out of seven years from 2010 to 2016.

We believe that proclamations of the death of active management based on this most recent streak are premature. We see the equity landscape moving forward becoming more conducive to disciplined, active-management outperformance. That being said, timing the cycles of relative performance between the two is difficult, if not impossible. Thus, an approach that combines the two should allow for better relative performance over longer periods of time while also lowering the aggregate cost of portfolio management.

The End of an Era?

Perhaps the most unheralded bull market in modern investment history occurred in a security generally considered to be conservative and stable: U.S. government bonds. The U.S. 10-year Treasury bond yield reached a high of 15.85% in the fall of 1981. For the next 35 years, interest rates steadily declined, reaching a low point of 1.36% last July. This provided a huge tailwind to returns, as bond prices move inversely to the direction of interest rates.

A combination of factors drove this sustained period of declining interest rates. First, the starting point for interest rates back in 1981 reflected a historically high inflationary backdrop. In addition, the 35-year period included the savings & loans crisis of 1990, the dot-com bubble bursting in 2000, and the Great Recession of 2007-2009. The Federal Reserve's response to each of these episodes was to ease monetary policy by cutting interest rates. Another catalyst for declining interest rates was the rise of global trade. China's admittance into the World Trade Organization sparked a deflationary wave globally as the private sector moved to take advantage of China's large pool of cheap labor.

Many of these factors look set to reverse moving forward. For starters, inflation today is almost a mirror image of the record high levels of 1980. In fact, inflation has run below the Federal Reserve's target rate of 2% since 2010. Second, the Federal Reserve evidently would like to put some distance between its target rate and the zero lower bound so that it has some ammunition to fight the next recession. Lastly, a rising tide of populism has sparked an increase in support for protectionist policies that are inherently inflationary.

We believe that interest rates in the U.S. reached an inflection point last July and that they are currently in a bottoming process that will lead to a secular period of rising yields. Importantly, while cyclical

inflationary forces are rising, there are longer-term structural factors that lead us to expect that inflation will not rise to excessive levels over the intermediate term. As such, the rise in interest rates should be gradual. Returns from bonds in a gradually rising interest rate environment may be lower than what investors have come to expect but should not impede clients from achieving their investment goals.

What this means – We expect that returns from fixed income may be lower over the next several years. Nevertheless, rising interest rates are not a reason to avoid the asset class altogether. Our return expectations should adjust higher as rates start to rise over the coming quarters.

We are finding opportunities for clients in non-traditional sectors of the fixed-income market. Regulations coming out of the financial crisis materially altered the banking sector's business model, creating openings on which investors can capitalize. For instance, over the past several months, we have sourced new ideas in private credit, mortgage-backed securities, and alternative lending that we think will perform better in a rising-interest-rate regime. We are optimistic that our clients' portfolios are well positioned given our outlook.

Conclusion

The most successful investors maintain a balance between discipline and flexibility. Having a well-defined investment philosophy and the conviction to stick to it, even in periods of relative underperformance, is crucial to long-term success. At the same time, investors must adapt their process to the always changing investment landscape. The evolution of our approach, joining active and passive approaches and sourcing non-traditional strategies within the fixed-income asset class, are examples of this adaptability.

Colony Spotlight

- Twenty-two Colony financial counselors were recognized in the 2017 list of "Five Star Wealth Managers" compiled by Five Star Professional.
- Nadine Lee, Managing DIrector & President of Colony Family Office, served as a guest speaker on the topic of "How to Plan After the Loss of a Spouse" at an event hosted by the New York Historical Society.
- Our South Shore team in Massachusetts moved into a larger office space in Hingham, MA to better accommodate the growing needs of our clients and employees.
- Jones Barclay Boston joined our team, adding our newest office location in Denver, Colorado and expanding our expertise, specifically in serving professional athlete and entertainer clients.

The Colony Group