IN THIS REPORT

What a Decade it Was! | 2
We look back at the decade that was and explain why investors should temper their expectations for the 2020s

Colony Spotlight | 4
- Colony's new book for business owners
- Retirement Is a Whole New Ballgame Under the SECURE Act

The Colony Group

MARKET PERSPECTIVES

QUARTER FOUR 2019

What a difference a year makes! After a rough end to 2018, when U.S. stocks recorded their first down year since the recovery started, investor sentiment was at a low point. Many economists were forecasting a recession for the coming year.

Fast forward to today. Global equity returns for 2019 were the strongest since 2009, with the MSCI All Country World Index returning +26.6%. Once again, U.S. equities outperformed international equities, with the S&P 500 Index returning +31.5% compared to the MSCI All Country World ex-USA Index at +21.5%.

Reflecting on these past two years of equity returns highlights how disconnected the economy and the markets sometimes become. In 2018, the U.S. economy experienced relatively strong growth and earnings were solidly positive, but stocks generally declined. 2019 was a mirror image in that economic growth slowed and earnings growth was flat to negative, but the equity markets' returns were exceptional.

The fixed-income markets also generated some excitement last year, posting returns well above their historic averages. The Bloomberg Barclays Aggregate Bond Index returned 8.7%, easily its best performance of the recovery. Interest rates declined as central banks around the world joined with the Federal Reserve to cut policy interest rates. The credit markets outperformed, with the Bloomberg Barclays Intermediate Corporate Bond Index returning +10.1%, as spreads relative to government bonds tightened after widening significantly in December of 2018 (spread is the difference in yield between two bonds of the same maturity but different credit quality).

We thought it would be productive to review for you the decade that was and its potential implications for the decade that will be. We are hopeful that you will find value in reading it.

Colony Investment Leadership Team

BRIAN KATZ, CFA

President of Colony Investment Management & Chief Investment Officer

RICHARD D. STEINBERG, CFA

Chief Market Strategist & Co-Chair, Colony Investment Management

JASON BLACKWELL, CFA, CAIA®

Chief Investment Strategist

What a Decade it Was!

Following a decade of exceptional U.S. equity returns, many investors expect more of the same for the new decade, which is a cause for concern to us. In this quarter's *Perspectives*, we look back at the decade that was and explain why investors should temper their expectations for the 2020s.

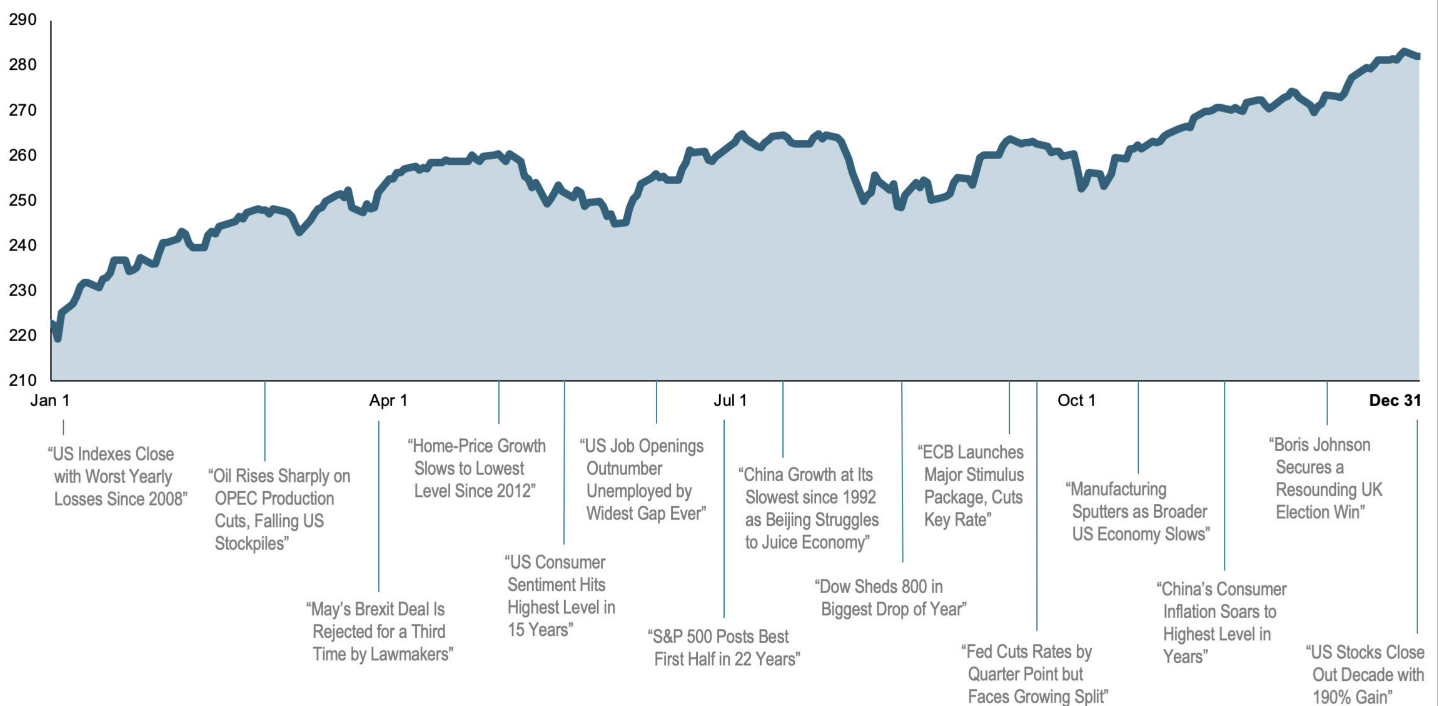
Focusing first on the equity markets, we were struck by the difference in returns for the 2010s relative to the 2000s. Indeed, U.S. equities, as measured by the Dow Jones U.S. Total Stock Market Index, generated a compounded annualized total return of -1.8% during the 2000s, a decade that included two of the most severe bear markets in history. The most recent decade, on the other hand, saw U.S. equities produce a +13.4% annualized return, well above historical averages. If you push the start date back several months to March of 2009, the bottom of the last bear market, the return rises to a gaudy 17.1%.

A combination of factors contributed to these strong returns. First, easy financial conditions engendered by central banks' interest-rate cuts and security-purchase programs (a/k/a quantitative easing) pushed valuations higher. Earnings growth was a material contributor as well, accounting for nearly nine percentage points of the 13.4% annualized return, negating the premise that the equity markets' recovery has largely come from expanding valuations.

The strong earnings growth experienced by domestic companies helps explain some of the considerable difference in returns between U.S. and international equity markets. The MSCI All Country World ex-USA Index returned 5.0% over the past ten years, less than half of what the U.S. equity markets returned. A combination of slower earnings growth, less valuation expansion, and a rising dollar all conspired against international equity markets. The trade-weighted dollar increased almost 25% over the past decade, proportionally reducing the value of international investments.

The fixed-income markets also performed well. Central bank policies designed to mollify the impact of the financial crisis pushed interest rates to unprecedented low levels, moving bond prices higher. Higher bond prices helped augment the total return from bonds that were otherwise anchored by the low level of yields. Corporate bonds and credit instruments performed better as wide spreads relative to government bonds – which were necessary to attract investors who were still fearful of the financial markets following the financial crisis – narrowed throughout the decade as the economy recovered. While overall bond returns were consistent with their historic averages, we believe their performance deserves praise when considering the lower than average starting point for yields; as yield typically comprises the lion's share of returns for the asset class.

MSCI ALL COUNTRY WORLD INDEX WITH SELECTED HEADLINES FROM PAST 12 MONTHS



These headlines are not offered to explain marketplace 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: MSCIACWI Index [net div.]. MSCI data © MSCI 2020, 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.**

The common theme when considering returns for stocks and bonds over the past ten years is the outsized role that fiscal and monetary policy played in contributing to returns. Policymakers were explicit in their goals of both boosting asset prices and keeping the economy from falling further into contraction. This contrasted with their response to the Great Depression, when officials tightened monetary policy, causing the downturn to accelerate. Many economists question the long-term consequences of today's policies, but that's a topic for a future *Perspectives*.

The aggressive policy response, however, was not a panacea for all asset classes. For example, most commodity markets experienced declines during the decade due to a combination of subpar economic growth and a strong U.S. dollar. In addition, many alternative investments struggled to generate meaningful returns, as low interest rates and low volatility rendered some strategies less effective. In addition, we believe that easy monetary policy made it more challenging for active managers to earn excess returns relative to their benchmarks. The rising tide of liquidity seemed to lift all boats regardless of the investment merits. Investors piled into index funds, without having to discern amongst good and bad securities, causing the passive vs. active debate to become a self-fulfilling prophecy as investor flows proportionately benefitted the largest index constituents.

WHAT THIS MEANS

It's not a bold call to predict that the next ten years will not be the same as the previous ten. Strong returns across most asset classes were buoyed by aggressive monetary and fiscal stimulus to a degree never before seen by the world. While we expect monetary policy to remain accommodative for the foreseeable future, there are several reasons we believe returns will be lower over the coming decade.

A primary concern for investors today is that many asset class valuations appear stretched. While there are segments of the global equity markets that carry attractive valuations, such as small-cap value and emerging markets, valuation measurements for the broader markets are flashing yellow, indicating that stocks generally are rich. This is especially true for large-cap U.S. stocks. As for bonds, yields are low on an absolute basis and relative to inflation, another sign of elevated valuation. While valuation is a notoriously bad short-term timing indicator, its track record for forecasting market returns many years out is quite good.

Another reason this decade may experience lower returns than the last is that policy makers may be running low on ammunition. Interest rates are near zero and, in some countries, negative. Academics question the effectiveness of negative interest rates. Indeed, Europe and Japan have struggled to stimulate growth despite maintaining negative policy rates for years. While unconventional policy tools such as quantitative easing remain an option, there are concerns that central banks may not have interest rates, arguably the most important monetary policy tool, at their disposal the next time the economy turns down.

Fiscal stimulus may also be restrained during the next downturn. Government debt is at record highs relative to global gross domestic product (GDP). While economists continue to debate whether there are limits to the extent a country could expand its outstanding debt, the inevitable rising cost of servicing this debt is causing some policymakers to pause.

Lastly, without a material pickup in global growth, earnings may struggle to grow at the same pace they did during the 2010s. Earnings-per-share growth averaged about 8.9% last decade. Revenue growth contributed to under half of that growth. The remainder came from profit-margin expansion and share buybacks. With profit margins sitting near historic highs and politicians considering restrictions on companies' ability to repurchase their own stock, it is unlikely that these two factors' contribution to growth will be as strong moving forward.

All these reasons become more concerning when considering the longevity of the current economic cycle. This summer, the expansion became the longest in history. We know from history that expansions don't last forever. As such, the likelihood of experiencing a recession during the next decade is high. With valuations elevated and policymakers' toolkits potentially diminished, it is more likely that the next recession will coincide with a bear market.

Conclusion

As we outline above, the past decade produced exceptional returns. We did not, however, discuss what we believe was the most extraordinary aspect of the past ten years: their uniformity. It's rare to have a period this long without experiencing a full business cycle (recession and expansion), market cycle (bull and bear), and/or interest-rate cycle (rising rates and declining rates). The 2010s experienced only an economic expansion and, for U.S. stocks, a bull market.

We are cautious about drawing definitive conclusions from a decade that was seemingly different from prior ones. Instead, we prefer to evaluate investments over a "full market cycle," which includes both sides of a cycle. Cycles do not adhere neatly to the calendar.

We know from more than 100 years of history that markets have up and down cycles (the last decade notwithstanding); however, for individuals whose investment objectives remain relatively steady, a disciplined plan of investing in a diversified portfolio should increase their chances of success in achieving their goals.

See Colony Spotlight on page 4.

COLONY SPOTLIGHT

▸ The Colony Group's New Book

It's never too early to start planning for life after the sale of a business. Colony's new book, *Your Next Adventure*, will help business owners prepare for a future filled with potential, purpose, and satisfaction.

In our book, Marshall Rowe, President, Business Owner Services; Jim Fitts, CFP®, Managing Director, Business Owner Services; and John Weeks III, CExP™ Managing Director, Family Wealth & Business Transition Planning, show business owners how to craft a robust transition strategy that considers business, personal, familial, and community needs.

Read more about the books we've written to help you achieve your financial goals:
www.thecolonygroup.com/books

▸ Retirement Is a Whole New Ballgame Under the SECURE Act

The Setting Every Community Up for Retirement Enhancement (SECURE) Act, recently passed by Congress, contains several important changes to longstanding retirement laws. Sean Kelly, CPA, Senior Tax Manager, outlines how they may affect you.

Read full report, here:
www.thecolonygroup.com/secure-act

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