4Q 2015 Market Insights
The Great Minority
Michael Paciotti, CFA

"Whenever you find yourself on the side of the majority, it is time to pause and reflect."
- *Mark Twain*

In the recent past, US equity markets have dominated the headlines and performance tables. Since the 2009 lows[1], the S&P 500 has advanced 230%, 104% more than international developed equities, 134% more than emerging markets equities and 244% over and above the gains of real assets (i.e. commodities). As the gap has grown, so too has the media frenzy relating to why the US is, and should remain, the dominant asset class. Talk has turned from basking in the glow of strong investment results, to questioning the benefits of including non-US assets in investment portfolios otherwise known as good old-fashioned diversification. Many point to the strength of the US economy, mild but positive inflation, and low interest rates as positive indicators, while Europe and the emerging world slog their way through a series of economic and geopolitical issues. US market proponents stop to take pride in the strength of our dollar and its position as the safe haven currency. As we marvel at our own greatness and clear superiority, is it possible that it is nothing more than an illusion or a convenient truth that we are all too eager to buy lock, stock, and barrel? That is not to argue the great economic super power that we are. US markets certainly offer stability of currency, interest rates and inflation that others do not. These facts are beyond reproach. However, as difficult as it is to believe, as hard as it is to imagine, fundamentally the US cannot be the source of sustained long-term outperformance for its equity investors mostly because we are superior and everyone knows it.

The Risk Argument

In investing, there are few things as irrefutable as the connection between risk and return. Taking single security risk out of the equation since it is generally uncompensated; return is simply the reward for the risk you take. The more risk an investor takes, the greater the potential upside. The argument about US equity dominance due to economic superiority is the same argument that many use when comparing growth versus value stocks. The growth stock universe is comprised of companies that are often from dynamic industries that are growing their earnings at a rapid pace. When compared to their value counterparts, growth companies typically carry low debt loads, while their balance sheets tend to be free from material deficiencies. By contrast, value stocks are those that have fallen on hard times, are often in mature industries, or are facing other adverse conditions or circumstances. As a result of these bumps and bruises, the market has discounted their prices, much like a dented can at the super market. Which is the long-term outperformer, the glamour growth company or the bruised and battered value stock? The answer is the less-than-perfect value stock. The reason is for all of the wonderful characteristics of the growth stock universes, dynamic industries that may even be in the media spotlight, high-growth rates, and better balance sheets -- these attributes command top dollar. By commanding a premium price, growth stocks are typically unable to keep up with value stocks over long periods (there are exceptions that relate to valuations, but that is out of scope for our purposes). The same argument can be made here with regard to US equity markets. Are strong and stable economic growth, low interest rates and inflation plus a stable currency, characteristics that most would want to acquire? They most certainly are and therefore command a premium price. That premium price today impinges future equity market performance. Take two identical, but hypothetical businesses. Both produce $1mm per year in earnings. You can buy one for $5mm and the other for $10mm. Which is the better deal? Clearly the one for $5mm because your return is higher because the price that you pay relative

[1] March 9, 2009 – August 31, 2015

to the earnings that you receive is lower. I know, but what if things are not equal? They are not in the value vs. growth stock comparison. Large growth stocks have historically grown earnings at 6.79% per year vs. 5.52% for value stocks and yet value stocks still win the performance race. $1 invested in each in 1979 would have produced $65 if invested in value stocks, but only $46 if invested in growth stocks. Price matters more than almost anything. Collectively, investors are pretty keen observers of the obvious or stated. In fact, they tend to extrapolate today on a linear plane to an unreasonable future destination. The fact that we are the world's largest and most stable economy, that our capital markets system is established, stable and includes investor protections is exactly what reduces the future risk premium on US stocks.

The Economic Argument

The economic argument is similar to the one used with emerging markets several years ago. Back in 2007, many pointed to the fact that the emerging world was growing at a double digit pace, while developed Europe and the US slogged through low single digit growth. It was therefore argued that the multi-year run of emerging markets equity performance would continue --it did not. What most overlooked was valuation. Emerging markets equities were saddled with a high valuation, as most investors knew the growth story and were willing to pay up for it. By examining table 1, we see that the economic argument falls apart. Those environments with the highest economic growth rates, quintile 5, produced annualized returns of 5.47% on average over the next 5 years, while those periods with the slowest growth produced average returns of 11.49% over the next 5 years. The reason, when the current economic climate is weak, it typically allows for upside surprise and valuation multiples that might be depressed to expand on the basis of better than expected economic news.

		5 Year Average Return	5 Year Median Return	Standard Deviation of Returns
Low GDP Growth	Quintile 1	11.49	11.93	6.47
	Quintile 2	7.65	9.01	8.76
	Quintile 3	6.02	8.89	7.23
	Quintile 4	4.55	5.20	6.11
High GDP Growth	Quintile 5	5.47	4.82	5.64

Table 1 - The table above details the relationship between US GDP growth and equity market performance over the next 5 years. As we can see, the highest growth environments have historically led to equity market performance that is ½ that of low growth environments.

Quintile	Adjusted P/E	Average 10 Year Forward Return	Standard Deviation of Returns	Downside Boundary (97.5% Probability or Better)
1	28.34	3.68	3.82	-3.96
2	19.53	8.03	4.02	0.00
3	15.80	11.21	4.59	2.03
4	12.19	13.41	3.54	6.34
5	9.44	15.57	3.05	9.46
Average	**16.96**	**10.44**	**5.66**	**-0.87**

Table 2 - The table above explains the relationship between US equity valuations and performance over the next 10 years. High valuations have historically led to poor equity market performance and vice versa.

Source: Factset, S&P, iCM Capital Markets Research

The Current Valuation Argument

Perhaps the most compelling point for non-US assets lies in the valuation argument. As we mentioned earlier in this article, at a certain point little matters more than price (valuation). As valuations rise, returns over the next ten years tend to decline and vice versa. We are not talking about a minor decline here folks. The difference is that your average return for the next decade could be 3.68% when you are expecting 10.44% (Table 2). In real dollar terms this is a $1mm difference. That is, if you start with $1mm and invest it for a decade at 3.68% per year versus 10.44% per year the difference in terminal value would have been $1mm. Your portfolio would have hypothetically grown to $1.4mm, instead of the $2.5mm that you were expecting. When valuations climb as they have for US stocks, it comes at the direct expense of future returns.

The last point that I will make as it relates to valuations is with regard to probabilities. Charts 1 & 2 plot the relationship between historical valuations and the out or underperformance of both commodities futures and emerging markets equities, as compared to US equities over the forthcoming 5 years. When each asset is inexpensive (at least 1 standard deviation undervalued) relative to the US, as is the case today, there have been zero historical instances where the US has won the performance race over the next 5 years. In fact, both emerging markets equities and commodities futures have historically outperformed the US by nearly 10% per year or more over those next 5 years.

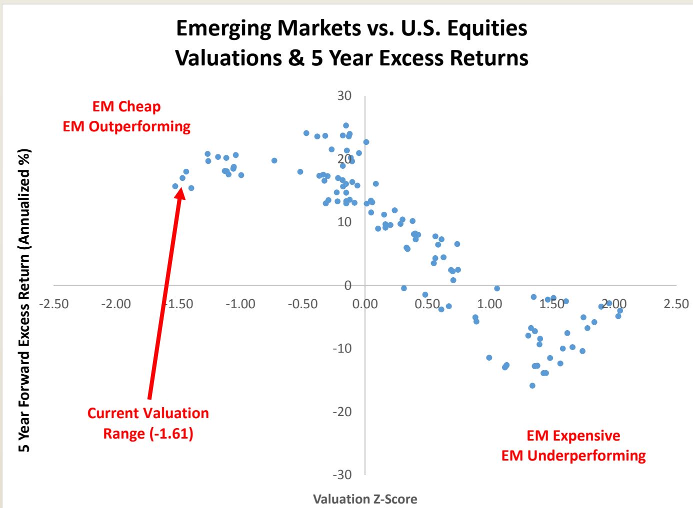

Chart 1 – Details the relationship between historical valuations and the subsequent returns over the next 5 years of emerging markets equities and US equities. As one can see, when emerging markets are at least 1 standard deviation undervalued vs. the US (z-score of minus 1 or less) there have been zero instances of underperformance over the next 5 years.

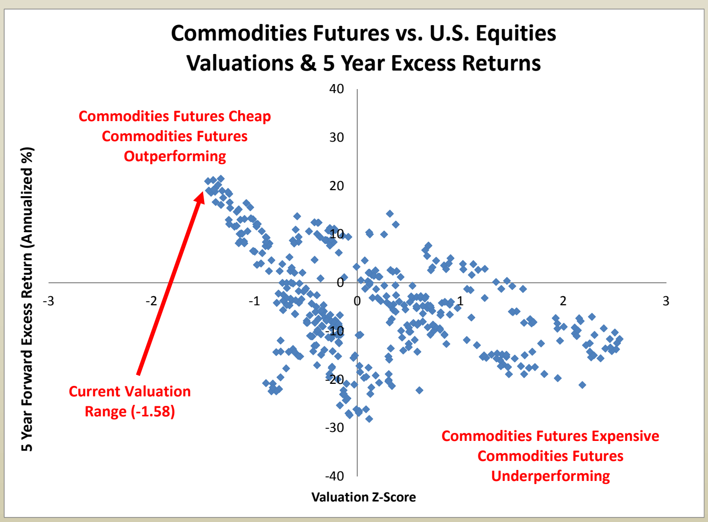

Chart 2 - Details the relationship between historical valuations and the subsequent returns over the next 5 years of commodities futures vs. US equities. Like the example above, there have been zero instances of underperformance over the subsequent 5 years when commodities futures are at least 1 standard deviation undervalued to the US (z-score of minus 1 or less).

Source: Factset, MSCI, Bloomberg, iCM Capital Markets

<u>Conclusion</u>

As is virtually always the case during the formation of bubbles, near-term performance breeds media attention, which in turn furthers the formation of the bubble. This result is common. Recent cries for concentration in US assets and questions over the benefits of diversification are not unique to this current market environment. In fact, we have seen this very same movie immediately preceding 1999 and it did not end well. The longer the US or any asset continues to outperform, the more inevitable the conclusion becomes. That is, it will eventually trail, and for that matter, trail so spectacularly that it will become appropriately priced for its given level of risk. If not, small companies would merge to become big, just for the sake of being big, if that was the key to superior equity performance. Foreign companies would move assets to the US if the equity of their shareholders would be enhanced by such a move. There is no silver bullet in investing and certainly no answer that applies in all circumstances. Risk and return are forever linked. Superior economic conditions, stability of currency, and political climate are all factors that make an investment less risky. Any asset carrying less risk cannot provide sustainable long-term outperformance over assets carrying less stable characteristics and correspondingly more risk. Today, all of these wonderful characteristics are sought after by investors in US markets and bid up to premium levels. This is a direct headwind to US equities and stands to further reduce future returns. As such, we have and continue to believe that we are ahead of this curve and properly positioned for the journey that lies ahead. We believe that risk matters, trees do not grow to the sun, and that certain long-standing investment practices like fundamental valuations matter most. Thank you for your trust and confidence.

Integrated | Capital | Management

410 Spruce Street, 4th Floor, Scranton, PA 18503
Phone: (570)344-0100, Email: info@icm-invest.com
www.icm-invest.com