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ADVISORINTELLIGENCE

Litman Gregory Fourth Quarter Research Q&A

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Each quarter, we hold a live webinar to address questions from clients about our investment views and current strategy. Among other topics, we discussed portfolio performance and our investment discipline, the key underpinnings of our strategic positioning, the performance of alternatives in 2016, and our thoughts on commodity-related investments.

Performance and Investing Discipline

Over the past several years your standard active model portfolios have had difficulty keeping up with their benchmarks. This has been an extended period of underperformance for you. Are you contemplating changes?

> We are not planning any changes to our investment approach as it applies to our Active portfolios. We always strive to improve, broaden, and deepen our knowledge and investment expertise (our circle of competence, as Warren Buffett would say); learn from our mistakes and the mistakes of other investors we study; and remain flexible and open-minded in our thinking and analysis, understanding that history does not exactly repeat.
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> However, at our core we will never waver from our bedrock belief that in order to achieve *long-term* investment success you must have a sound and sensible investment process that you *consistently* execute over time—a process you stick to through the inevitable market cycles, relative performance cycles, unexpected macro shocks, and whatever else the world throws your way. In other words, you must have an investment discipline.
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> Without a discipline, you are at the mercy of the markets—the interplay between our normal human behavioral tendencies and biases and financial market volatility that is almost certain to drive you to make poor investment decisions over time.

Can you please discuss further the discipline you follow at Litman Gregory?

> Our discipline at Litman Gregory is rooted in global diversification; risk management; in-depth investment due diligence; and fundamental, valuation-driven asset class analysis across multiple scenarios and time horizons.
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> Over the long term, by applying our discipline, our portfolios have generated excess returns over their benchmarks. And we have no doubt that our research team and process has only gotten deeper and better over the past twenty years.
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> Disciplined, valuation-driven investment approaches have outperformed over the very long term. Valuation really does matter—current valuation is a very strong predictor of future long-term returns. We think that will remain the case. Of course, value approaches don't work all the time or over all time periods. No investment approach does. It's easy to stick with something when it's "working"—when it's been outperforming. But the critical time to stick to your discipline is when it is *not* working.
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> It is during those periods when most people are their own worst enemies and throw in the towel, sell when prices are lower, and then buy into whatever asset classes or managers have been

working—buying high. Pretty much every study we've ever seen on the topic shows that most investors (or the average investor) destroy value in the timing of their investments. That is, investors' actual real-world returns are well below the underlying asset class or funds' reported returns. This reflects the fact that most investors really don't have a sound, sensible, disciplined investment process. We do. And we are sticking with it.

The history of financial markets is a history of financial market cycles; the market pendulum typically swings from one extreme to another. Without a strong investment discipline, you will find yourself chasing that pendulum back and forth, but you will probably always be a step or two behind it. Instead of remaining disciplined and riding through the inevitable performance cycles—and in our tactical asset allocation approach we tilt against the cycles as valuations move to extremes—you will instead invest based on the past three- to five-year performance numbers. That means you will sell what is undoubtedly closer to the low point of its cycle and will buy what is likely nearer to the top of its cycle.

If you're a disciplined momentum investor or trend follower, that's fine—it can be a successful approach. But in that case, you are likely timing your decisions on a much shorter look-back performance period (e.g., 12 months or less). Waiting for five years of underperformance or outperformance and *then* selling or buying is a terrible way to invest given the nature of market cycles. Yet that is the way most people seem to operate, including many financial advisors and consultants, based on the ubiquity of three- and five-year trailing performance numbers in the investment industry.

Underperformance is often harder for end clients to rationally think through than it is for investment professionals. Is there hope for a turnaround?

There is no question that this has been an extended period of underperformance for our diversified portfolios. But as we've discussed, it has also been an extended period of underperformance for value approaches in general. It has also been an extended period of underperformance for international and emerging-market stocks versus larger-cap U.S. stocks. Related to those points, this has been an extended period with broad headwinds to active equity manager performance relative to indexes. In particular, it has featured the distortions to financial asset prices driven by eight years of unprecedented central bank accommodative monetary policies.

However, in 2016 we started to see some of these cycles turn in our favor. While we are not at all confident in calling or timing the inflection points of market cycles, we are confident that by sticking to our long-term discipline we are well positioned to benefit from them when they inevitably happen.

We saw this on the fixed-income side in 2016, when our active bond manager and tactical asset allocation positioning were big positive contributors. These are positions we've held for several years as we waited for the interest rate cycle to turn in our favor.

International Equities

The overweight to foreign stocks is becoming difficult to defend with clients. Do you have any additional talking points we can use with clients?

We completely understand the frustration. When talking to clients it may be helpful to put into perspective that it's been less than two years since we initiated a fat pitch in Europe, funded from U.S. stocks. We never pretend to call the bottom or the top of any investment. Our time horizon for a return-based fat pitch is around five years. Sometimes our views play out sooner, other times they don't. We view investing as a marathon, not a sprint. That means we have to be patient.

We continue to believe Europe is significantly underperforming what we believe is its normalized earnings potential. Earnings don't even have to normalize fully for us to get paid, such is the magnitude of Europe's earnings underperformance in this cycle. In our modeling, we assume that normalization will take place in roughly five years.

It's taken longer this cycle because Europe's dysfunction, stemming largely from the inefficient euro construct in our opinion, has prevented coordinated and timely monetary and fiscal steps and delayed both a resolution to the debt crisis and an economic recovery. But we are seeing some positive signs. According to the Bank Credit Analyst, the eurozone's real GDP is estimated to have grown by 1.7% in 2016, exceeding the U.S. economy's growth for the first time since the great recession. Leading economic indicators for 2017 suggest a continuation of this trend. Finally, according to Ned Davis Research, about 45% of European companies' revenues come from outside Europe. If Trump's reflation efforts are indeed successful, it will help Europe's revenues and earnings as well.

It's important to point out that our approach to Europe in this cycle has been relatively conservative in that from the outset we did not believe Europe was going through a normal historical growth recession. For example, for years we have stated our concern related to the poor euro construct and that, among other factors, led us to require a higher margin of safety when considering Europe as a return-based fat pitch. First, when we introduced the Europe fat pitch, we had a higher return requirement than our historical analysis would indicate we needed. Second, around the time of the Brexit vote we didn't add much to our position because we wanted a greater margin of safety. Finally, we have also chosen to hedge our fat pitch even though we can see long-term indicators, such as Purchasing Power Parity, that suggest the euro is cheap and currency could be a tailwind to returns. That is because so far despite the cheap currency, Europe is having a tough time reflating and the European Central Bank continues to act to reflate and aims to weaken the euro. In a more normal environment for Europe, we would not have hedged our fat pitch.

Fixed-Income and Credit Risk

Have you thought about the equity-like risk in your bond funds in a severe 12-month downside scenario? From the surface, the prospect of a downturn with a lot of credit exposure in the flexible and floating-rate loan funds is concerning. Will core fixed-income offset that much risk?

Downside risk is front of mind for us, especially in our more conservative portfolios. Over the past several years, as core bond yields hit lows and duration has extended, we have shifted a meaningful portion of core bond exposure to higher-yielding, flexible, and absolute-return-oriented strategies. We have also made a tactical allocation to floating-rate loans. These holdings will have more credit risk than core bonds in a flight-to-safety environment.

We manage all our portfolios to a 12-month downside threshold that varies by portfolio. For example, our most conservative portfolios are managed to a 2.5% downside threshold over a 12-month period. In March of last year, we increased the core bond exposures in our conservative portfolios. The changes were the result of revisiting and reassessing our severe stress-test return assumptions for our flexible, absolute-return-oriented, multisector, and alternative strategy funds over a 12-month period. Our updated assumptions resulted in a slight increase in the overall portfolio downside losses in scenarios where stocks and credit sell off sharply. We made this tactical shift believing we were reducing the portfolios' downside, while only minimally sacrificing upside. At the overall portfolio level, we think the additional credit risk we are taking is more than offset by our meaningful underweight to U.S. stocks.

We spend a considerable amount of time thinking about liquidity in the floating-rate space—not only for our actively managed floating-rate loan positions but also at the ETF level. We think the real issue here is the mismatch of trade settlement for mutual funds, which is T+3 days and the much longer settlement period for loans, which can actually go into the weeks. In getting our arms around this, we've talked to active managers. We've talked to ETF providers, some of which are purely passive, some of which are active, and some of which chose not to actually do a loan portfolio. Ultimately, we're very comfortable with the two active managers we use in the space. Liquidity concerns are a bit alleviated by the cash they hold and some more liquid high-yield bonds they hold. They also hold some of the more liquid loans. The funds we use also have meaningful lines of credit they could draw on in a pretty draconian scenario should there be a stampede toward the exits in the asset class.

That is important because over the last ten weeks we've seen consecutive inflows into the floating-rate space, not too surprising given the rise in rates.

Commodity-Related Investments

How do you evaluate an investment in commodities?

We look at two types of commodity-related investments: commodity futures funds and natural resource stock funds. We'll make a few key observations:

First, commodity futures strategies that track a broad commodity index, such as the Bloomberg Commodity Index, provide strong diversification benefits when added to a traditional stock/bond portfolio. Their correlation to traditional asset classes is low; although, as with most asset class correlations, it varies over time. The widespread availability of investable commodity index funds over the past five- to 10-plus years has likely changed their correlation characteristics.

Second, commodity futures funds should provide strong inflation hedging characteristics or "inflation beta" (measuring the responsiveness of the asset class to changes in inflation). Most importantly, they typically respond strongly positively to *unexpected* changes in inflation.

Those are the two strong positives for commodity futures as part of a long-term diversified portfolio. The negative, or at least the big uncertainty for us, is the inability to confidently derive a longer-term expected return for a commodity futures fund. There is voluminous academic and industry literature on this. Suffice it to say, it is not clear how much of a risk premium you should expect to earn from owning a long-only commodity futures index fund over the long term. Yet it *is* clear that these funds can be highly volatile and have significant downside risk. We've seen this most recently in the years since 2008.

Related to this is the issue of "roll yield" and the term structure of futures curves (i.e., whether they are in contango or backwardation, and how that impacts expected returns). With the proliferation of investable commodity index funds, the potential for "front-running" by active managers can also negatively impact the expected returns to transparent rules-based index strategies.

How about natural resources stocks?

Compared to commodity futures funds, natural resources stock funds have higher correlation to the stock market, so the overall portfolio diversification benefit is lower. There certainly is some benefit though. A recent research paper by GMO argues the diversification benefit increases meaningfully the longer the holding period.

Natural resources stocks also historically have had a lower inflation beta than commodity futures. Again, it is still positive and higher than most other asset classes. So they do provide an inflation hedge, but not likely one as good as owning pure commodity futures. Where we see natural resources stocks having the advantage over commodity futures is in their long-term expected returns. Historically, investors have earned a meaningful risk premium from owning natural resources stocks, compensating them for their equity risk. We are confident that natural resources stocks, on average and over the long-term, will continue to earn an equity-like risk premium.

How do you currently view the asset class?

We don't have a formal tactical view on commodities. We can all cite plenty of reasons why inflation has been increasing recently and why it could increase further. That we can all cite reasons reflects the fact that the markets are already discounting them, at least to some extent. We can see that clearly in the rise in various market measures of inflation expectations, such as the jump in the breakeven inflation rate (comparing nominal 10-year Treasury yields to TIPS yields) from around 1.4% in July to around 2% now. There's been a similar increase in the "five-year/five-year forward inflation expectation rate."

Our consideration of owning commodity-related investments is not driven by a specific forecast of inflation or a tactical view on commodity prices. We think strategically about the impact on our portfolios of a potential inflationary scenario, and more importantly, the impact from unexpected inflation. This is key, because by definition you can't forecast unexpected inflation. In this context, for certain types of portfolios and client objectives and risk tolerances, we can see a valid role for holding a strategic (long-term) position in natural resources stocks and commodity futures funds.

—Litman Gregory Research Team (1/19/17)