October 17, 2017

A Primer on Market Lingo

The phrases ***bull market*** and ***bear market*** are among the many terms used in financial market parlance; they refer to periods of rising and falling prices, respectively. The term bull market has been arbitrarily defined as a period of rising prices uninterrupted by a price drop of 20% or more. At the end of the third quarter of 2017, US stocks had enjoyed over 8.5 years without a 20% correction, making it the second longest bull market since the Great Depression. The length of the current stock market rally, combined with relatively slow economic growth and expensive stock prices, has caused investors to question how much longer the rally can continue.

As risk managers, we regularly ask ourselves the same question. Given the variability of historical bull market length, and the tendency for bull markets to post outsized gains in their last several quarters, we have not been focused on the amount of time that this one has persisted. Rather, we have been more concerned about market valuation levels, as well as underlying economic conditions. As recent attendees of our strategy meetings have heard us observe, these two metrics appear to be somewhat at odds: stock prices appear to be expensive by most metrics (particularly in developed economies); against that the global economy has recently enjoyed a broad growth acceleration, and company earnings have been posting strong gains relative to last year.

While the extent of this bull market has raised questions about whether it might be overextended, the strong returns it has produced has also significantly increased investor wealth. This greater wealth can often lead to increased investor confidence, which on occasion leads our clients and friends to ask us whether it might make sense to take more investment risk. Our answer to that question is always the same whether we are in a bull or bear market: investors should adopt a cost-conscious investment strategy with a risk profile that is aligned with their life situation and financial objectives, and then stick with it throughout market cycles. We will make the tactical portfolio decisions for our clients, and are always available for a consultation to review the strategic appropriateness of a portfolio's risk profile.

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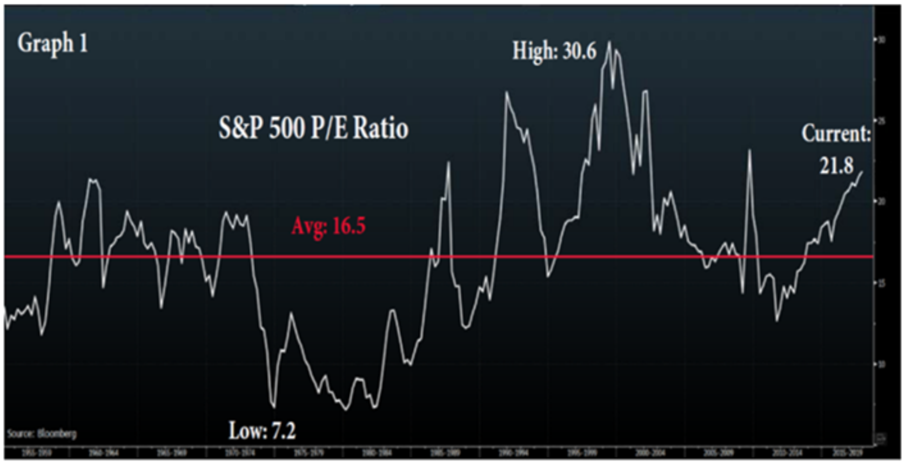
We've decided to devote the remainder of this note to define some of the other "finance-speak" terms that we commonly use. We hope this primer will be useful in helping our audience understand our lingo, and the metrics we focus on as we manage our client portfolios. So, in no particular order:

We often talk about asset class ***valuations***. When we talk about valuations, we refer not to nominal price levels, but to whether the asset class is ***rich*** (expensive), or ***cheap*** (inexpensive). To the extent possible, we seek to own less of the former, and more of the latter. Accordingly, we tend to ***underweight*** rich assets and ***overweight*** cheap assets, relative to our ***strategic benchmarks***. That simply means that we will deviate from our long-term asset class targets, if and when we find various sectors unusually attractive, or unattractive. Currently, our portfolio risk is slightly underweight relative to our strategic benchmarks, which we feel strikes an appropriate balance between rich valuations and increasing economic and earnings growth.

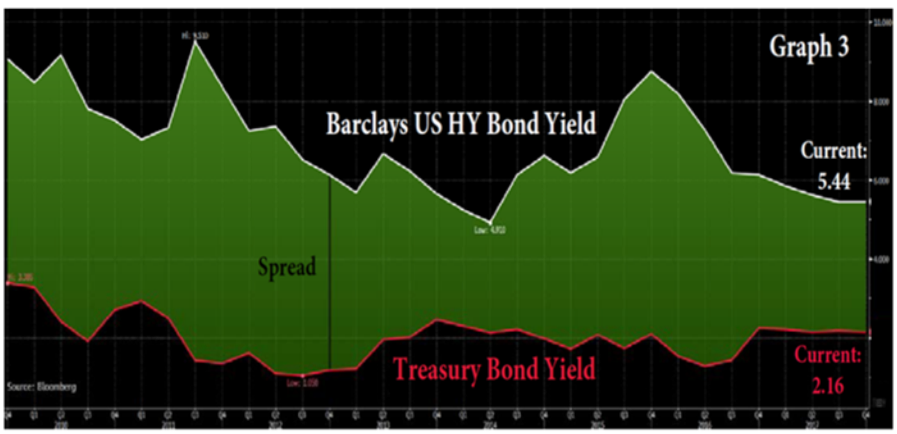


There are many different valuation metrics, and different ones for different asset classes. One of the most common valuation metrics used for stocks is the ***price/earnings (P/E) ratio***. The P/E ratio simply measures the price of a share of company stock (or of a market in aggregate), relative to the annual earnings that company (or market) is generating. Think of the P/E ratio as expressing how much it costs to buy $1 of company earnings – the higher the ratio, the more expensive it is to buy those earnings. Currently, US stocks have an aggregate P/E ratio about 30% higher than the long-term average, which influences our somewhat cautious positioning (interestingly, the US market has a P/E well below that preceding the 2000 “dot-com” bear market, but well above that before the ‘08/’09 crisis). Graph 1 shows a long-term history of the S&P 500 P/E ratio, with the horizontal line depicting the average P/E of 16.5.

We can try to arrive at an assessment of stock market ***absolute value*** by comparing the P/E (or other ratios) to the same market’s historical ratios. However, successful management of risk

also requires us to have a view on ***relative value***, which refers to the attractiveness of an asset or sector relative to others. Whereas stocks are clearly expensive now by most absolute measures, stocks still appear attractive when compared to the paltry yields available on bonds. This is shown in graph 2 , which compares high quality global treasury bond yields to the global stock ***earnings yield* ratio** (the reciprocal of the P/E ratio, which simply represents the return earned on $1 invested in a given stock or market). So our views on relative value will determine how we allocate our risk budget between asset classes.

When we assess bond risk, we have to consider two main risks embedded in all bonds: ***interest rate risk*** and ***credit risk*** (or ***default risk***). Since bond prices fall and investors lose money when interest rates rise, we have to be aware of the risk of rising rates, and whether we are getting paid enough to take that risk. With interest rates low, investors in high quality bonds are paid very little yield to take the risk of potentially large losses if rates rise considerably. For that reason, we are currently keeping the ***duration*** of our high quality bond holdings very low. Duration is a mathematical term that is closely related to a bond's maturity, and directly measures price sensitivity to interest rate increases. Credit (or default) risk refers to the risk that the borrower does not pay the investor back; this risk is much higher for ***non-investment grade*** (aka High Yield) issuers. In order to entice investors into accepting increased default risk, these issuers have to pay significant ***spreads*** (incremental yield above Treasury bond rates) to borrow money. In recent years, we have felt that this spread has generally provided attractive compensation for High Yield bond credit risk; therefore we have had considerable exposure to the sector, positioning that has worked out well in an extended low default environment. Graph 3 below shows High Yield and US Treasury bond yields, and the spread between the two.



Market pundits often talk about portfolio ***diversification***, and the desirability thereof. We seek diversification across portfolios to provide stability during times of downside volatility. The idea is some assets will zig when others zag, and as a result portfolios may not bear the brunt of the full decline in a given market, compared to undiversified portfolios. However, as the '08/'09 crisis painfully demonstrated, diversification is often illusory. In order to achieve true diversification, a portfolio must hold various assets that are somewhat ***uncorrelated –*** which means they are likely to move in opposite directions during turbulent times. Too often we see portfolios that were intended to be diversified, but are really not. For example, a portfolio of stocks across industries or regions may offer diversification benefits during stable periods (and will protect against the failure of a single company), but, because correlations tend to increase (ie. all stocks decline together) during periods of stress, the diversification benefits may be small or non-existent.

On a macro level, we often discuss a country's or region's overall economic growth, which is typically measured by the change in ***GDP (Gross Domestic Product)***. GDP represents the value of goods and services produced in a country (or region) in a given year.

One of the reasons that the global stock market rally may continue is the fact that GDP has been inching up in most of the world's regions. However, a potential threat to markets is that some of the world's major central banks are likely to ***tighten monetary policy*** as a response to continued economic strength. This means simply that the central banks may reverse some of the ***monetary easing*** (low cost availability of funds) they have implemented since the financial crisis, primarily by raising interest rates. One implication of this policy change is that debt will become more expensive to service, which poses a particular risk for households, companies, industries, and countries with excessive ***leverage*** (levels of debt).

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Despite favorable investment returns so far this year, recent weeks seem to have delivered an almost unremitting stream of bad news in the US, with ever increasing political rancor, the devastating hurricanes, the Las Vegas shootings, and the death of beloved rock icon Tom Petty, whose music touched tens of millions of lives for 40 years. This seems to be an appropriate time to recognize the good things that we also enjoy, not the least of which is the trust that you have placed in us as the manager of your investment portfolios, and your support as we continue to build our business here in Santa Fe. Thank you; the Santa Fe Advisors team will continue to try to earn both every day.

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Disclosures