KEEL POINT

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Reflection & Outlook: 2013 - 14

Each December we look back at the past year and offer our thoughts on what the year ahead might look like. We hope our clients and friends have enjoyed a relaxing and memorable holiday season and wish everyone a prosperous 2014.

Stocks: Momentum vs. Valuation

Equity markets in the developed world are set to turn in a significantly better than average year in 2013. This result is most palpable here in the US, but perhaps most noteworthy in Japan. After years of stagnation in both the economy and stock market, Prime Minister Abe has responded with stimulus in the form of aggressive monetary and fiscal easing and the promise of structural economic reform. The market cheered this breath of fresh air to the crescendo of a 58% return (in Japanese yen terms; 29% in US dollar terms) through December 27th. Clients benefitted from this exuberance via their exposure to non-US developed market equities.

We conveyed some of our thoughts on the US stock market advance in last month's *Bulletin* – specifically that it has been fuelled by P/E multiple expansion more so than earnings growth. The catalyst for that expansion has been relief that a host of worst case scenarios have not transpired. Despite jumbled messaging in the summer, the Fed ultimately delayed tapering their purchases of treasury and mortgage bonds and then barely dialed back those purchases in December. The 2013 fiscal squeeze, a combination of sequestered spending and tax increases, did not tip the economy into recession. Finally, worries about a contagious Eurozone disintegration eased as the continent pulled itself out of recession.

This amounts to a good deal of momentum for stocks heading into the New Year. It's not hard to see how a "we avoided the worst" narrative continues to propel markets in 2014. Combine that with the great rotation narrative (the idea that the tide of money that flowed to bonds after the credit crisis will reverse course into a more attractively valued equity market), and you have an even better story for 2014.

Valuations, however, are the wet blanket. Most measures that compare stock prices relative to one year of earnings have US equities fully valued. Those that compare prices to an average of multiple years of earnings conclude equities are overvalued. Further, corporate profits have been outpacing GDP growth since the US rebounded from the credit crisis, but profits have historically reverted to a mean below where we stand today. The IMF's October 2013 World Economic Outlook predicts a little more than 4% nominal growth for the US next year. Companies can usually grow earnings slightly faster, but without another P/E multiple boost or profit margin expansion, returns from US equities could be below average.

The Year Bonds Turned

The Barclays Aggregate Bond Index, a broad measure of US based fixed income instruments, is going to finish the year negative for the first time since 1999. Rising interest rates are trouble for bond investors; the yield on 10 year treasuries spiked 1.25% in 2013 (see bottom right corner of Figure 1). While we could not be sure of the exact timing of this negative outcome, we have been planning for pain in the broad bond markets for some time now.

One of the highlights in portfolios has been our bond managers' ability to navigate this poor fixed income environment. We have exposure in higher yielding corporates, paying both fixed and floating coupons, which have generated positive returns this year. The Barclays High Yield Index (fixed coupons) is up 7.3% and the S&P/LSTA Leveraged Loan Index (floating coupons) returned 5.2% (both figures through December 27th).

Figure 1: A Turn in Bond Yields?
10 Yr Constant Maturity Treasury Yield (%)
Source: Bloomberg

Next year the fixed income environment is just as tricky. Higher treasury yields mean traditional bonds (governments, municipals, and investment grade corporates) stand a better chance of earning a positive return, all else equal. Unfortunately for traditional bond investors, the Fed will likely continue to taper their purchases of mortgage and treasury bonds thus removing a significant buyer from the marketplace and driving yields higher (and prices lower). We will continue to avoid these sectors in favor of the higher yielding opportunities described in the previous paragraph, but low

spreads in these sectors mean we will likely need to be as active in managing our fixed in portfolio in 2014 as we were in the past year.

Traditional Finance Fading

One of the bigger themes for 2013 has been the decline of bank financing opportunities for lots of commercial activities that are now forced to turn to private markets. Banks have retrenched for a number of reasons: re-regulation via Dodd-Frank, litigation uncertainty, 2008 post-traumatic shock still nagging, easier net interest margin bogeys thanks to free money from the Fed, etc. This creates some opportunities for private capital to step in and provide financing to some neglected customers.

We have seen many private lending opportunities come across our desks this year. We participated with a group in the southeast that is lending to small businesses at attractive coupons with the benefit of bargain-rate leverage from the Small Business Administration. Mortgage servicing rights (MSRs) were a component of a second 2013 private equity vehicle we recommended; as Dodd-Frank rules are making MSRs less attractive for banks to hold, we expect the private sector to fill the void. We are also wrapping up due diligence with a group that lends to retail outfits against inventory/receivable collateral. We expect to vet many similar ideas in 2014.

But Public Markets are Growing Elsewhere

Clients often ask what is different about a Keel Point portfolio. While we could probably go on for a full two pages on the topic, if forced to give a Twitter-constrained answer, we might say: "Each portfolio is constructed with a client's mission, vision, values, and goals in mind; and the construction materials used are different."

One example of a different construction material is reinsurance. It's a critical component of the modern financial system, but the risk has historically been housed within the corporate structures of the world's reinsurance companies. However, catastrophe bonds and quota shares, two solutions for capital market participants to buy some of the reinsurance risk outright, are growing quickly. Catastrophe bonds outstanding, for instance, totaled $17 billion in 2013 versus just $5 billion in 2005.

Keel Point partnered with the first firm to offer reinsurance in a mutual fund format this year. We are attracted to this opportunity because it offers a completely different type of return stream to our clients. Bad years for stock or bonds markets should not have a statistical correlation with the performance of the reinsurance industry. Expected returns are within range of those of equity markets. Combine these two expectations and our belief is that client portfolios will experience, over the long run, more consistent results.

Some Ideas Didn't Work Well in 2013

A well-diversified portfolio will always have some investments that are laggards, and the past year was no exception. Extra scrutiny on the laggards, particularly managed futures and emerging markets, led us to take action in the former case and none in the latter.

Managed futures is a discipline that has historically improved portfolio results with a differentiated return stream. Practitioners follow momentum strategies that have generated positive returns in most market environments, including, most reassuringly, in sustained bear markets. Their success depends on the development of trends, positive or negative, in all types of markets (not just equity) that persist long enough to exploit.

This year has not been trendy and our view is that trends will struggle to survive next year as well. They have been consistently killed by central bank intervention. We expect more interference from the Fed, Bank of England, European Central Bank, Bank of Japan, and probably some emerging market authorities next year.

Our answer has been to change the mandate of the managed futures part of our portfolio, wherever appropriate, to a global macro approach. These managers have generated a differentiated return stream similar to managed futures in the past, but stand a better chance, in our mind, of repeating their success in 2014 and beyond. The key difference is that macro managers have human portfolio oversight that might outmaneuver the managed futures' algorithms in the presence of interventionist central banks.

Our other 2013 disappointment was emerging market equities. Slowing growth and declining currencies conspired to drag returns at least 25% lower than the other major global equity categories. Our propensity to overweight Asia was a relative success as our dedicated Asia managers performed better than the broad emerging markets space. We don't think the disappointing year demands change; rather we believe the relatively more attractive valuations have set up the space for a period of outperformance relative to their developed market peers. □

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