Investment Newsletter

March 2016

CLIENT INVESTMENT UPDATE NEWSLETTER

Commodities Funds: Handle with Care

By Alina Lamy

Oil prices have been declining over the past six months, from $49.20 a barrel last August to $33.66 at the end of January—a 32% decline. Normally, when an asset class experiences that kind of drop in value, we would expect to see drastic outflows. Interestingly, however, when looking at the money that flowed in and out of various categories of commodity funds, flows into energy funds have been mostly positive over this time period. Seeing how prices have reached such an extreme low, these positive flows suggest that some investors are betting on a possible reversal sometime soon and are trying to time the bottom—a speculative and very risky strategy.

Gold, on the other hand, hasn't appreciated much, but there is more to that than simply investors chasing returns. Gold is seen as a hedge, a way to try to preserve wealth against the risk of loss in other asset classes. With less-than-stellar stock market—the S&P 500 losing 5% in January and 8.5% YTD through mid-February—investors turned to gold, which is perceived as a safe asset in times of market stress. Precious-metals commodity funds received their first sizeable inflow since January 2015. The SPDR Gold Shares ETF was the most popular fund, attracting $1.4 billion.

There are many benefits that commodity funds can bring to a portfolio (diversification, first and foremost), but investors should also keep in mind that these are very volatile investments and should control their allocations accordingly.

Diversification does not eliminate the risk of experiencing investment losses. Transactions in commodities carry a high degree of risk, and substantial potential for loss. In light of the risks, you should undertake commodities transactions only of you

Canandaigua National Bank & Trust

understand the nature of the contracts (and contractual relationships) into which you are entering and the extent of your exposure to risk. Trading in commodities is not suitable for many members of the public. You should carefully consider whether this type of trading is appropriate for you in light of your experience, objectives, financial resources, and other relevant circumstances. Gold, like any other coin or bullion, is subject to investment risks like perceived scarcity of coin, its quality, current demand, market sentiment, and economic factors.

Source: Morningstar Direct, Morningstar Direct Asset Flows

Why Should You Diversify?

Equity markets have experienced a sharp decline to start 2016, leading some investors to reevaluate their asset allocation. As US stocks have outperformed developed ex US and emerging markets stocks over the last few years, some investors might consider reevaluating the benefits of investing outside the US. From January 1, 2010, through February 29, 2016, the S&P 500 Index had an annualized return of the 11.66% while the MSCI World ex USA Index returned 2.26% and the MSCI Emerging Markets Index returned –2.28%. While there are many reasons a US-based investor may prefer a home bias in their equity portfolios, using return differences over the last few years as the sole input into this decision may result in missed opportunities that the global markets offer. We recognized that stocks in non-US developed and emerging markets have delivered disappointing returns relative to the US over the last few years. However, it is important to remember that:

1) International stocks help provide valuable diversification benefits.

2) Recent performance is not a reliable indicator of future returns.

THERE'S A WORLD OF OPPORTUNITY IN EQUITIES

The global equity market is large and represents a world of investment opportunities. Nearly half of the investment opportunities in global equity markets lie outside the US. Non-US stocks, including developed and emerging markets, account for 48% of the world market cap and represent more than 10,000 companies in over 40 countries. A portfolio investing solely within the US would not be exposed to the performance of those markets.

THE LOST DECADE

We can examine the potential opportunity cost associated with failing to diversify globally by reflecting on a recent period from 2000-2009. During this period, often called the "lost decade", the S&P 500 Index recorded its worst ever 10-year performance with a total return of – 9.1%. However, when you look beyond US large cap equities, conditions were more favorable for global equity investors as most equity asset classes outside the US generated positive returns over the course of the decade. Expanding beyond this period and looking at performance for each of the eleven decades starting in 1900 and ending in 2010, the US market outperformed the world market in five decades and underperformed in the other six. This further reinforces why an investor pursuing the equity premium should consider a global allocation; by holding a globally diversified portfolio, investors are positioned to capture returns wherever they occur.

PICK A COUNTRY?

Are there systematic ways to identify which countries will outperform others in advance? It is difficult to execute a strategy that relies on picking the best country and the resulting importance of global diversification.

In addition, concentrating a portfolio in any one country can expose investors to large variations in returns. The difference between the best and worst performing countries can be significant. For example, since 1996, the average return of the best performing developed market country was 37.5%, while the average return of the worst performing country was –15.7%. Over the last 20 years, the US has been the best performing country twice, and the worst performing once. Diversification implies an investor's portfolio is unlikely to be the best of worst performing, but diversification provides the means to achieve a more consistent outcome and most importantly helps reduce and manage catastrophic losses that can be

associate with investing in just a small number of stocks or a single country.

A DIVERSIFIED APPROACH

Over long periods of time, investors can benefit from consistent exposure in their portfolios to both US and non-US equities. While both asset classes offer the potential to earn positive expected returns in the long term, they may perform quite differently over shorter cycles. While the performance of different countries and asset classes will vary over time, there is no reliable evidence that performance can be predicted in advance. An approach to equity investing that uses the global opportunity set available to investors can provide both diversification benefits as well as potentially higher expected returns.

Revisiting Yields

The Fed, after a long period of anticipation (and some mistimed calls by a few prognosticators), raised the fed funds target rate on December 16, 2015—the first increase since 2006. Some market commentators believed that it signaled the beginning of an era of higher interest rates led by a Fed tightening cycle.

Looking at interest rates over the past several weeks, it may surprise many that the five-year US Treasury note fell to its lowest yield in over a year. Recent actions of the Fed and subsequent changes in yields show how difficult it is to predict the future path of interest rates.

It is interesting that, in their late January meeting, the Federal Reserve decided not to raise the federal funds target rate. We can ask ourselves again, is the market leading the Fed or is the Fed leading the market in setting interest rates?

In February, yields on some bonds in the US fell to levels we have not seen in more than a year. Yields then increased, to further demonstrate the difficulty of predicting the path of interest rates. In mid-February, the five-year US Treasury note was as low as 1.10%. Today it yields 1.23%. At the same time, the yield on the 10-

year US Treasury note fell as low as 1.64%, while today it yields 1.76%.

Although some investors may view US interest rates as low, the interest rates in other developed markets are even lower than their long-term historical averages. For example, the yield on 10-year government bonds from Germany (.0.15%), Canada (1.18%), UK (1.40%), and Japan (-0.07%) are all below their long-term average.

TAKING A BROADER PERSPECTIVE

Given interest rate levels in developed markets globally, what then are the benefits of global diversification? Yield curves globally have not moved in lockstep with each other. For example, interest rate changes in Germany have no always coincided with analogous interest rate changes in the US. Because of this, global diversification across yield curves can help reduce the expected volatility of a bond portfolio.

Further, yield curves globally have different shapes. This implies expected term premiums (the expected premium for holding a longer-term bond over a shorter-term bond) vary from market to market and provide opportunities to increase expected returns by pursing term premiums globally. Thus, when compared to a domestic-only portfolio, global diversification can help reduce expected volatility as well as enhance expected returns.

What about volatility due to currency movements? By hedging the currency exposure of the non-domestic bonds in a global strategy, investors can benefit from this larger opportunity set without incurring increased volatility from currency movements. Hedging currency exposure also equalizes the short-term rate of interest between foreign yield curves. This implies, for a currency hedged global bond strategy, the shape of yield curves globally in more important consideration than their level.

SUMMARY

The recent actions of the Fed and subsequent changes in yields highlight just how difficult it is to consistently predict the future path of interest rates in one market, let alone across markets globally. A more prudent strategy that may increase expected returns and enhance diversification is one that uses information in yield curves globally and applies a variable country and variable maturity approach. A strategy should thus increase its allocation to yield curves where current prices indicate higher expected term premiums and lengthen its duration in those yield curves that are positively sloped. This can be done in a systematic and controlled way to manage the tradeoffs among expected returns, expected volatility, and global diversification.

As we have mentioned before, the market's ability to reflect the probability to different outcomes and events in security prices reinforces the importance of focusing on asset allocation, diversification, and information in security prices as opposed to parsing information from news in an attempt to forecast future market activity.