Investment Manager Meetings Recap

This quarter the Strategic Income Group Investment Committee met with the following companies: Invesco, AllianceBernstein L.P., Multi-Funds, Garrison Point Capital, Goldman Sachs, Provasi Capital Partners, PIMCO, and Federated.

In addition, we reviewed research from countless other companies.

Strategic Income Group Current Views (Q3 2016)						
		Bearish	Slightly Bearish	Neutral	Slightly Bullish	Bullish
Capital Market Outlook				X		
		Underweight	Slightly Underweight	Neutral	Slightly Overweight	Overweight
Equities	U.S. Large Cap			X	←	
	U.S. Mid Cap			X		
	U.S. Small Cap			X		
	International		X	←		
	Emerging Markets	X				
Fixed Income	U.S. Government			X		
	U.S. Investment Grade Corporate			→	X	
	U.S. High Yield			X	←	
	International	X				
Alternatives						X
Cash				X		

Please Note: These are 12-18 month views from the published date of the applicable commentary. Arrows represent movement from previous quarter.

Capital Market Views

Our Investment Committee did hear a consensus from our meetings this quarter on the economy. All the managers agree we are in the late or mature stages of a bull market and the late stages of expansion in the economic cycle.

This being said, not a single manager feels that there is a high risk of recession in the next 18-24 months. To conclude this they point to a lack of the four main reasons that most recessions start:

Four Reasons for Recession	Reality
1. Overconsumption	Consumers are not spending enough
2. Spike in oil	We have seen oil stabilize around $40 per barrel
3. Over-investment	Not enough investment
4. High interest rates	Interest rates will continue to be low for longer

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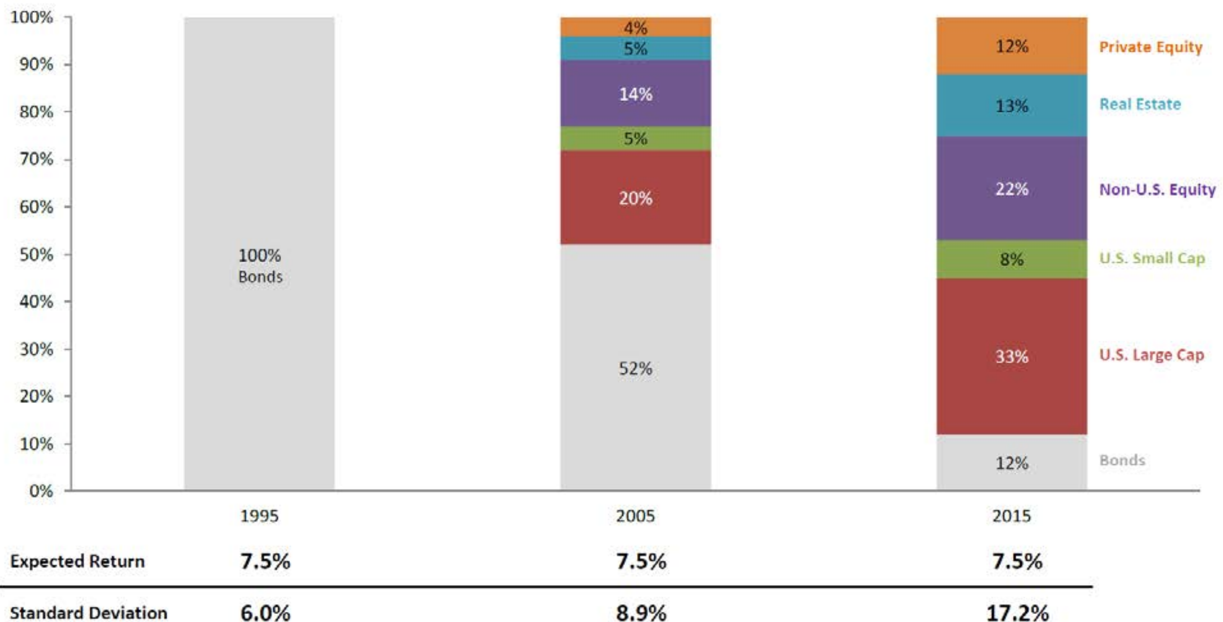
Not only are we *not* seeing reasons to be concerned with inflation, when we dig deeper, 10 of the past 11 recessions had high oil/energy prices. Additionally, in July the U.S. economy added 255,000 jobs which was well ahead of the 180,000 that were expected.

This leaves us with little concern regarding the overall economy in the short-term. The reality of how we should invest in this economy gets a little trickier.

Consider the chart below. In 1995 an investor was able to generate a 7.5% rate of return by investing 100% in bonds/fixed income and receiving a very manageable 6% standard deviation (amount of volatility). As the interest rates dropped and fixed-income investments paid less, the same investor just 10 years later would have to invest in more asset classes and assume more risk and volatility to receive the same 7.5% return.

We now see interest rates at the lowest level in history. This means that an investor has to assume substantially more risk – almost three times the amount of risk – to return the same 7.5%.



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How to Invest in this Market

As expected, we have seen a drastic reversal from the 1st quarter of this year. By February 11th of this year, the S&P 500 had already experienced a 12% sell-off causing many investors to become uneasy. Our view at the time was that the equity markets were oversold and we were expecting the markets to recoup the losses they had experienced.

We have seen that now with the S&P 500 making back all of the losses and more. The S&P 500 is now positive approximately 6% year-to-date. Unfortunately, earnings have not moved in lockstep with the movement in the markets and we now see equities as being slightly overvalued. This prompted us to move our U.S. large cap view from slightly overweight to neutral.

While it appears the economy is on solid footing, most investments in the U.S. have become overvalued. We see this in not only equity prices but also fixed-income prices. Many of the bonds that investors are buying are trading at a premium, well above par.

The biggest reason for this is that the U.S. is currently the strongest economy in the world. Foreign investors and governments are flooding the U.S. with their money. We have moved our international view from neutral to slightly underweight as reflected in our Strategic Portfolios. Foreign money is seeing more value in the U.S. and it is pushing up the prices of our investments to the point that they are now overvalued.

As a committee, we believe that this creates an environment where we will continue to see new highs followed by sell-offs that could be in the 10%-15% range followed shortly thereafter by new highs yet again. There is a good chance that this pattern continues for the next 12-18 months or until we see a movement up or down in earnings both in the U.S. and abroad. Investors would be wise to not get overly excited when the markets hit new highs and not get overly anxious when we see short-term pullbacks.

In March of this year we made several changes in our portfolios, moving into higher quality investments. These moves have proven to be correct. We continue to believe that higher quality investments will make sense in the coming months; however, we also feel that we would be wise to take some profits off the table.

During our meetings and through our research, we identified an area of the fixed-income market that looks very attractive. It is an area in which we feel we can generate equity-like returns (5%-7%) with substantially less risk and volatility. In our Strategic Portfolios, we are taking profits that we have received specifically in the equities over the last five months and removing some of the risk while markets are at all-time highs.

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It is important to remember, however, that the economy is growing very slowly (sub 3% GDP). This, coupled with low interest rates, brings the potential for returns much lower than recent decades. Our view is that equities are likely to generate returns in the mid-single digits and fixed income in the low single digits. This is another reason why we feel it makes sense to be proactive in managing our risk with these changes.

Several of the managers we met with mentioned that equities and fixed income could generate similar returns over the remaining part of the year. If this is the case, fixed income can typically do this with less movement and volatility.

Interesting Facts

- 6.7 years is the average life of 30-year mortgages.
- The U.S. economy added 255,000 jobs in July compared to an expected 180,000.
- July 2016 marked the lowest closing yield on 10-year Treasury notes (at 1.36%) and 30-year Treasury bonds (at 2.1%) in history. (U.S. Department of the Treasury)
- The S&P 500 Dividend Aristocrat index has outperformed the S&P 500 over the trailing 1-, 3-, 5- & 10-year periods. As of April 30, the Aristocrat index returned 10.29% annualized over the last 10 years compared to the S&P 500 at 6.91%.
- Low for Longer: The consensus of the managers we met with this quarter felt that the Fed might only raise rates one time per year for the next few years.
- Strong Dollar: The euro peaked on 7/15/2008 at $1.6038. On 7/29/2016 the euro closed at $1.1175. A weak euro (i.e. stronger U.S. dollar) has a negative impact on U.S. exporters, a critical factor to many American companies since 46% of the revenues of the average S&P 500 company come from foreign sales. (Transamerica: Standard & Poor's)

Opportunity in Residential Mortgages

We have moved our view of U.S. investment-grade debt from neutral to slightly overweight. This is due to the opportunity we are seeing in residential mortgages. The strategy that we are using has relationships with regional and national banks where they can buy these mortgages at a deep discount of around 69 cents on the dollar. Housing prices have rebounded and analysts see a more stable increase in the coming years. This further helps with the stability of these loans.

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As homeowners make their payments, we are able to earn a nice yield. In addition, another major advantage of these loans is triggered when homeowners either sell their home or refinance their mortgage. The average lifespan of a 30-year mortgage is actually only 6.7 years. This allows for the current loan to be paid off at 100 cents on the dollar for a nice profit. The goal of the manager is to generate around 6%-8% returns that are not impacted much by the ups and downs of the equity markets.

Final Thoughts

Discipline is the key to success. At Strategic Income Group, we believe in making investment changes according to fundamentals and not headlines. This year has been – and probably will be – full of headline topics that could make you want to change your investment objective: the elections, the Brexit, market sell-offs, and market rallies!

On Thursday night, June 23, 2016, the U.K. voted to leave the European Union (Brexit), our investment committee was in talks late into the evening. We saw the futures markets sell-off affect the Dow Jones Industrial Average by over 600 points. We knew it would be a wild ride on Friday. By 9:00am we had our course of action and by 10:00am we had an email out to all of our clients.

The reality was that no action was the best course of action. We had already made changes in March, decreasing our international exposure and moving to higher quality fixed-income and equity positions within the United States. We were confident that any sell-off would be somewhat short-lived and that our positions represented our view of

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Did You Know?

Did you know that at Strategic Income Group, **we can help you design and draft your estate plan?** We have both certified document preparers and attorneys that work through our firm to create an estate plan that meets your needs. Ask your advisor today to review your estate plan and make sure it is up-to-date.

What Are Investment Manager Meetings?

At Strategic Income Group, we believe in reviewing detailed investment research. Every 90 days we set aside a week during which around 7 to 10 investment managers give us recommendations on our current portfolios as well as share their firms' current views on the market and economy. This recap is our commentary on the most recent meetings.

where we needed to be. Within just a few days, the markets were right back to where they were the previous Thursday.

Our quarterly investment manager meetings and constant research during the quarter allow us to make changes when fundamentals change. Now again is one of those times when we will make some changes, rebalance the accounts, and take some profits off the table. We are not trying to time the market, we are trying to protect what we have gained in the last few months.

If you have not been to one of our investment manager meetings yet, we encourage you to come next quarter. Look out for the email invitations in late October. Of course, we also believe in meeting with our clients on a regular basis. If you do not currently have a scheduled appointment with your advisor, please call us at (480) 466-7070 so we can meet with you soon.

Questions?

If you have any questions whatsoever regarding our investment manager meetings or any of the notes, give us a phone call or stop by our office:

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