A Closer Look

Perspective on Asset Allocation

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In Brief

- **Stock market volatility has increased markedly this year, and it seems likely to continue in the months and quarters ahead.**
- **Although the U.S. economic expansion is growing increasingly mature, we continue to expect additional economic and stock market gains — even if it stands to be a bumpy ride.**
- **Now is an ideal time to review asset allocations and investment plans to ensure they remain current and aligned with your long-range goals and tolerance for risk.**

Volatility has returned to the stock market in 2018 after being conspicuously absent in 2017. In the first quarter of 2018, the S&P 500 moved up or down by more than 1% on 28 days. In the full year 2017, that only occurred eight times. The biggest drop in the market last year was 3%; by mid-February of this year, the market had already experienced a 10% slide.

The U.S. is getting later into an already-long economic cycle, valuations on many financial assets are a bit stretched, and the 10-year U.S. Treasury recently crossed the 3% level as interest rates and inflation have both trended higher. Add to this trade tensions that have led to higher tariffs and could even lead to a global trade war. Given these real challenges, and a plethora of news and noise on other topics, we expect market volatility to continue.

While we are still optimistic that the economy and stock market can continue to advance, we are bracing ourselves for a bumpy ride. As such, we believe now is an opportune time for families to revisit their asset allocation and investment plan. For most families, this means checking not just that their overall asset allocation aligns with their big-picture goals, but also making sure that each of their different accounts and entities (IRAs, trusts, charitable accounts, etc.) is up to date with their current thinking, objectives, and risk tolerance.

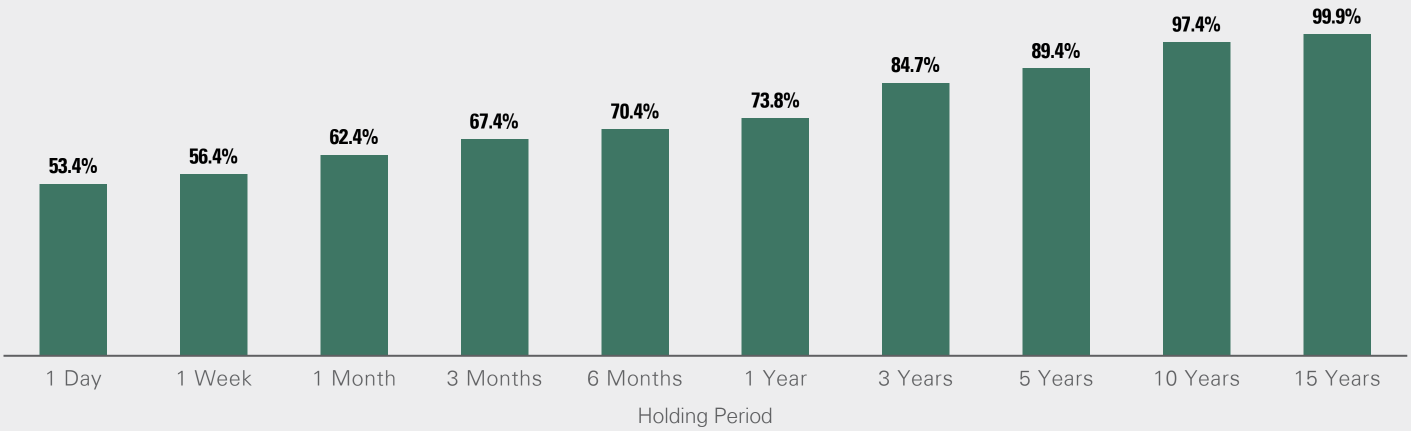
Stocks for the Long Run

Stocks are the growth engine and cornerstone of most investment portfolios, and rightly so — the U.S. stock market has returned 8.6% annually going all the way back to 1800. But over the short term, and certainly in years like 2018, investing in stocks can feel a lot like gambling. Investment horizon in crucial. Investing in stocks for a day comes with roughly the same odds as a coin toss, but investors who can look 5 to 10 years and beyond have the odds in their favor (Exhibit 1). This is the exact opposite of the dynamic that exists in gambling, where the longer a gambler sits at a blackjack table, the worse the odds of making money (and the better the odds for the house).

To earn the long-term returns the stock market has afforded, investors need to be able to survive the short term. And the short term can be very scary. In just the last 20 years, we have seen two instances where the broad stock market lost half of its value (the technology bubble in 2000–2002 and the financial crisis of 2007–2009). Investors who had the intestinal fortitude to stay invested in stocks during the darkest days have fully recovered and made a lot of money. However, this is easier said than done, and many investors don't realize they have misjudged their risk tolerance until near the bottom of a bear market.

Exhibit 1: Probability of Gain in the U.S. Stock Market

Key Takeaway: For investors with long time horizons, investing in stocks has historically paid off nicely.



Reflects daily and weekly data since 1950; monthly and yearly data since 1800.

Source: Global Financial Data, Standard & Poor's, Yahoo Finance

The Role of High-Quality Bonds

Unfortunately, the correlation of higher-return, higher-risk assets (e.g., U.S. and non-U.S. stocks) tends to rise in a time of crisis. This type of diversification seems to have failed when investors needed it most. Gold and similar asset classes have shined in certain bear markets but have been less reliable and have dropped in value in others. High-quality bonds, however, have been a dependable asset class that has provided consistent support to an overall portfolio during bear markets for stocks. Exhibit 2 shows the performance of high-quality bonds in every bear stock market dating back to the Great Depression. Their long-term returns certainly don't compare to stocks, but they have provided ballast to a portfolio in difficult times.

Long-Term View of Stocks and Bonds

Stocks and bonds have been the core building blocks for portfolios over the years, and for good reason. Stocks have delivered strong returns over the long run. Unfortunately, they have also posted harrowing losses periodically in the short run. Bonds have been a good complement, delivering positive returns in nearly every bear market for stocks and providing much-needed stability. The stock/bond mix for a family and each of its accounts can be customized based on the family's unique tolerance for risk and long-term return objectives. (A fully diversified client account at Bessemer would typically include exposure to many other assets in addition to large-capitalization U.S. stocks and high-quality bonds. We recommend clients include mid- and smaller-capitalization companies, developed and emerging market stocks, and alternatives asset classes like hedge funds, private equity, venture capital, and real assets, where appropriate.)

Is This Time Different?

Perhaps looking at historical returns and relationships between stocks and bonds is no longer relevant today. The question "Is this time different?" is a provocative one. While it's easy to say things are always changing and of course this time is different, it's just as easy to rationalize that the market follows distinct patterns over time, these patterns should continue, so of course, this time is not different. Regardless of one's philosophical view, we believe this question should be carefully considered today in light of current market realities.

Exhibit 2: Bear Stock Markets

Key Takeaway: Bonds have provided stability to portfolios during bear markets for stocks.

Bear Markets	Stocks	Bonds
Sep 1929–Jun 1932	(84)%	+14%
Mar 1937–Mar 1938	(50)%	+2%
Mar 1939–May 1940	(22)%	+1%
Jun 1946–Feb 1948	(20)%	+0%
Aug 1957–Dec 1957	(15)%	+6%
Jan 1962–Jun 1962	(22)%	+2%
Feb 1966–Sep 1966	(16)%	+2%
Dec 1968–Jun 1970	(29)%	+3%
Jan 1973–Sep 1974	(43)%	+5%
Dec 1980–Jul 1982	(17)%	+24%
Sep 1987–Nov 1987	(30)%	+3%
Jun 1990–Oct 1990	(15)%	+5%
Jul 1998–Aug 1998	(15)%	+3%
Apr 2000–Sep 2002	(44)%	+33%
Nov 2007–Feb 2009	(51)%	+14%
May 2011–Sep 2011	(16)%	+5%
Average	(31)%	+8%

Bear market defined as S&P 500 decline of at least 15%. Bonds reflect 5-year Treasuries.

Source: FactSet, Global Financial Data, Standard & Poor's

Since the lows in March 2009, stocks in the U.S. have been on a near-10-year run, and stock market valuations are high. Maybe stocks are so expensive today that future returns have been compromised and stocks won't be the long-term engine of growth they once were. And likewise, bonds may no longer be an effective insurance policy against big drops in the stock market because interest rates today are so low. Year-to-date bond returns have been negative, which feels especially bad given how stocks have gyrated. Let's examine the merits of each of these points in more detail.

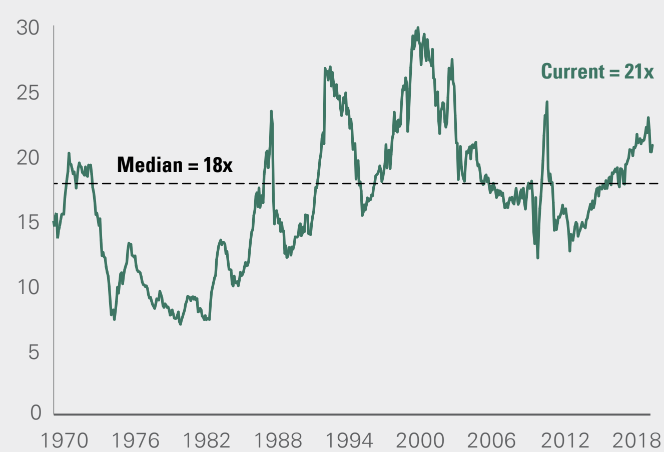
High Stock Valuations

On just about any measure, stocks are expensive. The current price-to-earnings multiple (based on trailing 12-month earnings) for U.S. stocks is significantly above its longer-term median (Exhibit 3). Other valuation metrics, including the Shiller price-to-earnings multiple, which looks at a longer-range picture for earnings, comes to a similar conclusion — stock valuations are high. While valuation metrics haven't historically been a good predictor of short-term market movements, they have had some relationship with longer-term returns. That is, higher valuations have meant lower stock market returns over the ensuing 5 to 10 years.

While stocks might not hit their long-term average annual return of 8% to 9% over the next 5 or so years, we still believe they are likely to generate acceptable returns. Valuations are high, but they look much less out of line when viewed in the context of today's still-low interest rates. As rates gradually move higher, however, valuations for stocks should come down a bit as bonds become a more compelling alternative. This will likely be a headwind for stock returns.

Exhibit 3: Price-to-Earnings Ratio, S&P 500

Key Takeaway: U.S. stock valuations are currently above their long-term median levels.



As of May 25, 2018. Price-to-earnings ratio based on trailing 12 months' earnings before extraordinary items.

Source: Bloomberg

Earnings growth is an important driver of stock returns, and we wouldn't be surprised to see an acceleration in earnings growth over the next 10 years as compared to what we experienced the last decade. As of now, companies in the S&P 500 are expected to generate earnings growth of 20% in 2018 (supported by the recent corporate tax cut) and nearly 10% in 2019.[1] While earnings estimates generally come down over time, with companies then beating the new lower estimates, we believe stronger earnings growth will be a support for stock returns over the medium term. A final factor to consider is company spending on buybacks and dividends (expected to be $800 billion and $500 billion in 2018, respectively[2]) which is likely to accelerate in the short term due to the recent tax law changes.

Low Rates for Bonds

Interest rates have edged up over the last couple of years, but they are still quite low relative to history (Exhibit 4). This suggests that bond returns moving forward are likely to be more muted than in past decades, as the starting yield environment has a big impact on the total return earned by investors. Fortunately, inflation has also been low recently, allowing bond investors to eke out a small "real" or inflation-adjusted return this decade.

The primary role of high-quality bonds, however, is not to generate big returns, but rather to provide a cushion to the overall portfolio in the event of a severe stock market downturn. We believe high-quality bonds will still play this role when the time comes. In the next bear market for stocks, when investors are fleeing risk, we believe they will once again seek the safe haven of U.S. dollar assets, including high-quality taxable and municipal securities. The U.S. dollar is still the deepest, most liquid currency in the world, and in times of crisis, we still believe U.S. bonds will appreciate, albeit modestly, in value.

Looking forward, one additional concern today is inflation. So far, inflation and inflation expectations have been anchored. But if inflation surprises to the upside, and this isn't accompanied by a pick-up in real GDP growth, this could spell trouble for stocks AND bonds — after all, bonds wouldn't be protective if what is pulling the stock market lower is higher inflation. Although a high-inflation/low-growth outcome is certainly possible, it is not our base case. Were we to anticipate this environment, commodities and commodity-related investments could play a more meaningful role in portfolios than is the case today.

Other Things to Worry About Now

The list here is endless, but it always is. Today, it includes a potential global trade war, mid-term elections and continued political polarization in the United States and abroad, more heavy-handed technology industry regulation, slowing overseas growth, a deterioration in the U.S. relationship with Russia, and North Korea, just to name a few. These are all valid concerns and real worries. But are they significant enough to stop the very positive *long-term* trends that have helped support the stock market (Exhibit 5) over time? We believe the answer is no.

Exhibit 4: Treasury Bond Yields and Inflation

Key Takeaway: 10-year Treasury bond yields are low relative to history, as is inflation; bond returns may be more muted in the future.

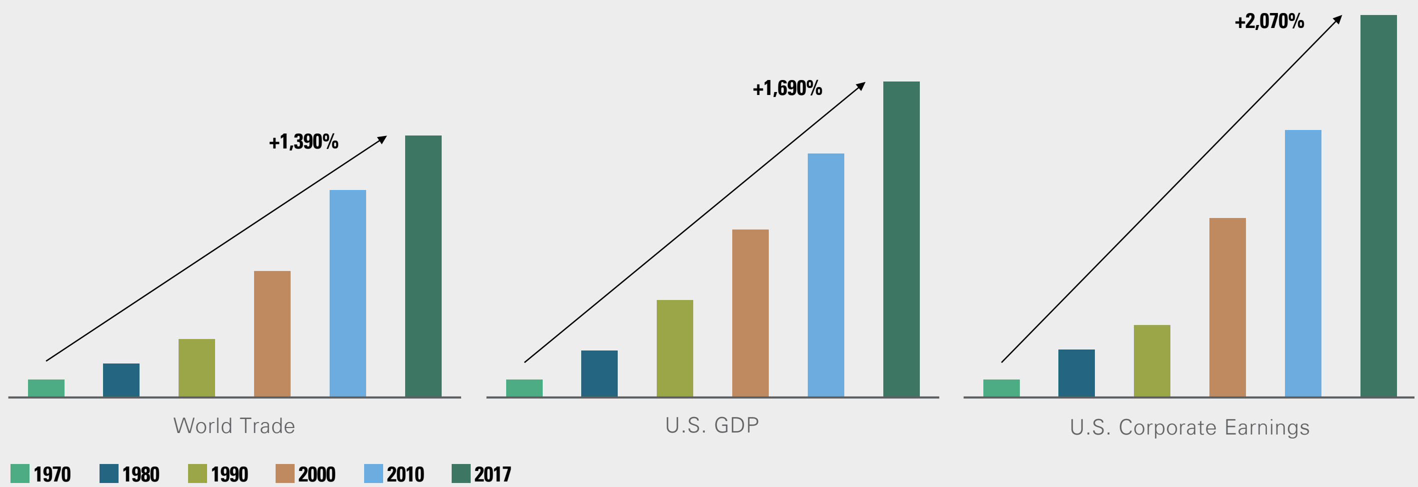
	1940s	1950s	1960s	1970s	1980s	1990s	2000s	2010s
Average 10-Year Treasury Bond Yield (%)	2.0	2.9	4.7	7.5	10.6	6.6	4.4	2.4
Average Inflation (%)	5.7	2.1	2.3	7.1	5.6	3.0	2.6	1.7

As of April 30, 2018. Reflects 10-year maturity and Consumer Price Index.
Source: Bloomberg, U.S. Bureau of Labor Statistics, Global Financial Data

[1] From Factset for S&P 500 companies as of May 21, 2018.
[2] Estimate from JP Morgan as of May 18, 2018.

Exhibit 5: Long-Term Growth Drivers

Key Takeaway: Significant long-term growth in world trade, gross domestic product, and corporate earnings have helped to propel the U.S. stock market.



As of May 29, 2018. U.S. corporate earnings are measured using S&P 500 trailing 12-month earnings per share. U.S. GDP refers to nominal GDP. World trade is measured as the volume of trade of goods and services for the world.

Source: Bessemer estimates, Bloomberg, U.S. Bureau of Economic Analysis

The growth over time in world trade, U.S. GDP, and U.S. corporate earnings has helped drive stock prices higher over the long run. This has occurred through multiple political administrations in the U.S. and abroad. The stock market has climbed the proverbial "wall of worry" through world wars, inflation and oil shocks, presidential assassinations, and terrorist attacks. The global economy and capital markets have proven remarkably resilient, and we believe that these long-term trends will continue.

Conclusion

Although we are late in the current business cycle, most economic indicators suggest that the end is not quite yet in sight. If this is the case, the trend for the stock market should be higher, albeit with more volatility than we experienced over the last couple of years. Revisiting your asset allocation and investment plan is akin to tightening your seat belt, making sure your portfolio is well positioned for whatever comes next.

At Bessemer, we are constantly studying and observing the global economy and markets on our clients' behalf, and we will make active, tactical adjustments to portfolio positioning when we feel it is the right thing to do. The starting point for making those adjustments is each client's long-term, or strategic, asset allocation. With all of the changes we have lived through in the markets in the last decade, now is an ideal time for clients to revisit their asset allocation and investment plan with their Bessemer client advisor. Even if market dynamics hadn't changed, family dynamics often do, and revisiting the investment plan is a helpful exercise.

With special thanks to Marc Stern for his significant contributions.

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