—New Albany—
Investment Management

June 9, 2018

Market Insight: No Longer Do All Markets Rise and Fall Together…

There is no doubt, most money managers would say it has been a challenging market out there. Though a quick cursory summary could point out the new highs in some sectors, it certainly does not represent the whole market. This year has been a volatile ride, and left many areas in the market in stall speed. Since experiencing its first 10% correction in two years in February, the broad market has been contained in a large trading range as investors contemplate both positive and negative news. Political drama in Italy over the Eurozone, implementation of US tariffs, and temporary slowdown in growth are just some of the recent negatives that have shaken investor confidence. At the same time, record corporate earnings, the positive effect of tax cuts on future economic growth and earnings have given investors reason to remain quite positive. A wide range of cross currents have created a disjointed investing environment. Volatility remains elevated and sector performance varies widely such that total portfolio performance could be significantly muted if the asset exposure is weighted in the underperforming sectors. So what has changed?

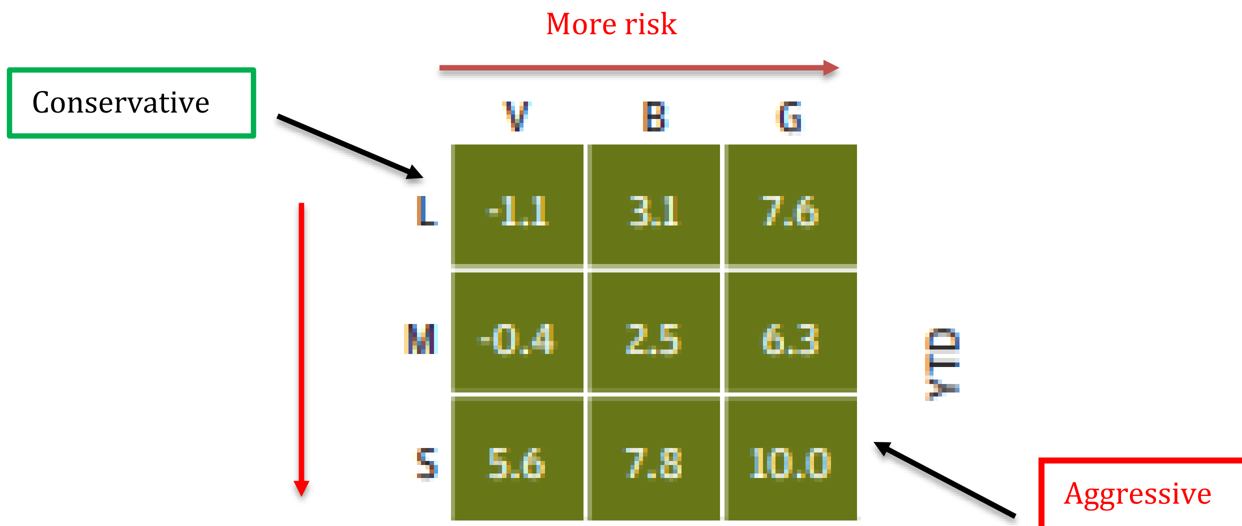
Rising Rates and uncertain Fiscal Policy are the main culprits of investor angst. Though everyone had been expecting rates to rise, the reality of higher rates has still been a wakeup call for investors. Suddenly bonds and dividend paying stocks are no longer so attractive. At the same time, uncertainty over changes in Fiscal policy and trade in particular, has raised a lot of anxiety about the future flow of goods around the globe and hence many large cap stocks are suffering. Separately, each of these factors have had a unique impact on stocks and bonds, and combined, they have undermined investors' confidence and disrupted the traditional risk/return dynamic of asset performance. No longer do all markets rise and fall together, but now each sector has taken its own path.

Risk/Return: Both stocks and bonds have distinctive and unique risk/return profiles that perform differently in different investing climates. In choppy uncertain markets like we have today, typically the lower risk (less volatile) assets perform better. Likewise, when markets are strongly trending, investor confidence is high and they are eager to take more risk and flock to the more aggressive/volatile sectors. Today however, just the opposite is seen playing out - riskier assets are outperforming in a big way. What has typically been 'safe haven' sectors for more conservative investors are now just as risky or more than the 'growth sensitive / less liquid' sectors that attract aggressive investors. A good way to see this is to look at performance across the style sectors for stocks and across the yield curve for bonds.

The Stock 'Style' Box: Performance by 'Style' categorizes stocks two ways: market capitalization (Large, Mid, and Small) and sensitivity to economic change (Value, Blend, Growth). In terms of risk or volatility, generally speaking, Large cap stocks are less risky relative to Small cap stocks because they are more established and liquid; likewise, Value stocks are less risky than Growth stocks because are slow growing and represent the staples consumers use. So a typical 'Conservative' investment strategy would be more weighted in Value and Large Cap stocks, while an 'Aggressive' investor would be more weighted in Growth and Small Cap stocks.

Given today's volatile choppy market, history would say the 'safe haven' or 'Conservative' stocks should perform better than the 'Aggressive' stocks, but the style box says otherwise.

The chart below shows the percentage performance of US stocks by Style thru 6/1/18. The horizontal axis is Value (V), Blend (B), and Growth (G). The vertical axis is Large (L), Mid (M), and Small (S). The Red arrows points to increasing risk/volatility by category. The chart shows that a Conservative investment strategy weighted in Large/Value stocks is significantly underperforming (-1.1%) an Aggressive strategy (+10%) weighted in Small/Growth stocks.



Notice how all the 'Growth' categories have outperformed the 'Value' categories and even more surprising is that Small caps are outperforming Large caps. So despite the elevated uncertainty and volatility, investors are still buying more risk! What gives?

Much of this wide performance variance is due to the impact of changes in fiscal policy as it relates Tax Reform, employment, the US Dollar, Oil, Tariffs and Trade. Each of these factors have a unique impact on industrial and service companies (both large and small, domestic and international) and hence the disparity in performance. For example, Small Caps are expected to benefit from full employment, tax reform, a stronger dollar, and rising energy prices. But Large Caps are hurt more by trade issues, tariffs, foreign policy, and a strong dollar. Thus the style box would say investors are more confident about the domestic economy than globally.

But effects of changes in fiscal policy on stocks are only part of the performance discrepancy story as investors have also had to contend with an unfriendly bond market.

Unfriendly Bond Market: Rising interest rates have pummeled the Bond Market and have made it even more difficult for the conservative investor who is overweight in bonds. The purpose of holding bonds in a portfolio is for income and overall portfolio price stability**.** A well-rounded investment strategy has some combination of bonds and stocks because typically prices move inversely and thus when both are held in a portfolio, the overall value change (risk) is mitigated in volatile markets. However, with the Fed raising short term rates, all rates out the maturity spectrum have also risen which means all bond prices have fallen this year. There has been no place to hide except in 'Ultra-Short' bonds or Cash. Below is the year to date performance of Investment Grade bonds and shows how the longer the maturity, the lower the return.

Ultra-Short: 0.5-0.7% Short Term: -0.3% Intermediate Term: -1.6% Long Term: -4.7%

The Double Whammy! Typically a 'Conservative' portfolio (usually designed for someone approaching or in retirement) will be over weighted in bonds and the stock exposure will tilt toward Large Value. Unfortunately, these are the very sectors that are performing the worst! This shift in risk/return dynamic began late last year, and has really accelerated over the last several months. With rates likely to continue rising and fiscal policy likely to continue to muddle along, the current forces on these sectors should remain for the foreseeable future. So how does an investor profit in this type of disjointed market without taking a huge amount of risk?

Active verses Passive Portfolio Management: Changing market conditions emphasize the need for active portfolio management rather than a static buy and hold strategy**.** Yes, positive returns are harder to earn now but with careful attention to how much and where the risk is allocated, the opportunity for returns is still possible. Understanding specific stock style and sector risk, bond credit and duration risk, and how these assets to fit together, is essential in managing the total portfolio during this challenging investment climate.

Investment Strategy: We have made some changes in the stock component of our portfolios over the quarter. While still maintaining a pro-growth/risk tilt in the portfolios, overall stock weighting has been reduced slightly. At the same time the stock exposure has been reallocated to more aggressive sectors including Small cap and Developed Foreign markets. On the bond side, the strategy goal is income and capital preservation. Bond duration continues to remain quite short to avoid rising rates and average credit quality is at investment grade. We are pleased to see this combined strategy is working.

These are my own thoughts. Please contact me with any questions or concerns.

I hope you are enjoying these sunny days!

Kind Regards,

Barbara

Barbara HS Huff
CEO & President
New Albany Investment Management
614-216-6139
www.newalbanyinvestment.com