Future Partner Conference – Clark Capital

Outlook for Investing – A Longer Run Perspective

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Topics

- The recovery continues – despite the widespread distrust of stock markets
- Is there a “New Normal” of depressed returns?
- Challenges facing U.S. economy.
- True test of diversification – fate of retirees during financial crisis.
- My new book, ***“Investing for a Lifetime”***

Introduction

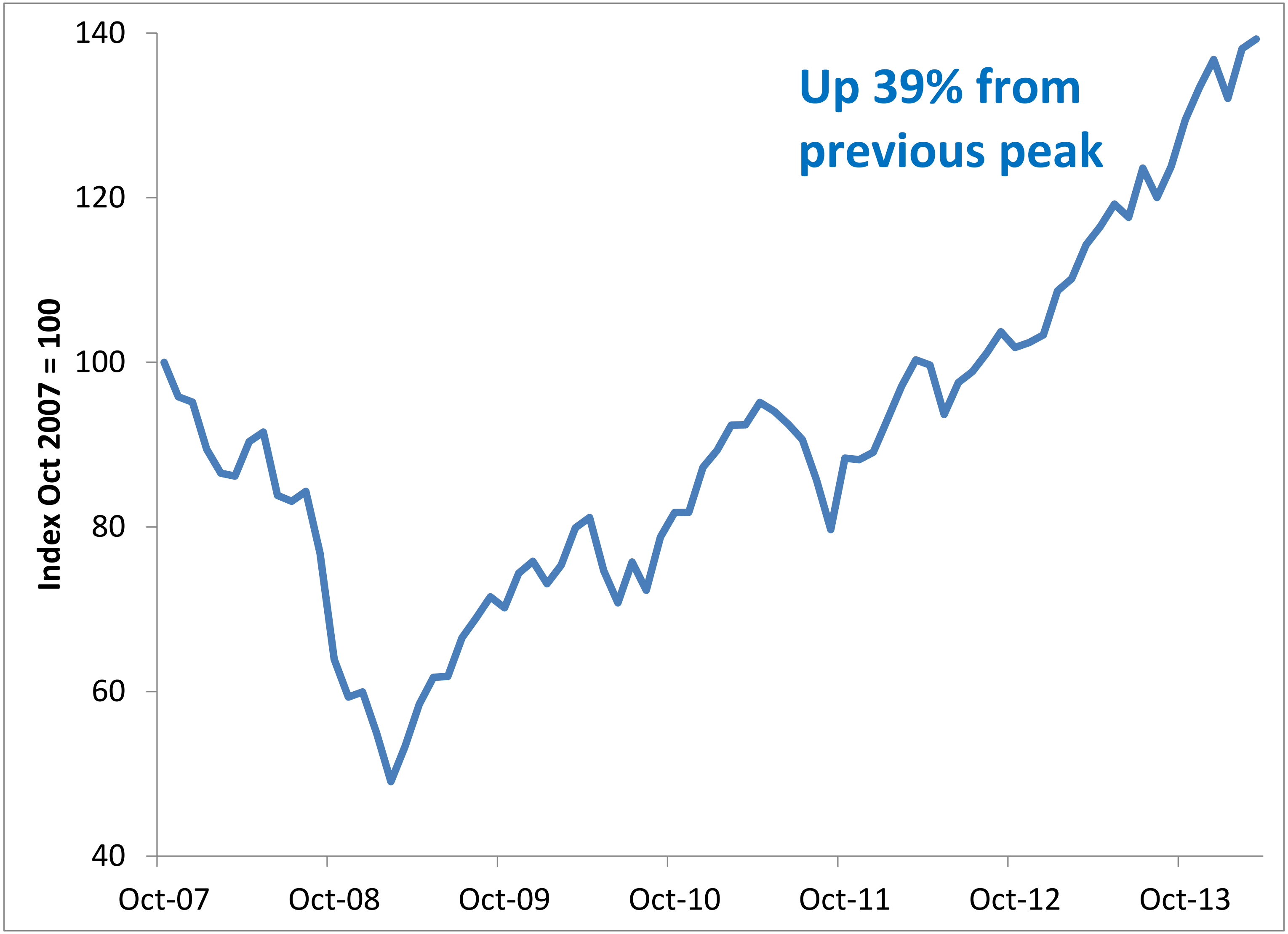
- For the last five years, I have presented a uniform theme at meetings:

Investors should not panic. They should have faith in the American economy.

- Investors who did not panic have been rewarded.
- Since the depths of the market in early March 2009, the S&P 500 index has risen over 180%.

S&P Returns from Oct 2007 thru Mar 2014

Index Oct 2007 = 100



Source: Standard & Poor’s

But are we in a "New Normal"?

- In May of 2009, Bill Gross of PIMCO declared that we had entered a ***"New Normal"*** environment for investing:

1. Extended period of low growth and low earnings growth – requires ***"getting used to a 301(k)."*** The policy portfolio (60/40) is dead along with the notion that ***"stocks always outperform"***
2. Must focus on ***"stable income"*** investments such as bonds and stable blue chip stocks.

Bill Gross introduced the "New Normal" too soon -- shortly after cyclical rally began

- S&P 500 reached its bottom on March 9, 2009 – just six months after Lehman failed.
- It has been a ***great cyclical rally*** ever since then.

After a recession, we always experience a sharp cyclical rally

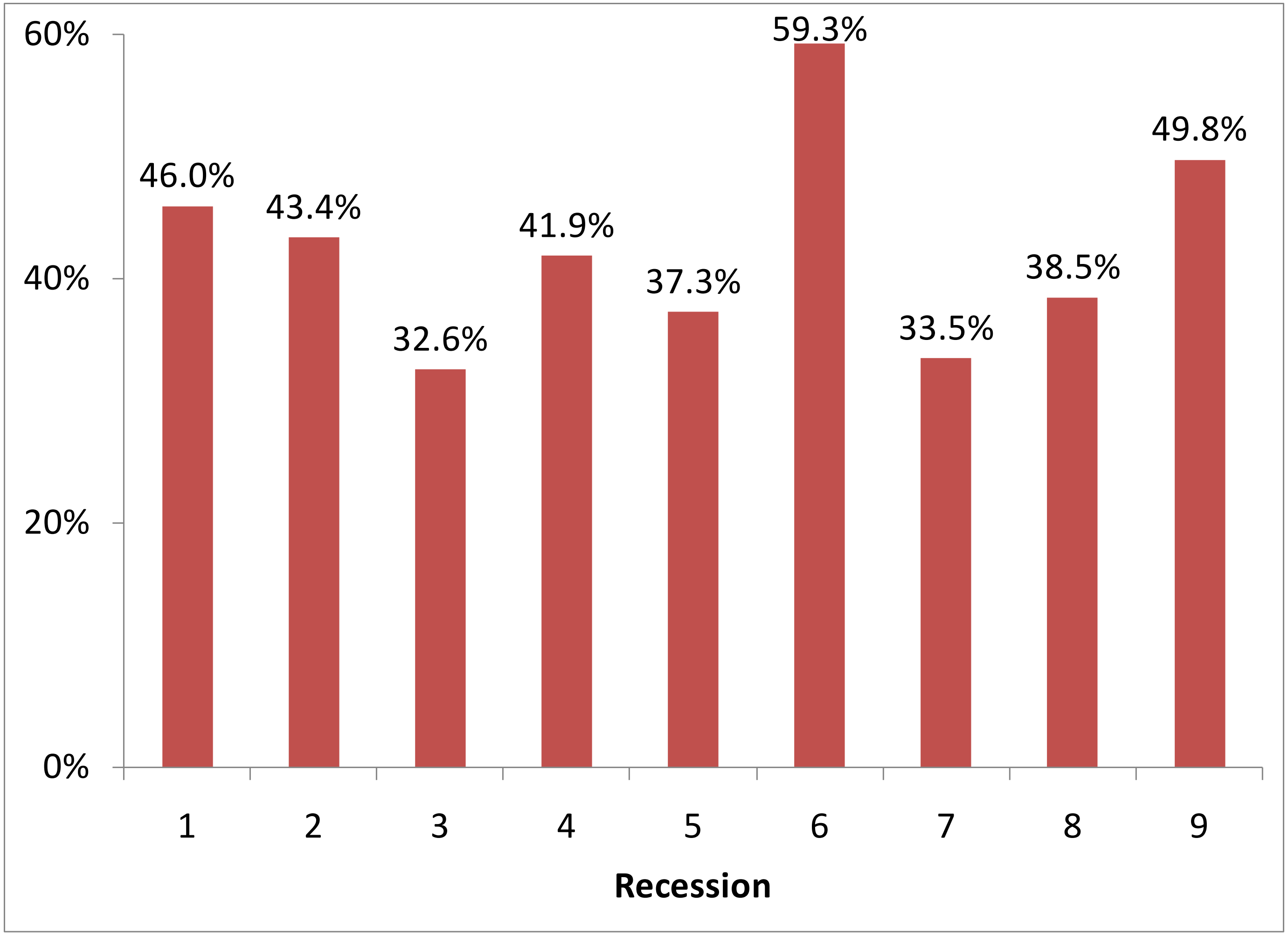
- Key features:

1. **Rally almost always starts before the end of the recession.**
2. **Once rally starts, the market rises sharply over the first twelve months.**

- ***If you bought into the "New Normal" too soon, your portfolio would have missed out on one of the great stock rallies.***

From Table 1-5

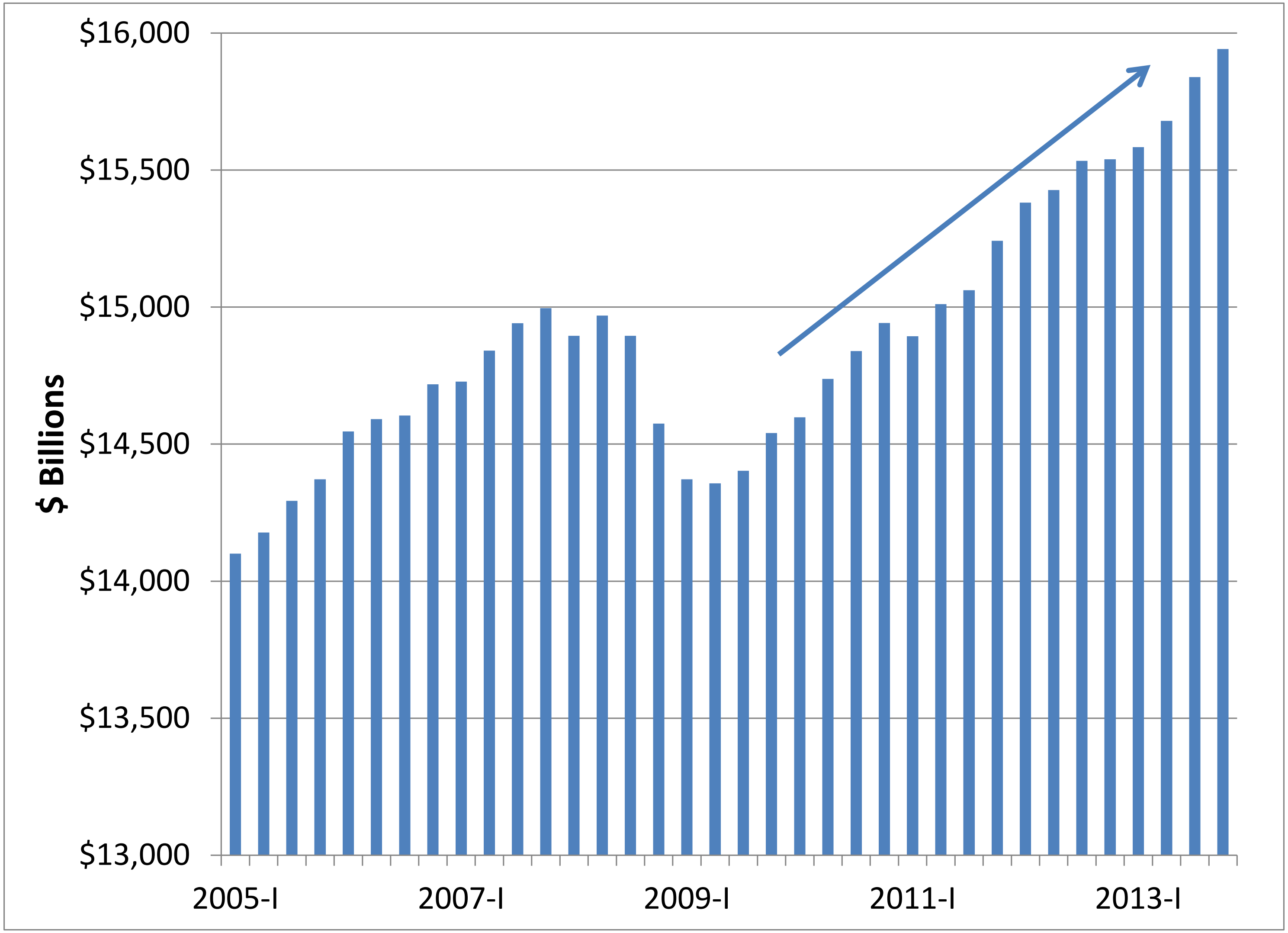
<u>Recession returns: S&P 500 return in 1st 12 months</u>



Source: Marston, 2011

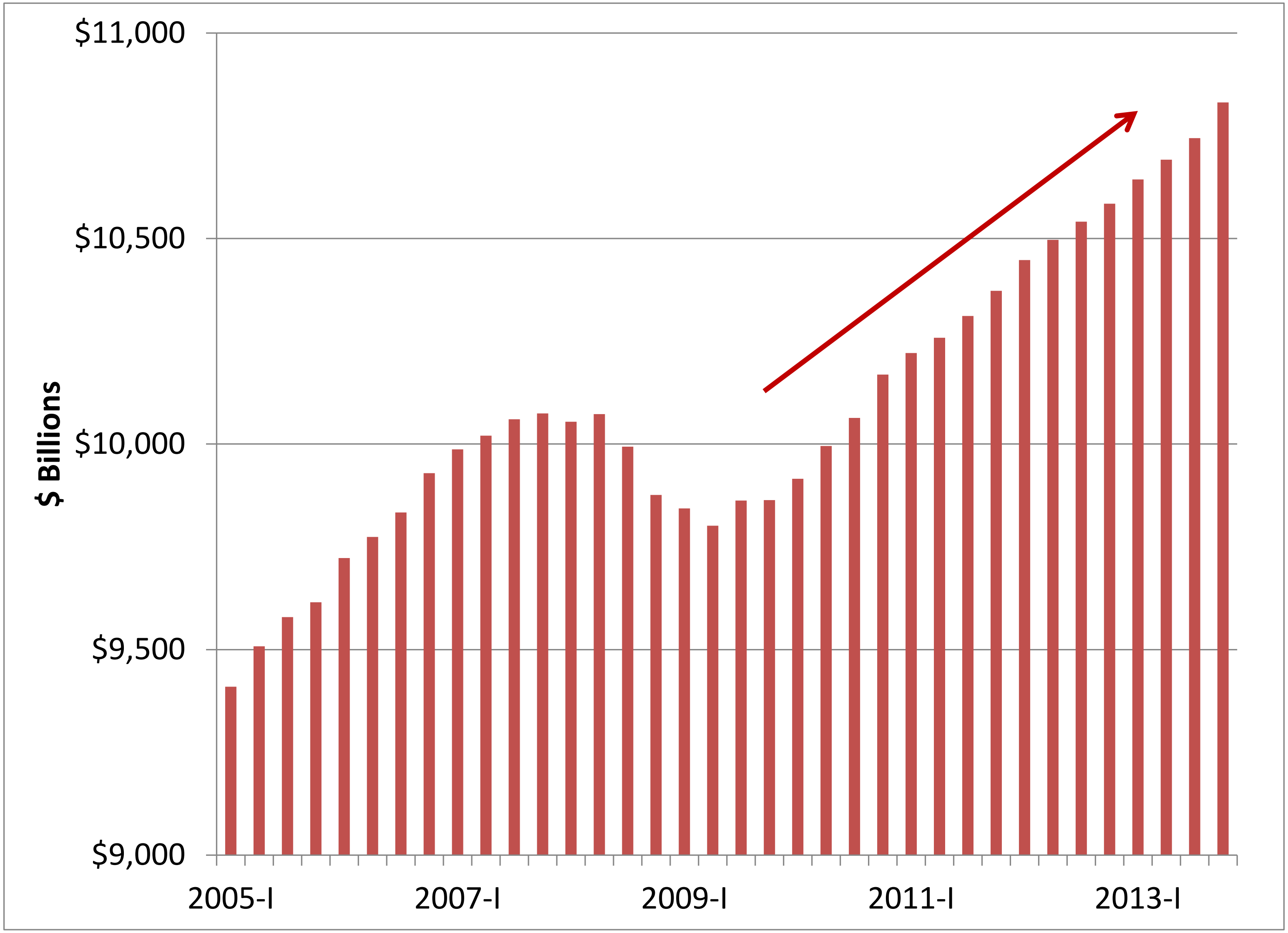
Despite the naysayers, the U.S. economy continues to improve

U.S. Real Gross Domestic Product thru 2013 Q4



Source: U.S. Dept of Commerce

U.S. Real Consumption Expenditures



Source: U.S. Dept of Commerce

Sources of U.S. GDP Growth

Sources: Department of Commerce and Morgan Stanley Forecasts

Growth has been driven by exports, business investment, and, since 2012, residential construction.

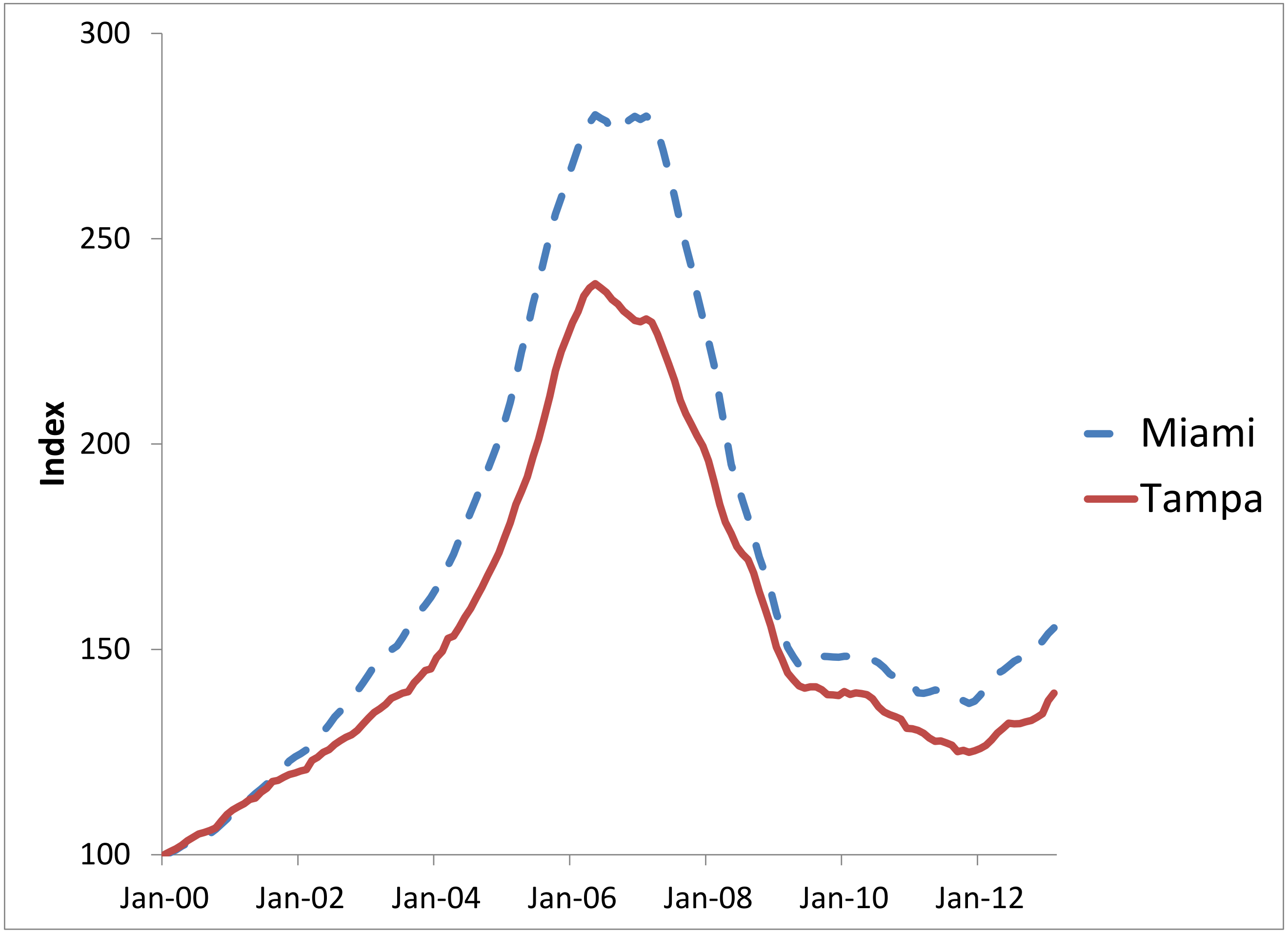
	2010	2011	2012	2013	2014F
GDP as a whole	2.5%	1.8%	2.8%	2.6%	2.7%
Consumption	2.0%	2.5%	2.2%	2.3%	2.5%
Government	0.1%	-3.2%	-1.0%	-2.4%	-1.3%
Exports	***11.5%***	***7.1%***	3.5%	4.9%	5.1%
Business investment	2.5%	***7.6%***	***7.3%***	***4.6%***	***7.4%***
Residential investment	-2.5%	0.5%	***12.9%***	***6.9%***	***17.6%***

Two unusual features of recovery

1. Despite the fact that consumer demand has rebounded, ***the balance sheets of many consumers remain severely impaired***.
   - Financial crises have lingering effects!
   - Housing prices remain depressed in many areas of the country
   - On other hand, equity markets have bounced back nicely

House Prices in Tampa and Miami

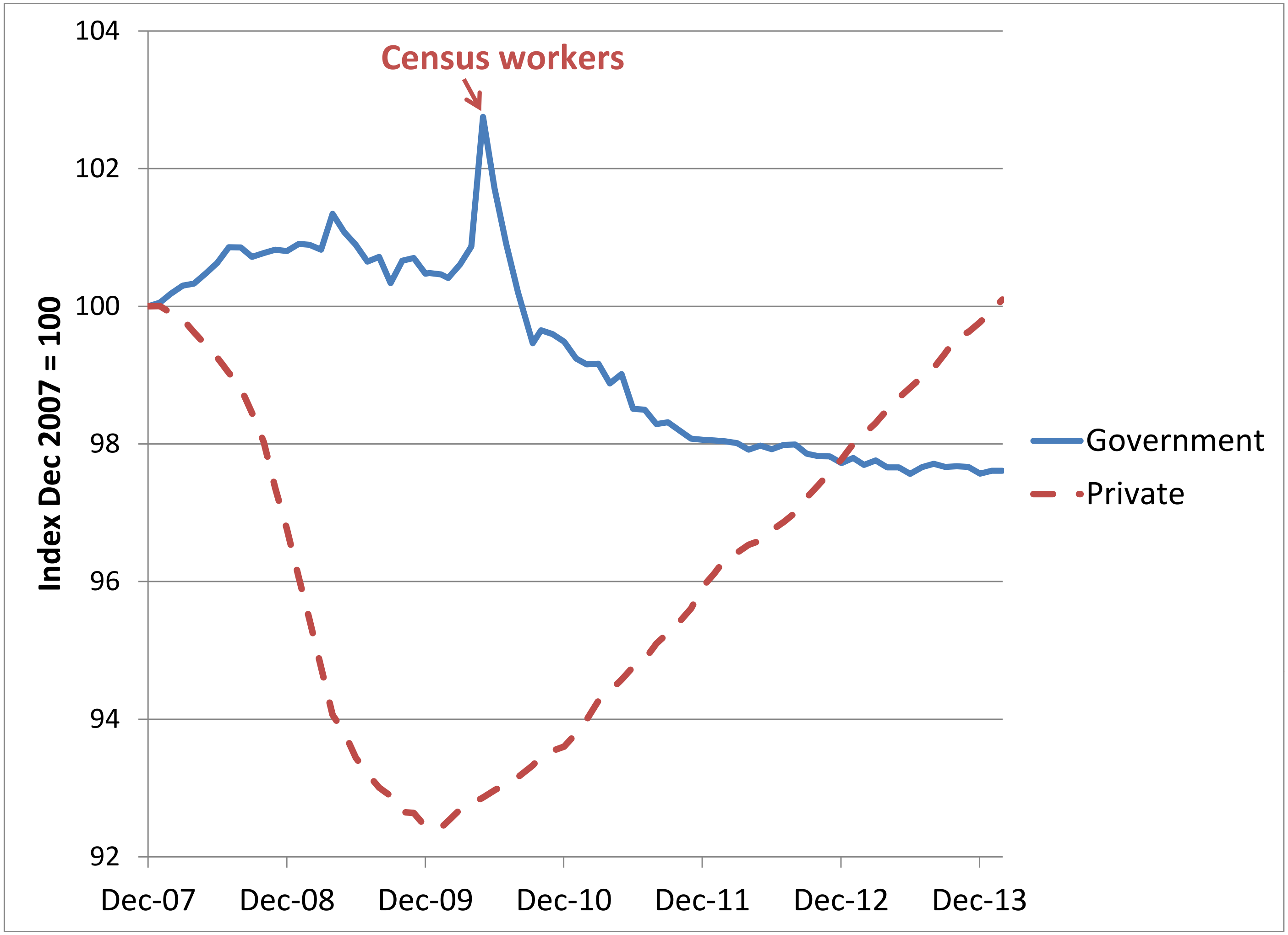
Data Source: Case-Shiller



Two unusual features of recovery

2. Despite recovery of GDP, ***labor demand remains below normal.***

Employment in Private Sector and Government since 2008 through March 2014

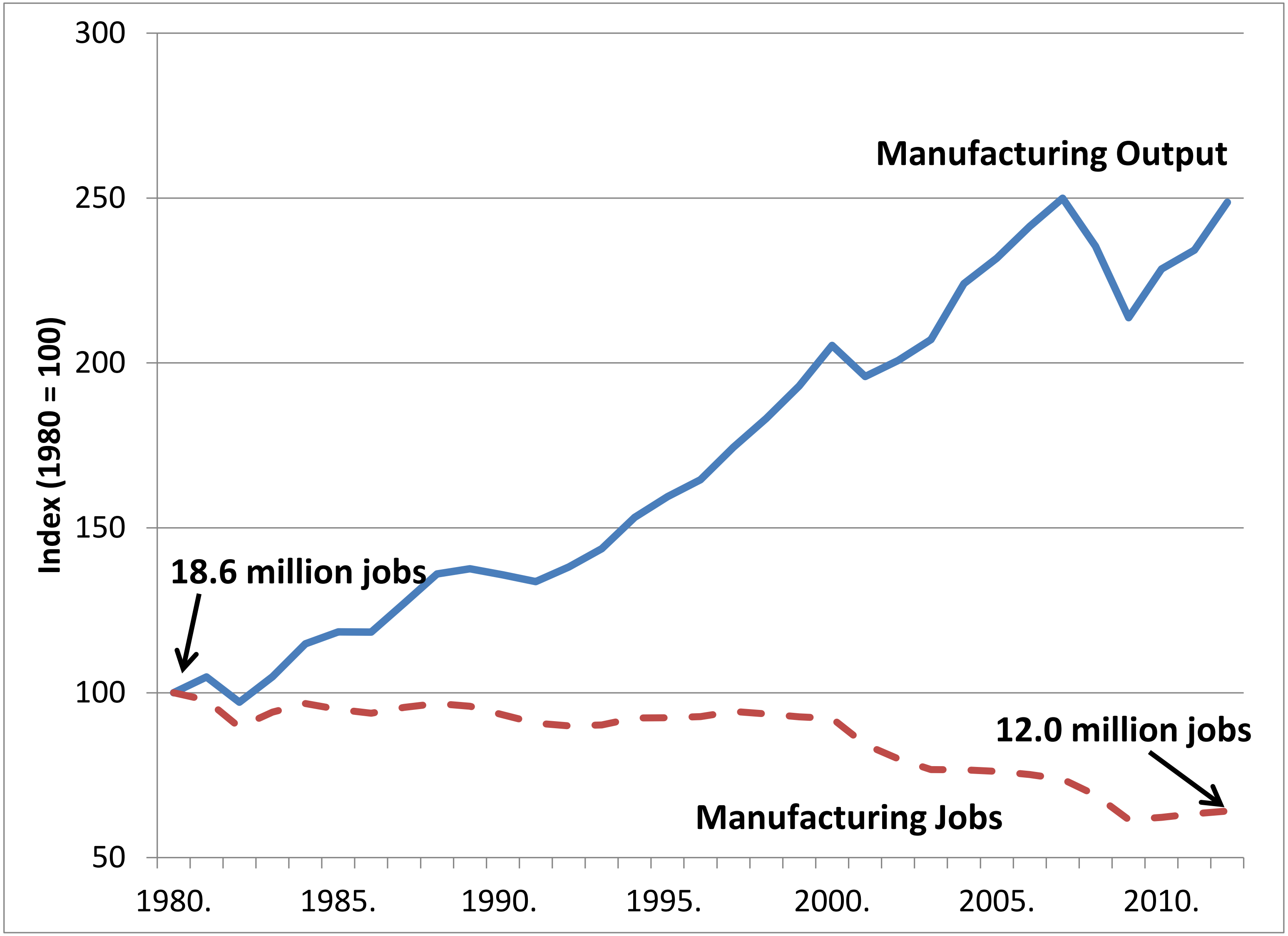


Source: Bureau of Labor Statistics

Two long run trends in labor market

1. ***Productivity growth*** has ***reduced need for labor.*** Examine manufacturing over last 30 years.
2. Jobs increasingly demand ***skill*** and ***education***.

Production and Employment in Manufacturing



Bureau of Labor Statistics and Council of Economic Advisors

Unemployment rates in March 2014
National unemployment = 6.7%

By Education	Unemployment Rate
< High School	9.6%
High School Diploma	6.3%
Some College	6.1%
College Degree	3.4%

Source: Labor Department BLS

Is there a "New Normal"?

- Second element of "New Normal":

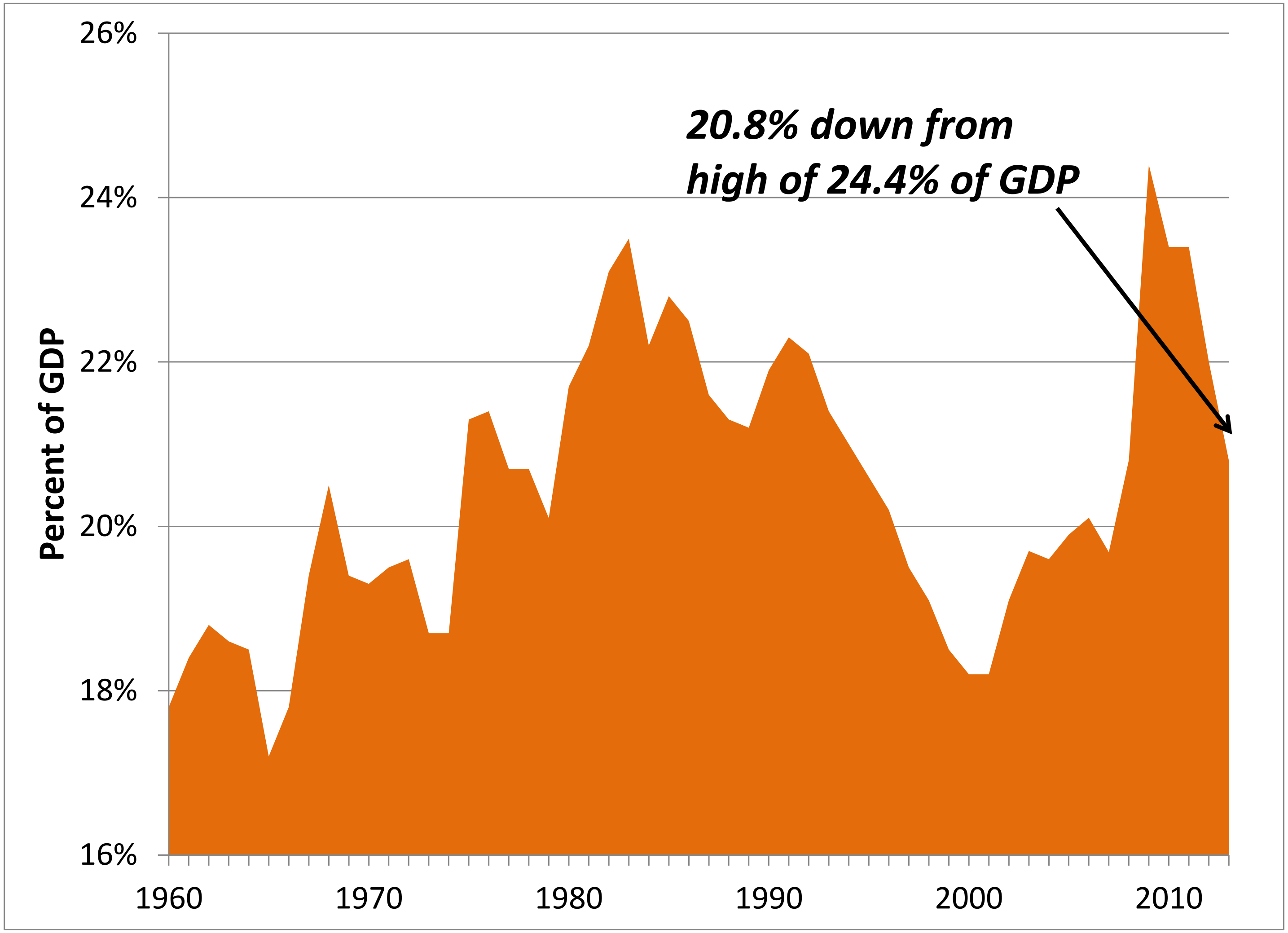
2. Must focus on ***"stable income"*** investments such as bonds and stable blue chip stocks.

- ***But can we trust bonds to behave in the near term? Problems:***

1. ***Fiscal deficits***
2. ***Monetary overhang***

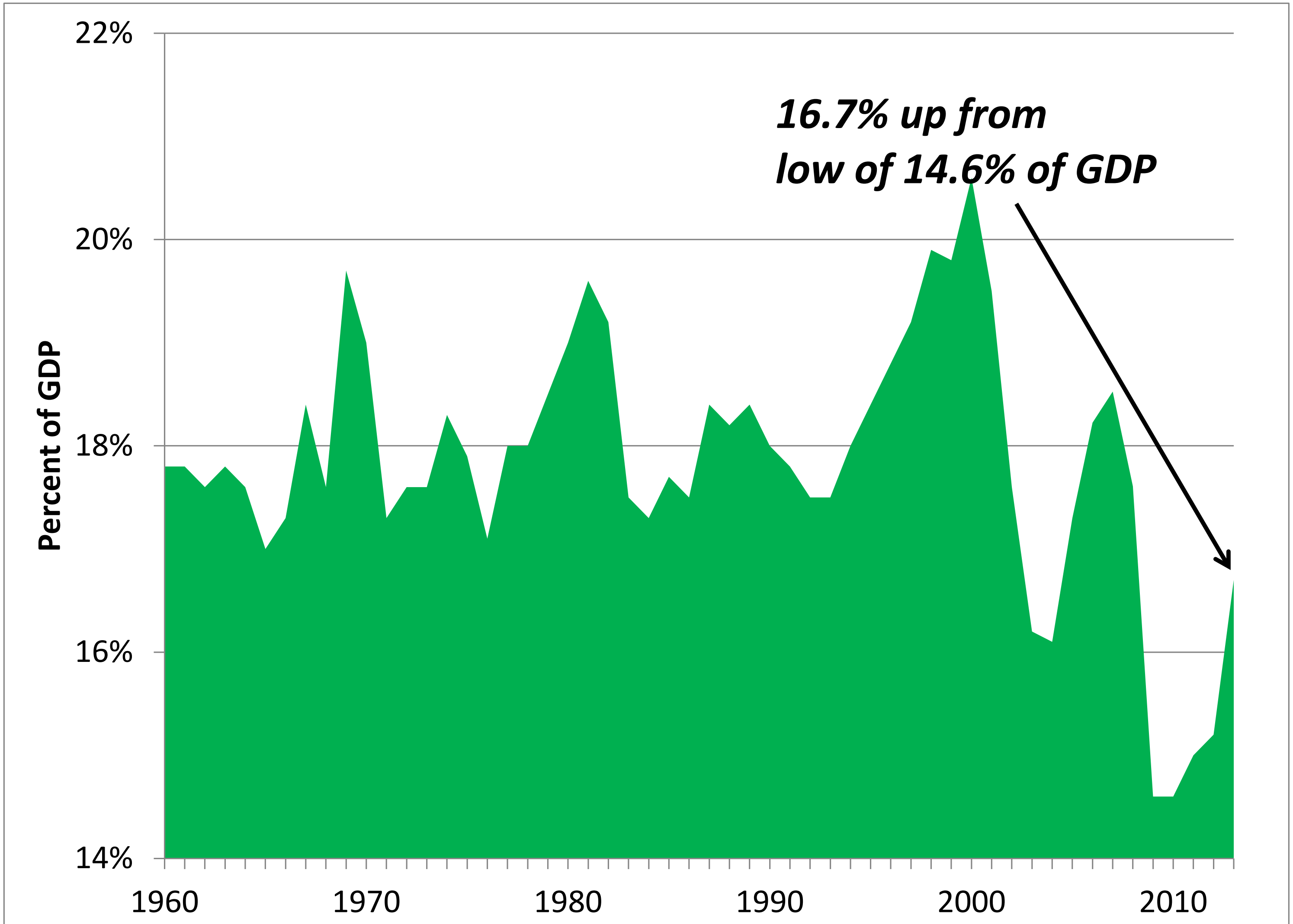
Federal Expenditure as Percent of GDP, 1960-2013

Economic Report of the President (Feb 2013) updated with CBO data (April 2014)



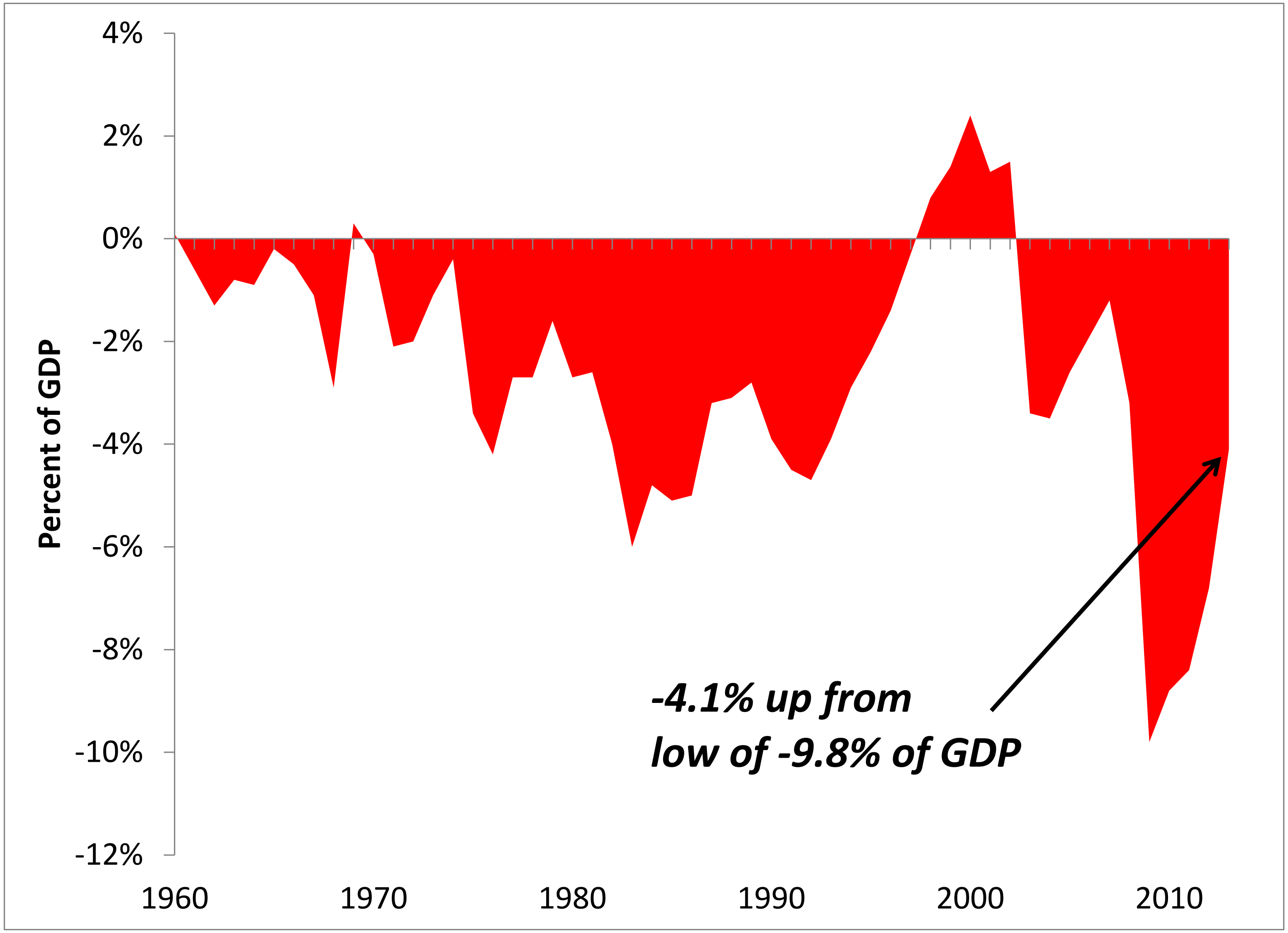
U.S. Tax Receipts as Percent of GDP, 1960-2013

Economic Report of the President (Feb 2013) updated with CBO data (Apr 2014)



U.S. Fiscal Deficit as Percent of GDP, 1960-2013

Economic Report of the President (Feb 2013) updated with CBO data (Apr 2014)



Why deficit problem cannot be easily solved

- Let’s just look at ***Medicare*.**

Medicare is heavily subsidized by general taxes

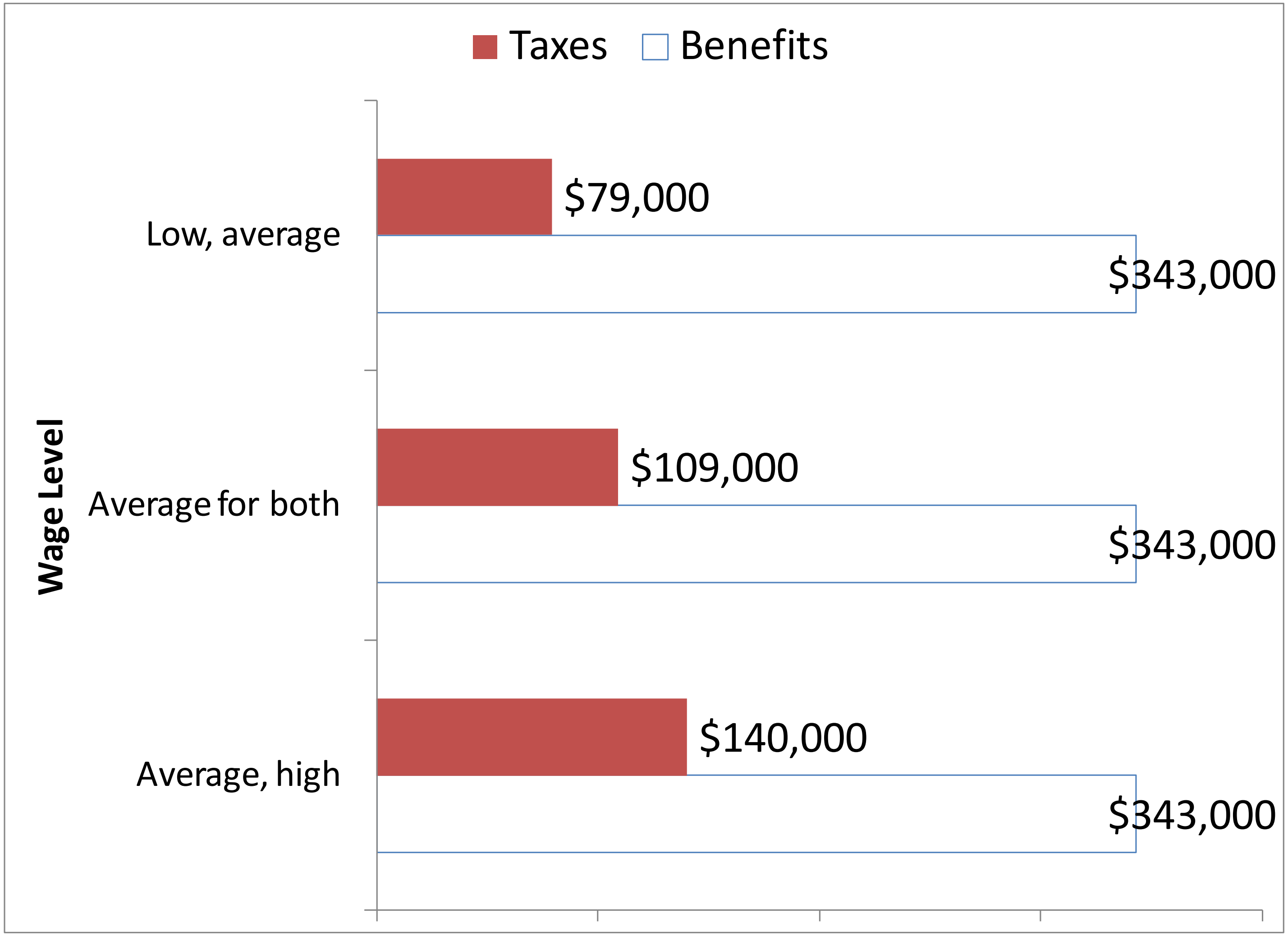
Study by Urban Institute (2011)

- Compare ***lifetime benefits and taxes of 65-year old couple***
- Even highest earning couple receives an enormous subsidy from the general taxpayer

- Three levels of 2010 earnings:
  - Low = $ 19,400
  - Average = $ 43,100
  - High = $ 68,900

Medicare Benefits and Taxes over Lifetime

65 Year-Old Couple Source: Urban Institute (2011)



How can you change such a system?

- ***Everyone in Medicare loves it!***
- Why not? There are tremendous transfers in the system – from the general taxpayer to the retired.
- Remember that Medicare is just one of the runaway programs.

- My point is that this ***fiscal problem is fundamental***.
- And ***our bond market has not yet woken up***.

2. Monetary overhang

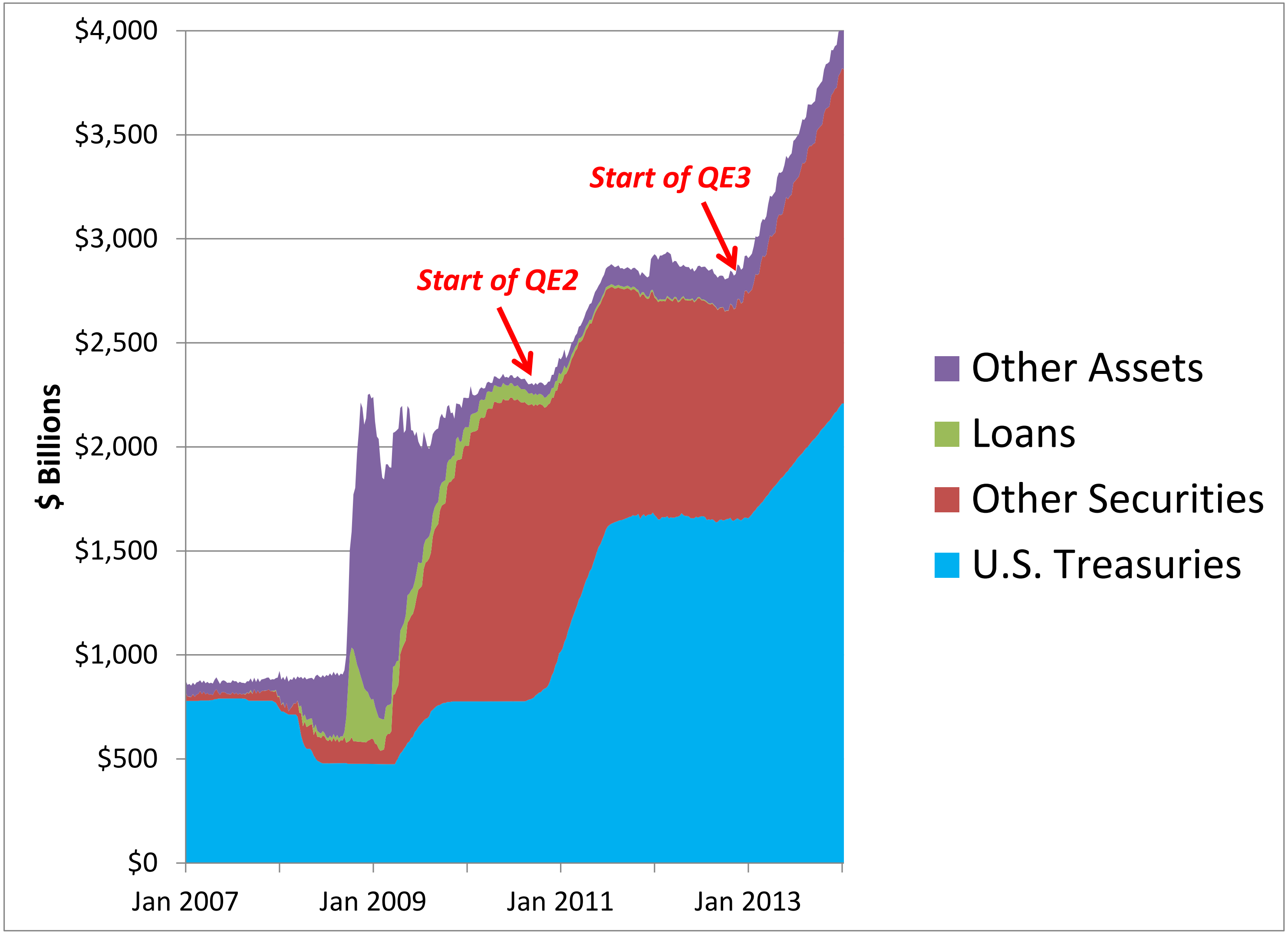
- Federal reserve did heroic work during the financial crisis – providing massive liquidity to save banking system and bolster economy.

- But legacies:

1. Fed balance sheet has ballooned.
2. So has cash at commercial banks.

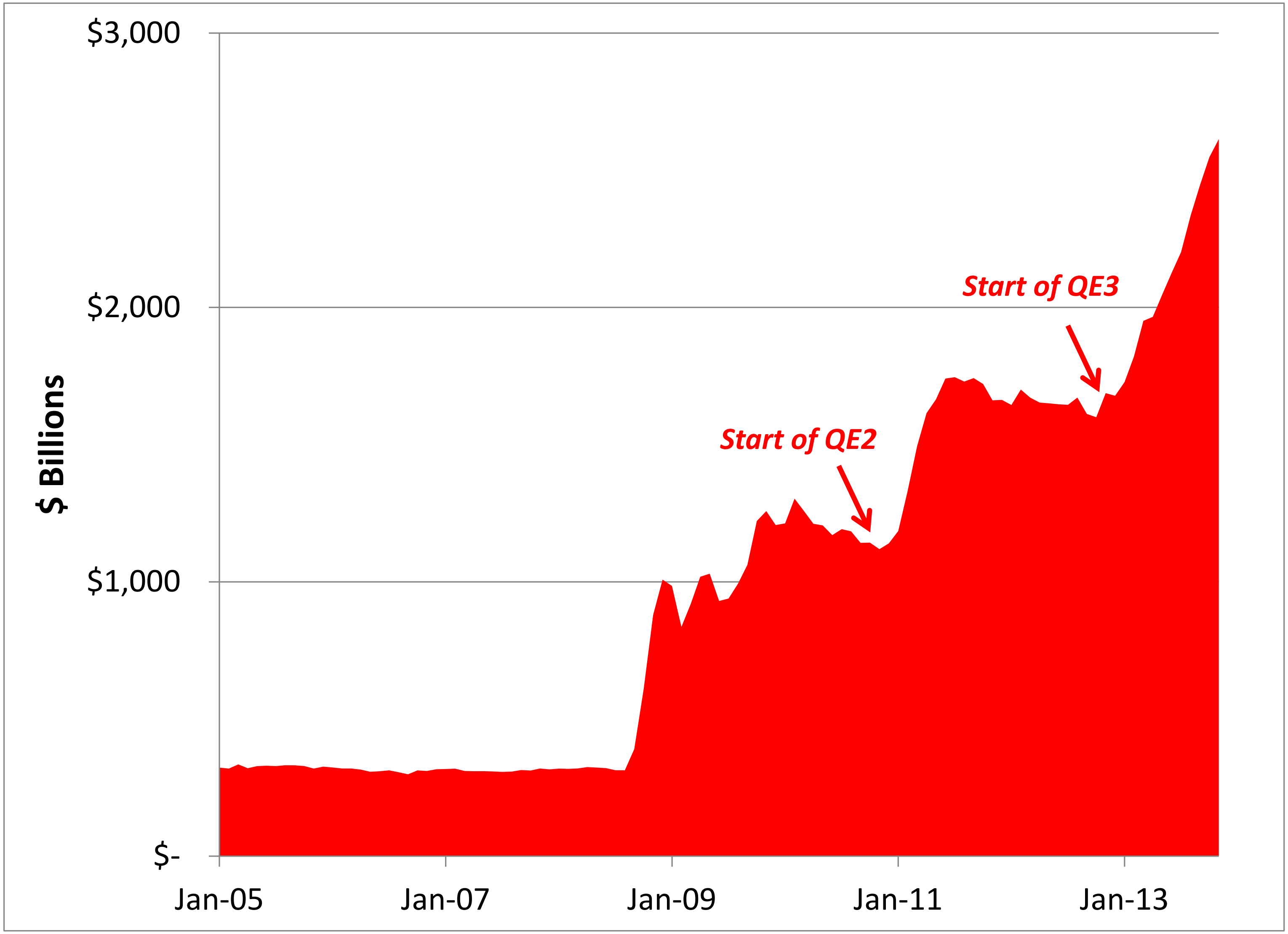
Assets on Fed's Balance Sheet

Source: Federal Reserve Board



Federal Reserve H.4.1 Release

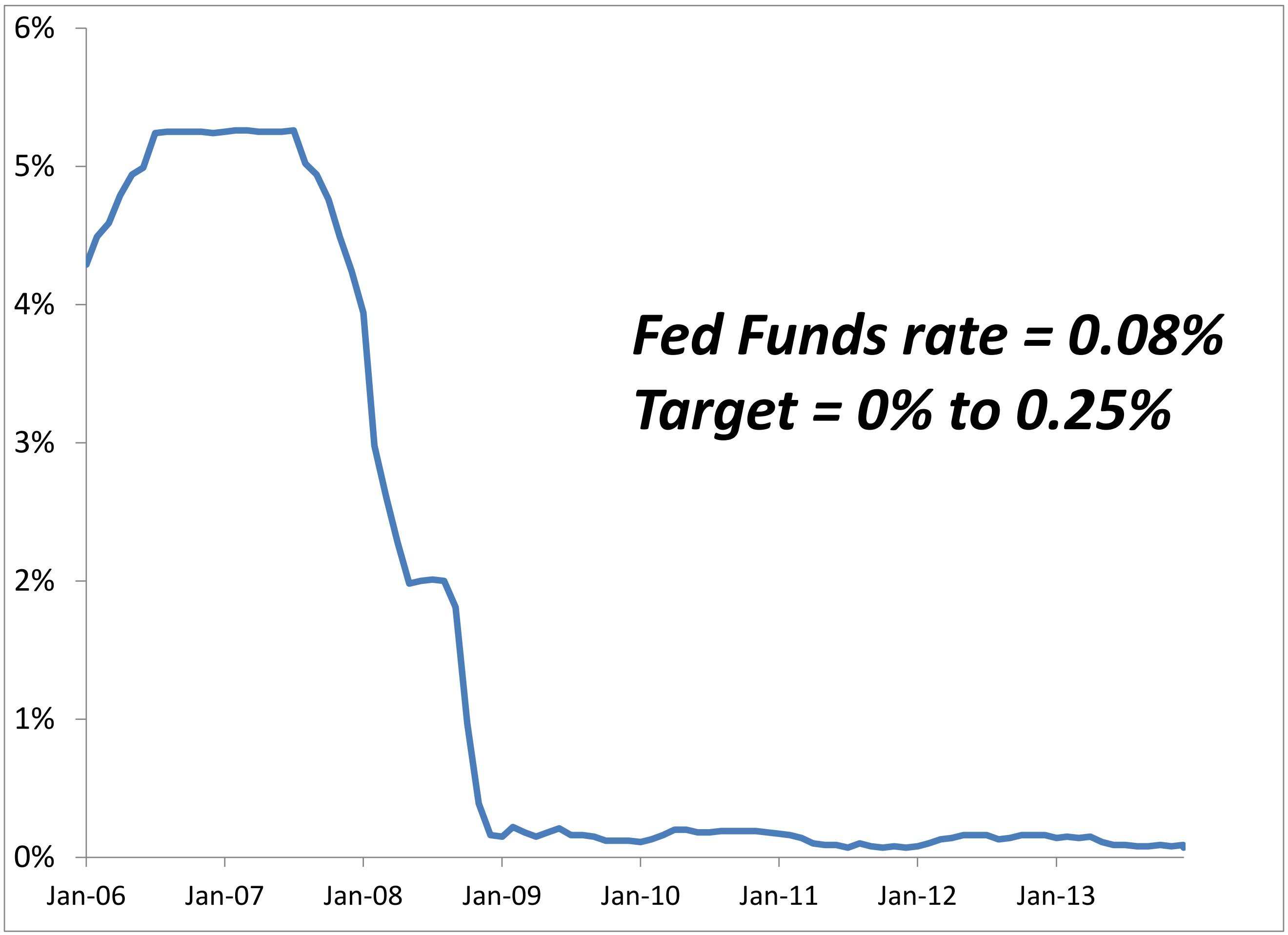
Cash assets at commercial banks



Source: FRB H8 Series

Federal Funds Rate

Source: Federal Reserve Board



Legacies of Fed's "Quantitative Easing"

- No one at Fed has articulated a strategy for withdrawing this massive liquidity from the system.

- How do you reverse course without jeopardizing the economic recovery?

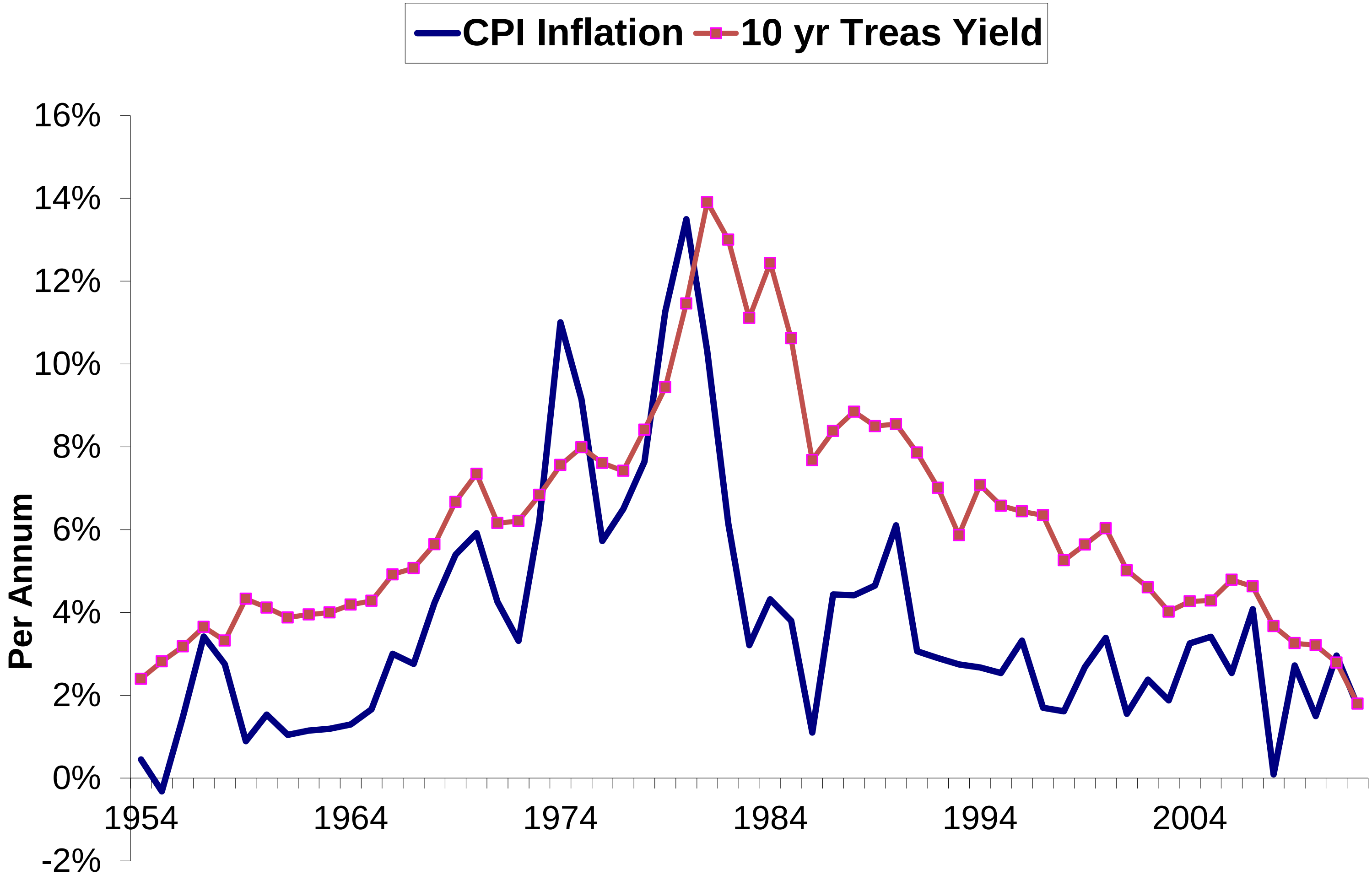
Bond market returns in past

- ***The bond market has been so kind to us for the last 30 years.***

- Why? Bond interest rates were so high in the late 1970s.
- Then they came down over time.
- Gave us wonderfully high returns.

Figure 3.3. Inflation and Bond Yields, 1954-2012

Data Source: IMF, International Financial Statistics and Bureau of Labor Statistics



What this means to investors

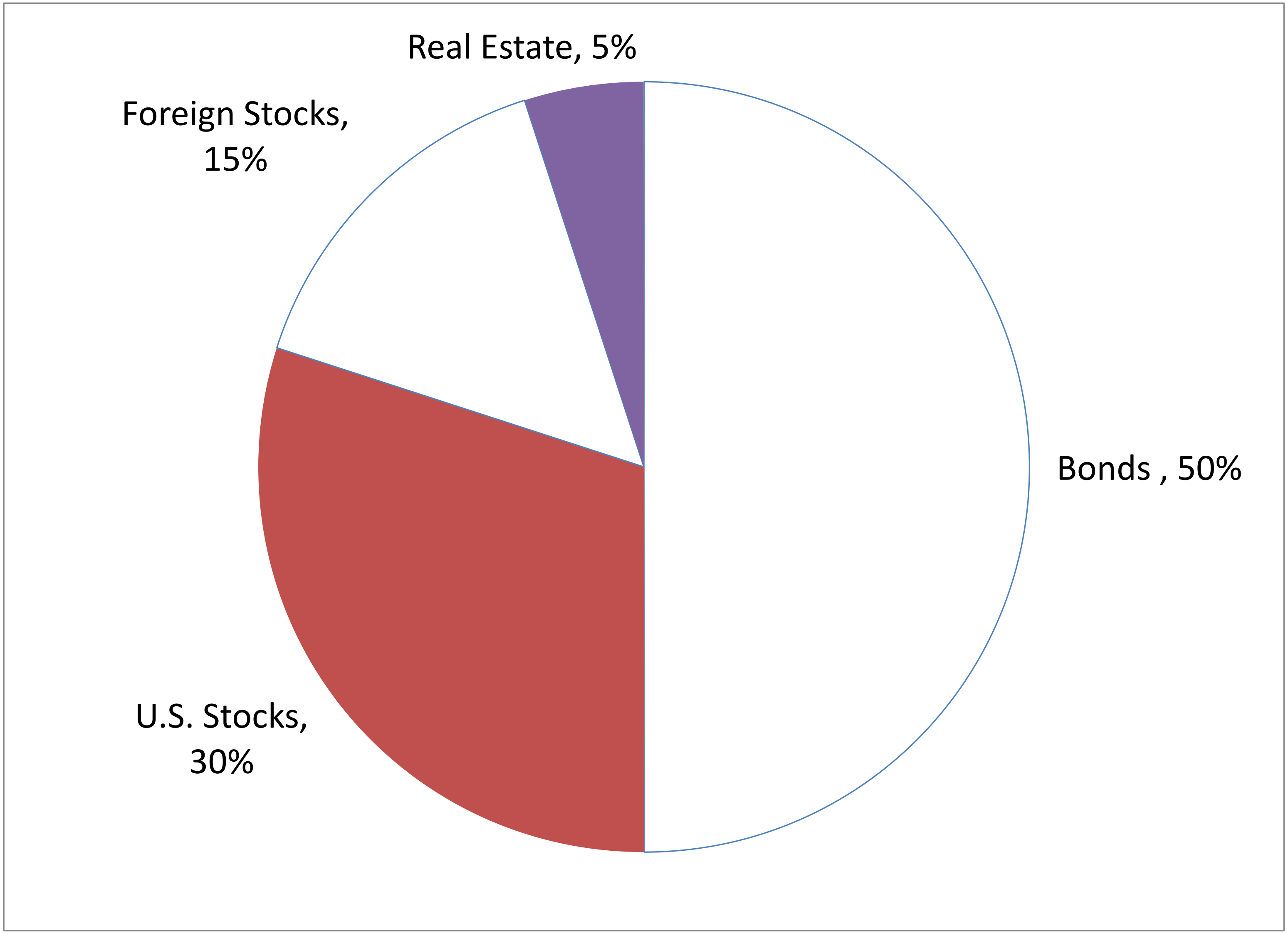
- Investors have to be wary of bond markets
  - Keep durations low!
  - Investors have had to take on more credit risk than normal – watch for any downturn in the business cycle!
- Yes, equity markets have risen a lot. But most of the rise is the normal cyclical rebound experienced in every past recession.
- In meantime, diversification is the key.

True test of diversification

- True test of diversification is the experienced of retirees since the financial crisis began.
- Let’s ask what happened to retirees if they stuck with their strategy.

- A reasonable portfolio for a 60-something:
  - 50% in stocks
  - 50% in bonds

Portfolio for investors in retirement



Marston, 2014

How well has portfolio performed?

Annual Return on	Last 25 Years 1988-2012	"Lost Decade" 2001-2012
Bonds	7.2%	5.9%
U.S. Stocks	9.7%	2.6%
Foreign Stocks	5.5%	3.6%
Emerging M Stks	12.7%	13.1%
REITS	10.9%	11.1%
Portfolio	11.2%	7.5%

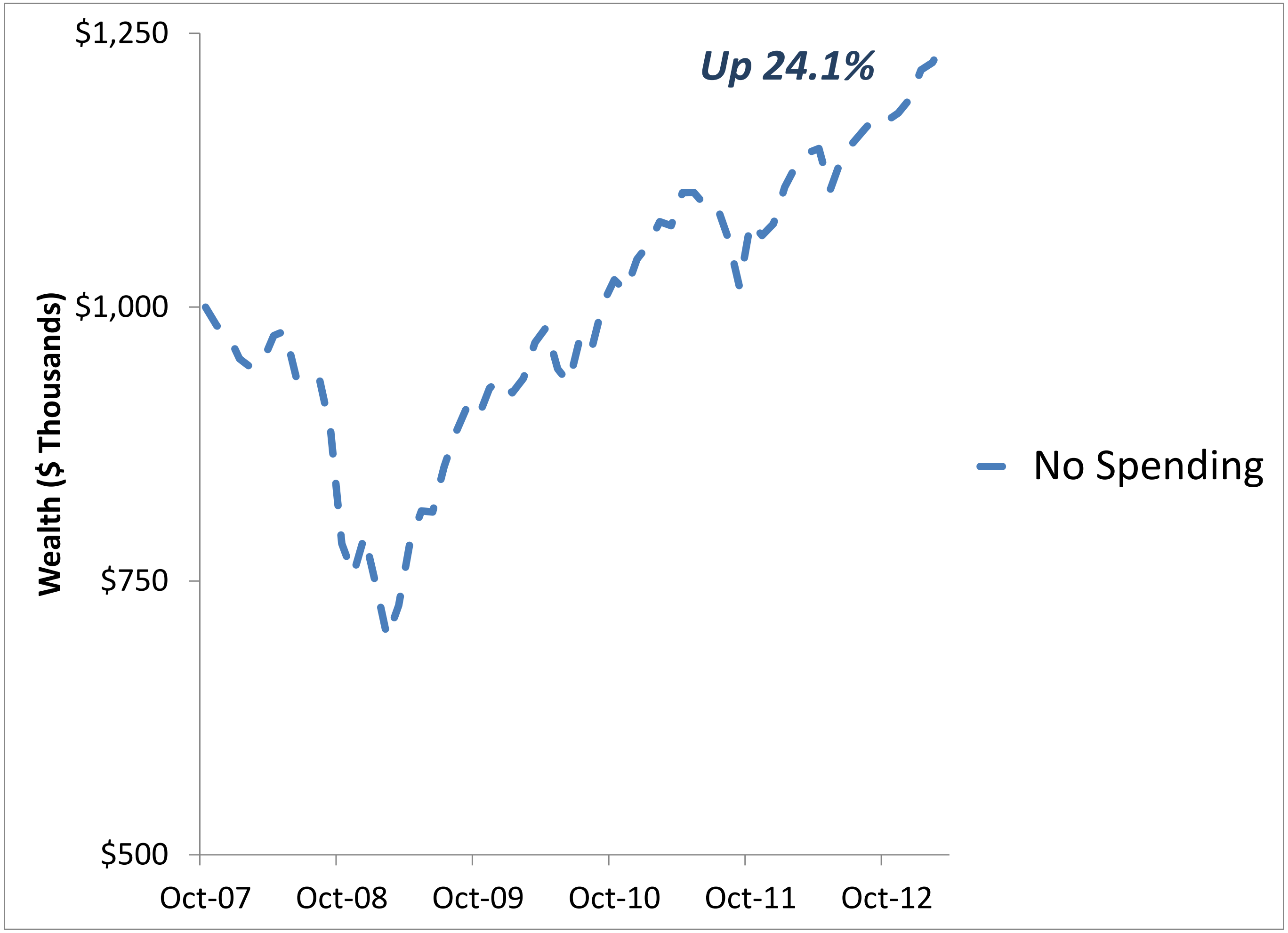
Sources: Barclays Aggregate Bond Index, S&P 500 Index, MSCI EAFE and Emerging Market Indexes, and FTSE NAREIT Index.

How well did retirees do in financial crisis?

- The recent financial crisis was admittedly the worst crisis in my career.
- The Fed and Treasury intervened just enough to turn things around.
- So let’s see how a retiree fared – if he or she followed sensible advice and ***did not panic***.
- Take a portfolio with $1 million before crisis:

1. If not retired, it is up 24% since crisis.

Figure 19.2. $ 1 Million Portfolio during Financial Crisis. 50/50 Stock/Bond Portfolio



Sources: same as table

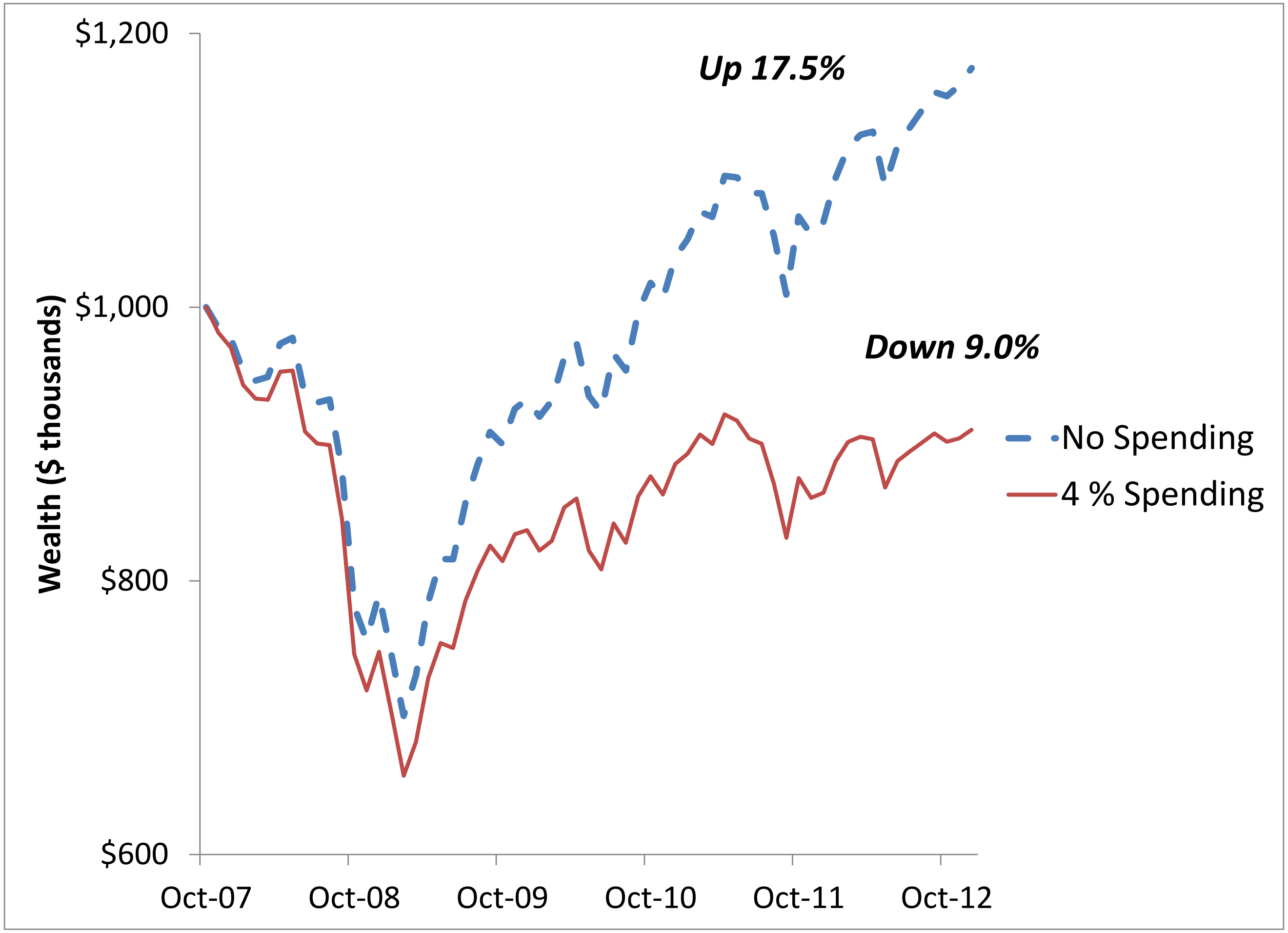
How well did retirees to in financial crisis?

- Take a portfolio with $1 million before crisis:

1. If not retired, it is up 24% since crisis.
2. ***If retired and retiree is spending 4% per year, is down 4.8% since crisis.***

Figure 19-2 $ 1 Million Portfolio during Financial Crisis. Effects of 4 % Spending Rule

Sources for data: Citigroup, Barclays, Russell, MSCI, and NAREIT



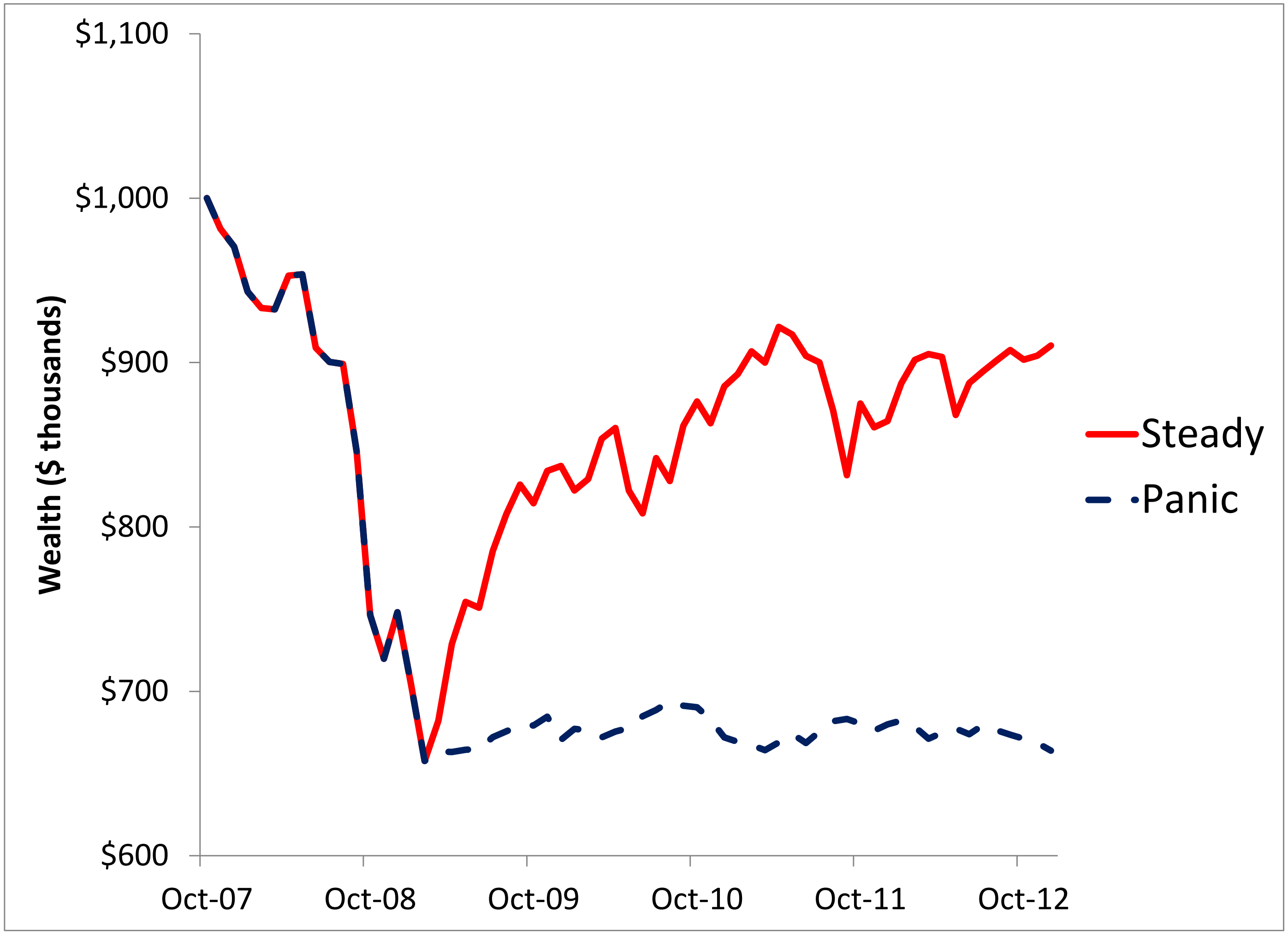
What if a retiree panicked?

- Some retirees panicked during the financial crisis.
- We should sympathize with them – it was a scary period.
- This was a true test for financial advisors as well --- could you keep retirees in a sensible portfolio?

- Here is what happened to retirees who did panic and switched to bonds in the spring of 2009.

Figure 19-3 Steady Investing vs. Panic during Financial Crisis

Sources for data: Citigroup, Barclays, Russell, MSCI, and NAREIT



My new book

- To be published in June by Wiley

Investing for a Lifetime

- Themes:
  - Saving and investing during the working years
  - Wealth management – best practices
  - Spending plan for retirement

- My last book

Portfolio Design (Wiley, 2011)