# FIVE CHALLENGES FACING INVESTORS

Global Financial Private Capital

## SYNOPSIS

- The "60/40" playbook worked well over the last three decades thanks to falling interest rates and strong economic growth.
- Five challenges face investors that will make the 60/40 approach less effective.
- Complex markets call for more sophisticated solutions, and using a playbook designed for simpler times is akin to bringing a knife to a gun fight.

## THE 60/40 PLAYBOOK

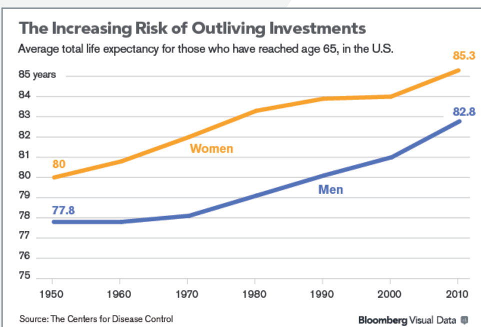
Over the last three decades, the most common approach to asset allocation was to put 60% of assets into stocks and 40% into bonds. This "60/40" playbook worked well for two reasons.

First, the "40" was supported by falling interest rates, which caused bond prices to rise. A simple index fund was all that was needed to generate good income and still sleep well at night. Second, the "60" was fueled by strong economic growth, which propelled stock prices higher.

However, the 60/40 playbook is a simple solution to simple markets, and there are five long-term challenges that investors now face that demand a new approach.

## 1. PEOPLE ARE LIVING LONGER

The chart below shows the rise in life expectancy for men and women since the 1950s due to advances in medicine, healthier lifestyles, and education.




According to the Centers for Disease Control and Prevention (CDC), American men who reach age 65 will live another 17.8 years on average, while women will live 20.3 years, and 47% of couples will have a spouse live past 90 years.

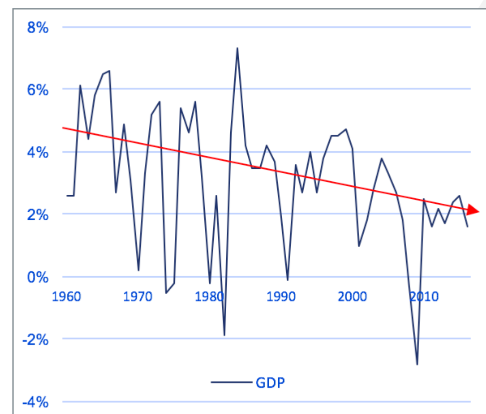
Although this is a trend that arguably most are happy to see, it represents a challenge for the first wave of retirees who are now subjected to the "do-it-yourself" world of 401Ks and IRAs. They are being forced to do what pension managers did for their parents, which was to ensure they did not outlive their nest egg.

> *"...the 60/40 playbook is a simple solution to simple markets..."*

## 2. GLOBAL ECONOMIC GROWTH IS SLOWING

The chart below shows that the economic growth that drove stock prices higher over the last three decades is slowing down. Developed markets like the U.S. have become too big to continue historic growth rates, China has doubled in size over the last decade, and emerging markets have emerged.

### GLOBAL GDP GROWTH




*Source: The Federal Reserve Bank of St. Louis, GFPC analysis*

The implication for investors is substantial because economic growth is the driver for long-term stock prices. Less fuel means expectations on stock returns must come down as well.

## 3. RISING INTEREST RATES CHANGE EVERYTHING

The biggest challenge with rising interest rates is that it has been over half a century since the last time any of us ever experienced them.  The table below shows how bonds performed back in

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the 1950s, which is the closest match to today's interest rate and inflationary environment.

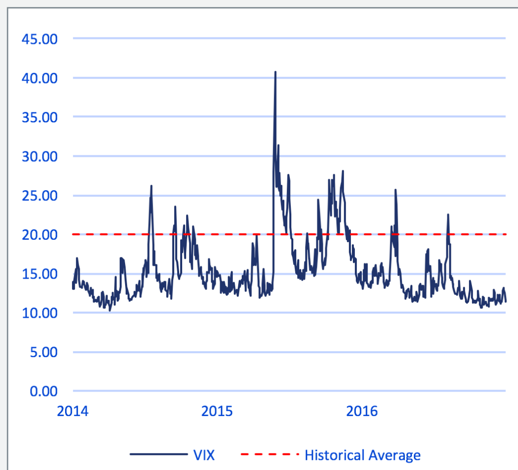
| 1950 – 1959 | Long-Term U.S. Treasuries | Long-Term Corporates | 10-Year U.S. Treasuries | Treasury Bills (Cash) |
|---|---|---|---|---|
| Annual Return | -0.08% | 1.00% | 0.78% | 1.96% |
| Real Return[1] | -2.12% | -1.04% | -1.27% | -0.09% |
| Worst Annual Loss | -6.11% | -6.81% | -2.65% | 0.96% |
| Total Real Return | -19.97% | -10.60% | -12.38% | -1.33% |

*[1] Real returns remove the effects of inflation*
*Source: Ibbotson Data*

The returns in the red-dotted box indicate that it is very possible to lose money in bonds, but the answer to the risk of rising rates is not to run to cash. They are just too important to proper diversification, so a more appropriate solution is to change a bond strategy to one that is designed to operate in a rising rate environment.

## 4. VOLATILITY IS LOW

The Volatility Index (VIX) is computed by the Chicago Board Options Exchange. This gauge is the de facto standard for measuring and tracking equity market volatility, and many consider it to be the "fear gauge" for stocks. Currently, the VIX is sitting at all-time lows.




*Source: The Federal Reserve Bank of St. Louis*

Low volatility equating to a challenge for investors may seem counterintuitive, but the VIX is a "mean-reverting" index. This means that when it is below its long-term average (red-dotted line) it tends to rise to its mean.

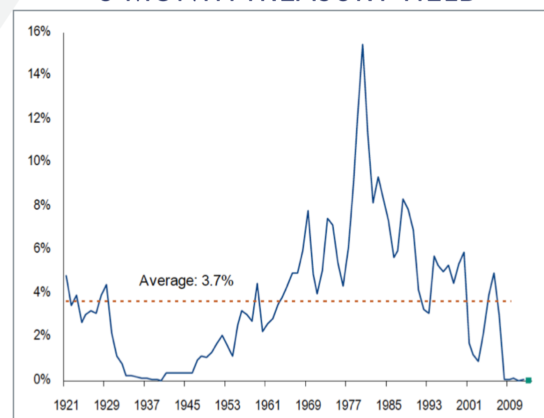
The biggest risk to a volatility spike is not the damage that is done to a portfolio but rather what it does to the mind. The emotional toll on enduring major swings in stock prices causes investors to lose sleep, or even worse, sell into panic.

Volatility also acts like a compressed spring, where the further down it goes and the longer it stays there, the more violent the release. Unfortunately, crystal balls do not exist in this business so timing these events is impossible. The challenge then becomes managing volatility without knowing when it will arrive.

## 5. CASH WILL CONTINUE TO LOSE MONEY SAFELY

Cash and other "safe" investments sure have not felt safe since the end of the financial crisis, and the chart below explains why this will likely not change anytime soon.

### 3-MONTH TREASURY YIELD




*Source: BofA Merill Lynch Global Research, Haver Analytics, Bloomberg*

The yield on 3-month Treasury bills is a good proxy for cash investments and supports these five painful truths on cash:

1. Investors in cash investments have earned no income for over 8 years.
2. The last time rates were this low was after the Great Depression, and it took 16 years for the deposit rate to rise from the zero level. We could be in this same range for another 8 years if history were to repeat itself.
3. The red-dotted line represents the average yield over this period, and it took 34 years to reach this 3.7% level.
4. Bank deposit rates are based on supply/demand, and since the Fed flooded banks with so much cash after the financial crisis, the last thing they need is more of our deposits.

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5. The Fed thinks inflation is running just under 2%, but ask yourself if your healthcare bills, dinner tabs, and other expenses are only going up by 2% each year. Any investment return that fails to beat inflation is losing purchasing power.

The reality of the Fed's decision to enact their war on seniors and savers is that cash and other ultra-safe investments will not cut it for decades to come.

## IMPLICATIONS FOR INVESTORS

Do not interpret these challenges facing investors as words of caution that support a bearish stance on the future for investment returns, because nothing could be further from the truth.

Mark my words. The innovation and entrepreneurship that is driving the world economy, particularly here in the U.S., has just begun. The advances in technology and medicine alone are going to change the world more than once over the next decade.

However, these hurdles have elevated the complexity of positioning to benefit from what is to come. Complex markets call for more sophisticated solutions, and using an old playbook designed for simpler times is akin to bringing a knife to a gun fight.

Think about what it took to fix a car in the 1980s versus today. Back then, a wrench and a basic understanding of an engine could fix most problems. Today, consumers practically need an engineering degree to change the air in the tires. The sophistication has turned cars into computers on wheels, but is this a bad thing?

Cars today are safer, run on less fuel, have cameras to ensure we don't dent bumpers, and do other amazing things like parallel park themselves. Sure, wrenches have been replaced with trained mechanics, but that is the tradeoff for the benefits that came with advancement.

The team here at Global Financial Private Capital recognized these challenges long ago, and we have spent the past year working on a new playbook that is specifically designed to operate in tomorrow's markets.

This new playbook is predicated upon increased diversification to manage unexpected volatility, a proprietary asset allocation framework that can quickly adapt, and elite money managers utilizing strategies that fish in ponds where others are less-equipped.

*The bottom line* is that financial markets evolve over time, and the biggest risk to meeting financial objectives is to refuse to adapt along with them. Our answer to the changing landscape for investment returns will be introduced over the coming weeks.

Sincerely,

**Mike Sorrentino, CFA**

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