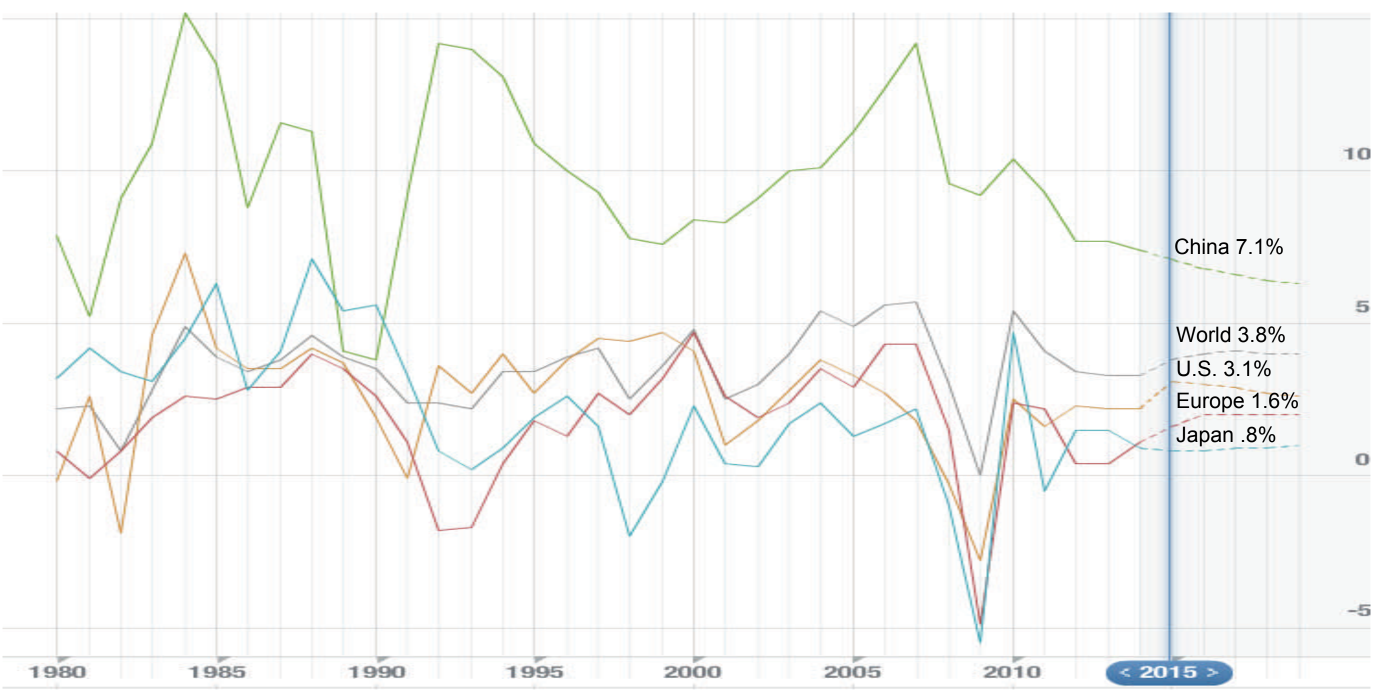
OUTLOOK STILL SEEMS OK & THE CASE FOR LOWER-RISK EQUITIES

QUICK UPDATE

Last time, I mentioned that the International Monetary Fund had reduced its outlook for global growth due to some disappointing data and that it had subsequently increased the probability of a near-term recession to 14% within the U.S. and to 33% for the rest of the world, as a whole. I mentioned that Germany had recently experienced a significant downturn in economic output and that the Eurozone was grappling with the threat of deflation, but that we planned to maintain some exposure to European equities because I think the eventual policy cure could lift equity valuations over there. I mentioned that the Chinese economy continued to slow and that the IMF was concerned that if world economic growth were to disappoint or if geopolitical tensions were to flare, borrowing costs could spike which might then roil the world's capital markets, but that, despite all of this, prospects for the U.S. economy still seemed pretty good and that the forecasters and research firms we rely upon were still pretty sanguine with respect to the overall investment climate. They still are.

According to the IMF, the plunge in oil prices might improve world economic growth by .3% - .7% during 2015, which is actually a substantial boost. The IMF's latest forecast for economic growth around the world is shown, below. I'm pleased to see solidly positive forecasts for the U.S. and for the world in general and that the IMF expects economic growth to accelerate within Europe.



GOLDMAN SACHS THINKS THE U.S. ECONOMY DEPENDS ON ULTRA-LOW RATES

According to Goldman Sachs, equity values could take us on a journey during 2015 and drop us off pretty much where we already are. If the Fed were to begin either increasing interest rates (removing economic stimulus), or begin advocating for such a change in the second half of 2015 as Goldman Sachs expects, Goldman thinks any advance in equity prices we might enjoy in the interim is likely to wither away before the results are tallied for the new year. Conversely, it believes that if the Fed were to delay its widely dreaded interest-rate action until after the close of 2015, U.S. equity values might advance by some low double-digit figure during the whole of 2015. Nonetheless, Goldman Sachs seems to have concluded that any rise in equity values may not well survive the rise in interest rates that is expected to occur over the next year, or so.

ZACKS RESEARCH DOESN'T

Noting that Goldman Sachs apparently subscribes to the notion of "secular stagnation," Zacks Research is skeptical of Goldman Sachs' conclusion. Whether the notion of secular stagnation ever was or is true or whether it will remain true, it essentially postulates that the financial crisis of 2008/9 weakened the U.S. economy to the point that it has since become reliant on ultra-low interest rates.

Finance folks know that rising interest rates present a headwind to economic activity and result in asset valuations that, *ceteris paribus*, are generally lower. I know very few Latin phrases, so I try to work that one in wherever I can. It roughly translates to "all else being equal" or "everything else remaining constant," but in the case of an eventual rise in interest rates, things are decidedly not likely to remain constant.

The grid below depicts the returns generated by stocks during a few previous rising-rate environments. The returns are admittedly not drool worthy, but they're not negative, either.

		Federal Funds Rate			
Period	Number of Rate Hikes	Beginning	Peak	Change	**Average Annual Total Returns**
1994 - 1995	7	3.00%	18.00%	15.00%	**6.00%**
1999 - 2000	6	4.75%	5.00%	0.25%	**6.50%**
2004 - 2006	17	1.00%	16.00%	15.00%	**5.25%**

Source: Standard & Poors, Federal Reserve, J.P. Morgan. Total returns as represented by the S&P 500.

While no one is likely to argue that rising rates do anything to actually boost stock valuations, the Fed is on record as being disinclined to raise rates unless and until it believes the underlying health of the economy is strong enough to handle the insult. This is the unequal portion of the dynamic that could allow stocks to generate positive returns even in the context of the Fed removing some economic stimulus. The fact that stock prices might have increased somewhat more in the absence of any such rate hike is an argument that's true enough, but one that misses the point.

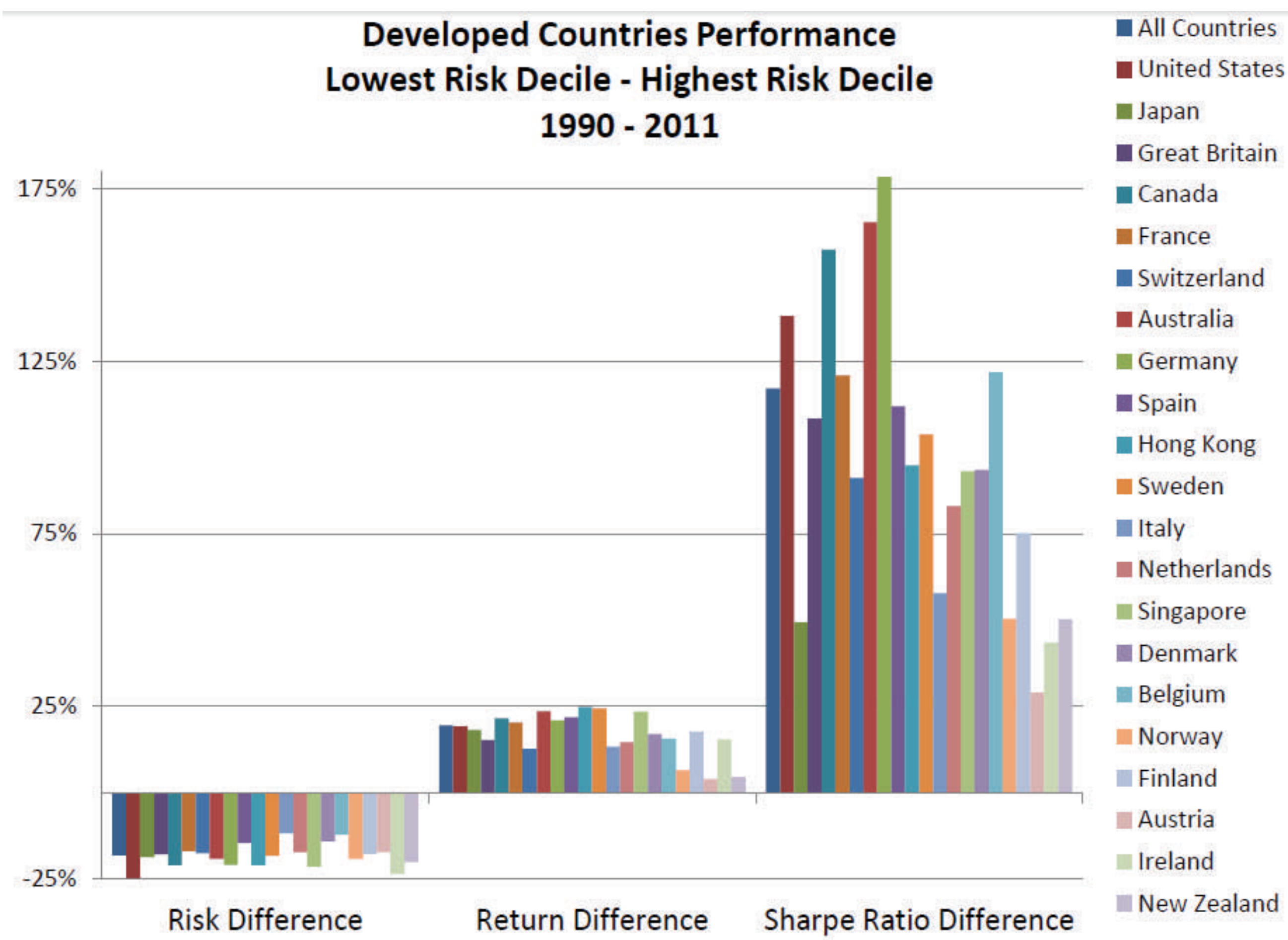
2014 might have turned out to be the best year for job growth since the 1990s. Corporate profits are historically high, various leading economic indicators are high and/or rising, forecasters generally expect the U.S. economy to continue growing at a decent clip and they generally expect the Eurozone to exhibit at least some growth. Zacks' conclusion is that any increases in the Federal Funds rate (the rate at which large banks lend and borrow amongst themselves) are likely to be modest, at least at first, and that any revisions to monetary policy are not likely to derail the economic momentum that now exists — at least not at this point.

The graph below depicts Zacks' aggregate corporate earnings estimates over the next year or so. To decode the abbreviations a bit, "A" pertains to actual figures while "E" pertains to estimated ones. I couldn't find an explanation for the expected contraction in estimated earnings for the first quarter of 2015, but by the third quarter of 2015, Zacks expects aggregate earnings to be about 7% higher than they were for the third quarter of 2014. Admittedly, analysts have tended to be overly optimistic, but *ceteris paribus*, higher estimates are preferable to lower ones and are *arcanum boni tenoris animae*!

THE LOW-RISK EQUITY ANOMALY … AND OUR PREFERENCE FOR IT

For many years now, we have tilted the equity weightings of most of the portfolios we oversee toward equities that are valued at lower prices in relation to their earnings, cash flows, and liquidation values. We do this partly because value-oriented equities have tended to offer more generous dividend yields and partly because they have also tended to exhibit less volatility (i.e., lower risk) — two attributes that find easy favor with our mostly-retired client base. While most folks instinctively understand that higher returns are normally associated with a higher overall level of investment risk, I suspect that comparatively few are aware of the more nuanced details of this relationship.

For example, since equities present a higher overall level of investment risk than do bonds, one ought to expect equities to have generated higher average rates of return. While the integrity of this risk/reward relationship often holds up *between* stocks, bonds, cash, and other asset classes, it sometimes breaks down *within* a given asset class. Please read on before trying to make sense of the graph, below.



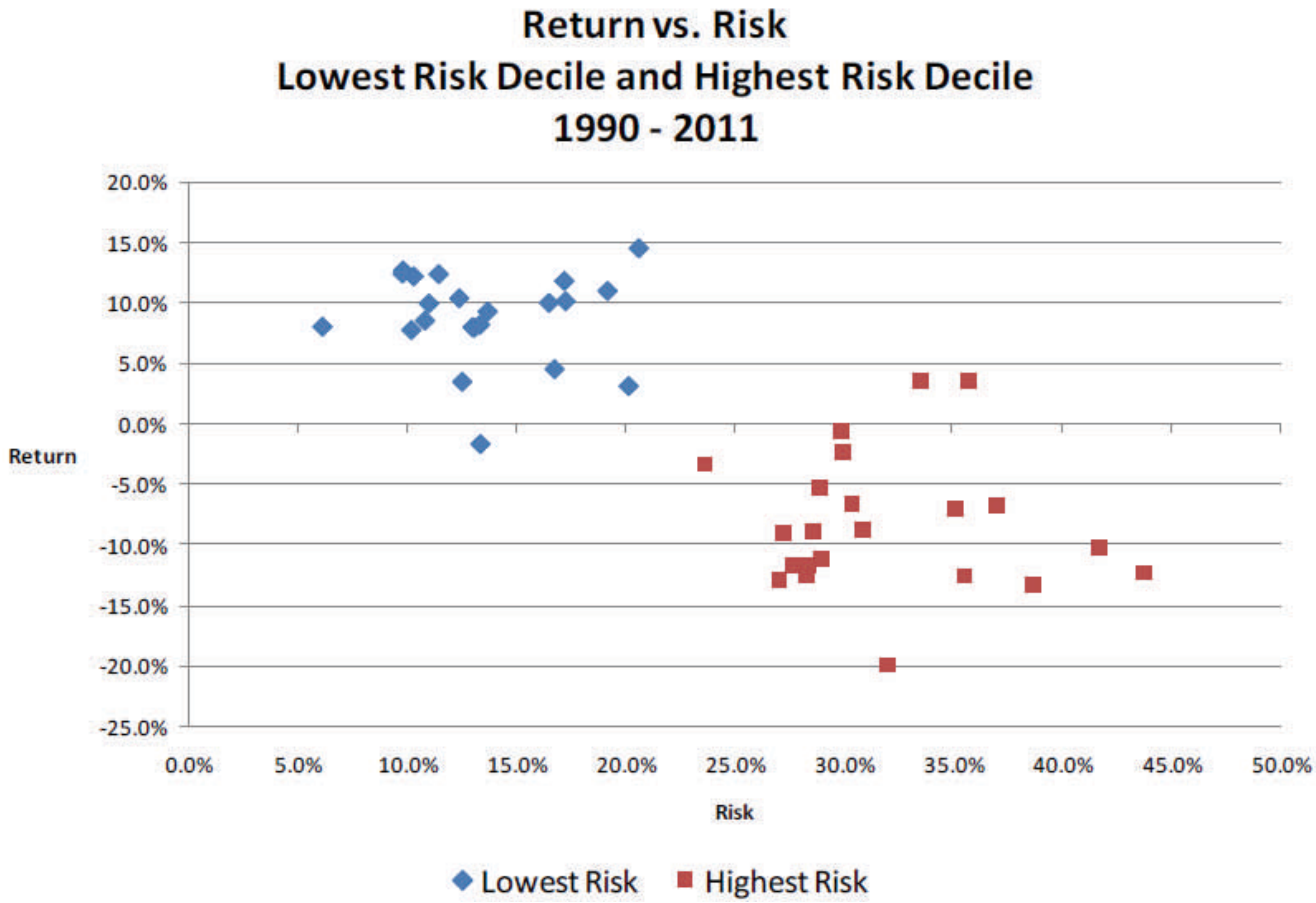
In 2012, Nardin Baker and Robert Haugen published the results of a 21-year study that examined the relationship between risk and return within the stock markets of 21 major countries. The title of the study sums the results up nicely — *Low Risk Stocks Outperform within All Observable Markets of the World.*

I have nothing to sell here, so I'll reveal the authors' conclusions up front. They didn't just find that low-risk equities have outperformed high-risk equities on a *risk-adjusted* basis, or that they outperformed in just *some* of the world's markets. They found that low-risk equities outperformed in *each* of the 21 countries they studied. Those 21 countries are listed in the graph on page four.

For each of those 21 countries, the authors categorized all publicly-traded equities into 10 distinct groups according to their level of riskiness, as measured by share-price fluctuation. They then compared the returns generated by the most risky stocks (the top 10%) to the returns generated by the least risky group of stocks (the bottom 10%). They either did not examine the remaining eight groups of stocks, or did not report on them, or maybe I just didn't read that part.

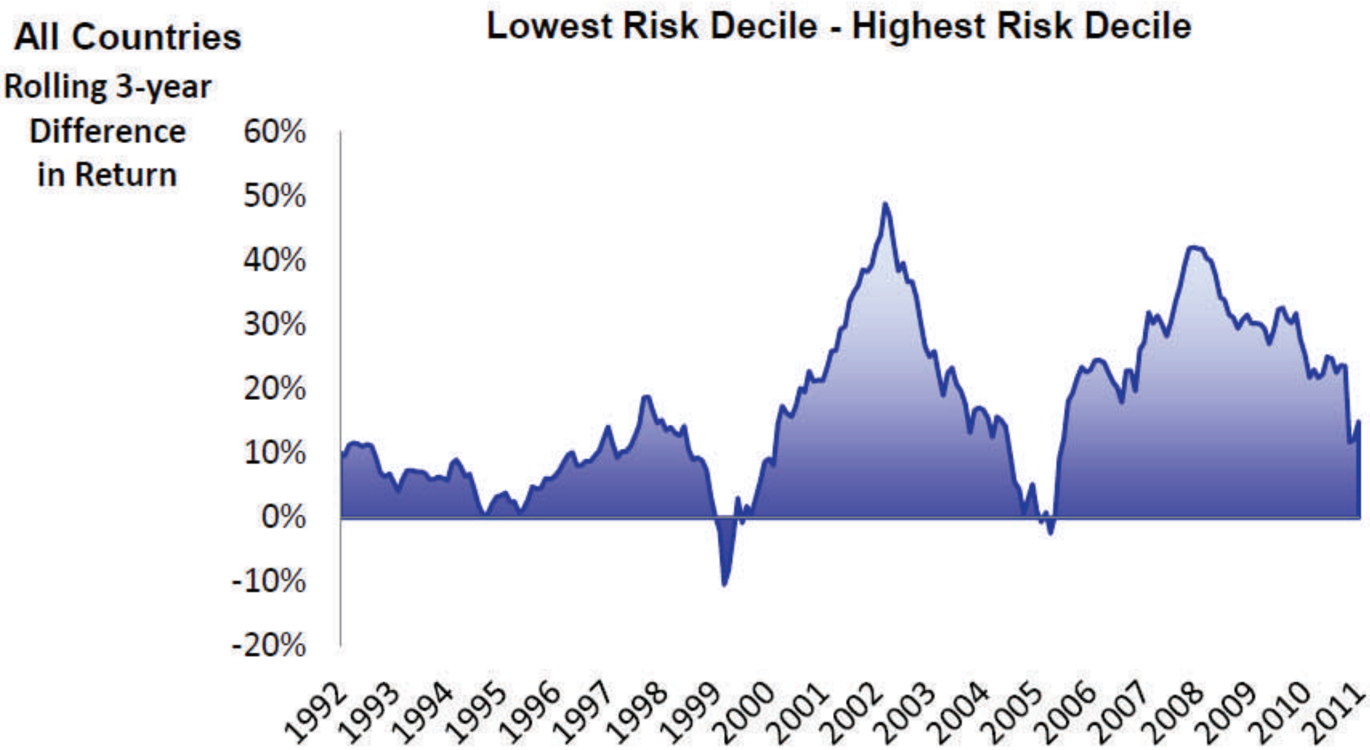
As expected, the low-risk stocks exhibited far less volatility than the high risk stocks did — as depicted by the negative "Risk Difference" bars for each country. Since risk and return are supposed to go hand in hand, one would intuitively expect the "Return Difference" bars to also have been negative. After all, why would anyone invest in high-risk stocks without expecting to be compensated for bearing the incremental risk? Perversely, not only did the low-risk stocks actually generate *higher* absolute returns for all countries as a whole, that general result held true for *every* country studied. Still referring to the graph to the left, the very tall "Sharpe Ratio Difference" bars illustrate that on a risk-adjusted basis, low-risk stocks outperformed high-risk ones by a very significant margin. Again, this outperformance occurred in every country studied.

Investors generally try to either maximize return per unit of risk, or minimize risk per unit of return, so the widespread persistence of this anomaly is surprising. The graph on the following page plots the individual risk/return relationship of the low-risk stocks and the high-risk stocks of all 21 countries, for each year during the 21-year study. For instance, each blue dot represents the overall risk/return performance of all low-risk stocks for a given year while the red dots do the same for the high-risk stocks.



Since investors are assumed to be at least somewhat rational, they are considered to be, at once, return maximizing and risk minimizing. That is, they would strongly prefer to own investment "dots" that map as high and as far to the left on the graph above, as possible. The graph above does not indicate which dots belong to which years, but those details are unimportant. The real lesson is that over at least the last couple of decades, owning more blue dots and fewer red dots would have resulted in a more stable portfolio *and* higher returns.

To further rule out the possibility that this low-risk stock anomaly exists only because of some highly irregular event that just happened to fall within the 21-year study period, the authors examined the risk/return ratio of low-risk and high-risk stocks over a series or rolling, three-year periods. They did this for all 21 countries, as a whole. Again, they found that low-risk stocks generated higher absolute returns than high-risk stocks as evidenced by the graph on the next page. If they were to have graphed the superiority of low-risk stocks on a risk-adjusted basis, the results would have been even more dramatically in favor of low-risk stocks.



To be fair, academicians can and do argue over whether the low-risk stock anomaly can be explained away or justified on grounds that serve to neutralize its apparent attraction. In my opinion, however, the conclusion of this study is compelling due to the length of time this anomaly has persisted, i.e., at least as long as this 21-year study, and the consistency with which it appears throughout the world's equities markets. Assuming you've happened to own more "blue dots" all along, this anomaly is a little like buying a Buick and then discovering that it's also faster than your neighbor's muscle car.

I've spent some time on this topic only because I think folks who have a higher tolerance for risk may falsely assume that higher returns necessarily require the acceptance of higher risk. I'm glad to share this study with you, but selfishness suggests that we keep this study among ourselves.

BEWARE THE INVESTMENT NEWSLETTER

Please be aware that con artists often promote their wares through investment newsletters. The worst of these publications rely upon scary headlines, bold predictions, revealed secrets, and plenty of exclamation points, but others are more subtle. Please be careful, and bear in mind that real research is pretty boring and that sincere advisors are often filled with a healthy dose of self doubt.

THE VALUE OF DIVIDENDS ... A LITTLE REMINDER

Within the universe of low-risk equities, we especially favor dividend-payers — especially those that have increased their dividends regularly. In addition to putting cash in shareholders' pockets, a regularly rising dividend signals confidence in the business model and in future operating conditions, and it encourages companies to handle whatever cash they do retain, more judiciously.

To the extent a given company adopts a dividend policy of paying a certain percentage of its earnings to shareholders, future dividend increases become a function of future earnings growth.

Historically, earnings and cash flows have increased significantly faster than has the cost of living. According to a recent study by mutual fund sponsor Lord Abbett, owning one share of each company in the S&P 500 would have put $0.71 in your pocket back in 1945. By 2014, that figure would have risen to over $38 representing an average annual increase of almost 6%. If corporate earnings do, in fact, increase by the 7% Zacks Research estimates, your near-term dividend increases might continue to outpace rises in the general cost of living.

Isn't that a nice thought? — Glenn Wessel

Dividend growth on the S&P 500 Index, 1945–2014