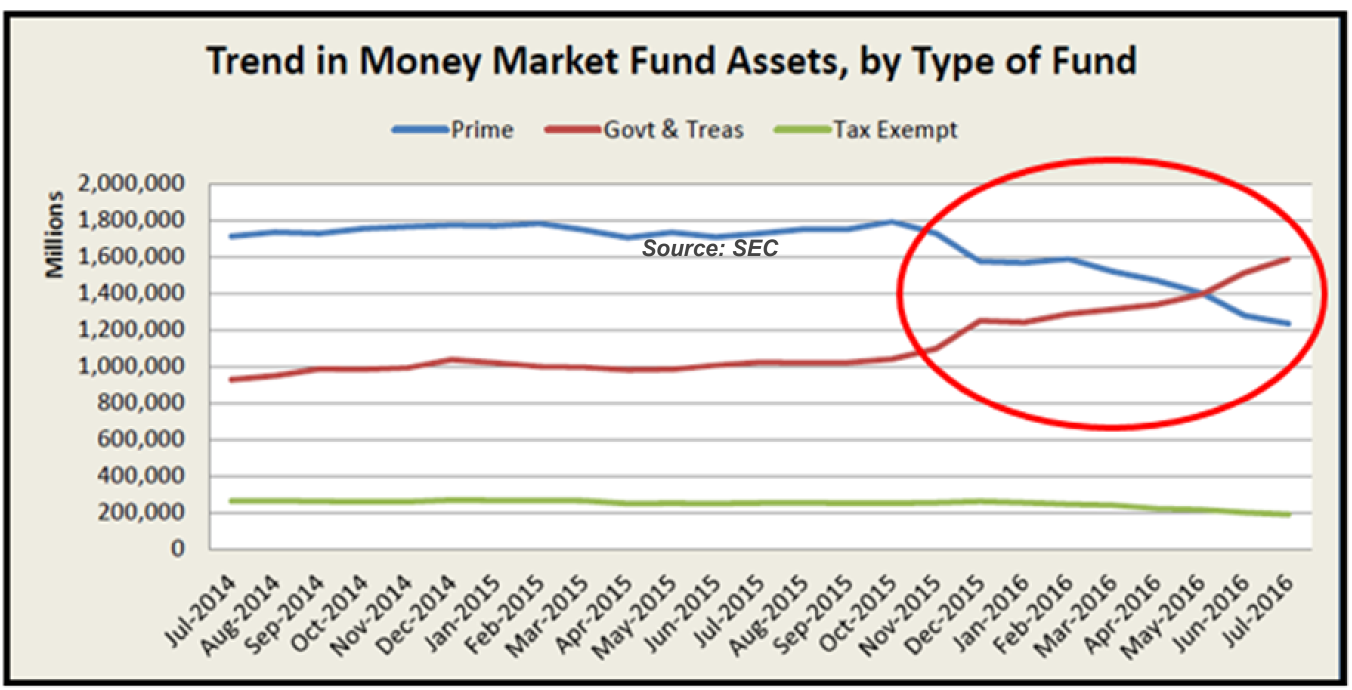
ODDS & ENDS ABOUT THINGS OTHER THAN THE ELECTION

MONEY-MARKET REFORM

By the time you read this, the Securities Exchange Commission will have reformed the manner in which some money-market funds calculate the per-share values they report to investors each day. The new regulations establish three categories of money-market funds (retail funds, government funds, and institutional funds). They also restrict who can invest in retail funds.

The new regulations permit retail and government funds to continue to use an accounting method that, under typical market conditions, will allow them to maintain the stable per-share prices that are so familiar to investors. In contrast, institutional money-market funds are now required to implement the same mark-to-market accounting practices to which *non*-money-market funds have long been subject. These new accounting rules will tend to result in share prices that vary somewhat. Under the new reforms, certain money-market funds will also have the ability to impose exit fees and to temporarily suspend withdrawals (known as gates) in certain circumstances.

In response to these reforms, investors have been dumping shares of funds that are subject to these new rules, i.e., funds that invest in the short-term debt of corporations

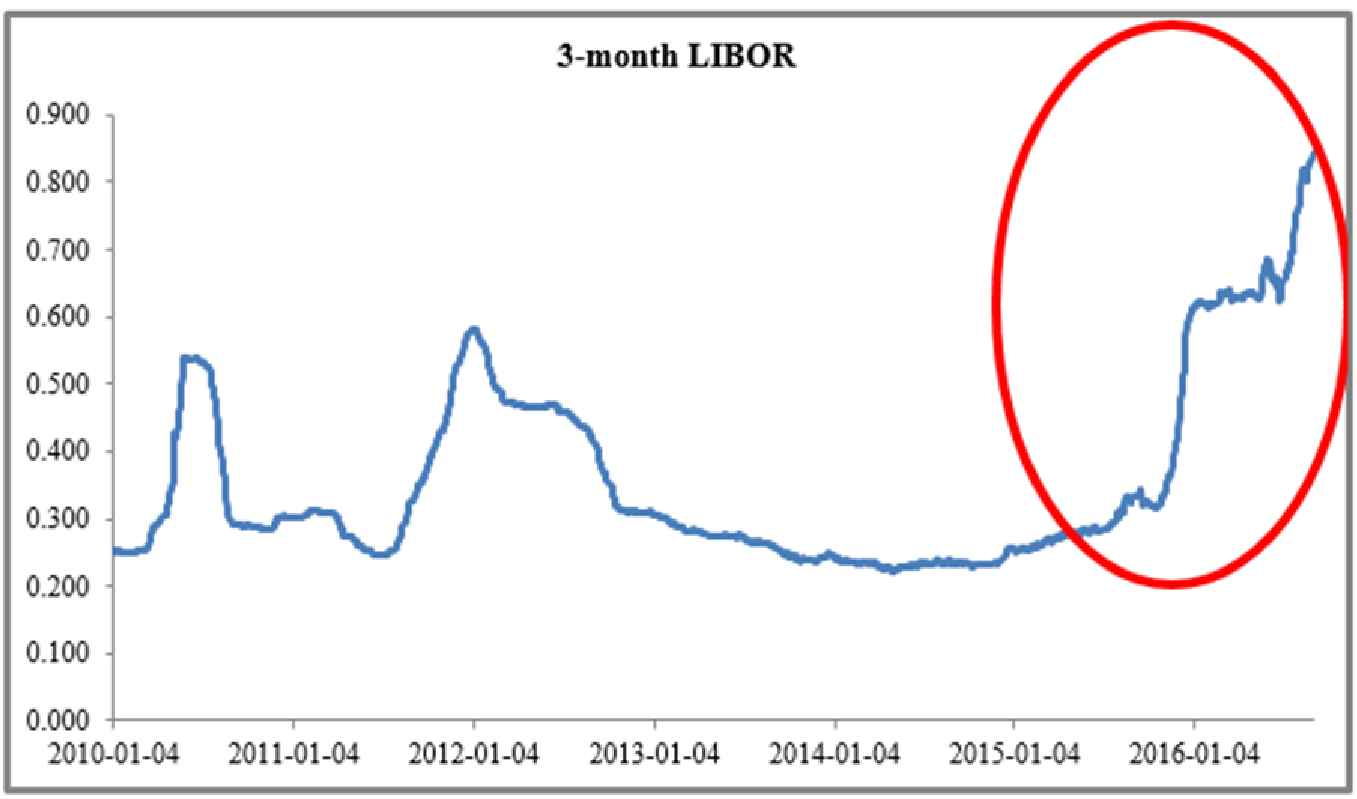


and financial institutions ("Prime" funds) in favor of funds that invest in debt issued by the federal government and U.S. Treasury ("Government & Treasury" funds). From the end of October 2015 through July 2016, assets in these money-fund categories have swelled by $547 billion (52.5%). Again, most of those inflows are the result of investors fleeing prime and tax-exempt money-market funds.

Fund managers are responding to these mass redemptions by moving away from prime categories and increasing holdings of government securities. In anticipation of these new rules, Fidelity Investments repurposed its largest prime fund, a fund that holds $115 billion worth of assets, into a government fund late last year.

While retail money-market fund investors are not subject to floating per-share values, they now are, along with institutional investors, subject to potential redemption restrictions. Under the new regulations, a given fund will now be allowed to temporarily deny investors' liquidation requests and/or impose withdrawal penalties of up to 2% if its liquid assets fall below a certain threshold.

IMPACT ON SHORT-TERM RATES



As investors have liquidated prime money-market fund shares, portfolio managers have had to liquidate substantial portions of their investment portfolios. This selling pressure has depressed the prices of short-term debt instruments, forcing their yields higher as depicted on the previous page. That graph captures the "3-month London Interbank Offered Rate," an index that captures the borrowing rate faced by large, global banks operating in London. Because it's the most commonly used benchmark, the 3-month rate shown here is the one that pertains to loans denominated in U.S. dollars.

IMPACT ON AVAILABILITY OF FUNDS TO BORROWERS

So far, the impact of money-market reform has been to make it easier and/or less expensive for the federal government to borrow money while making it harder for the private sector to do so, "crowding it out," so to speak. Economists frown on this.

CAN MONEY-MARKET REFORM PREVENT A FUTURE CRISIS?

The new reforms are designed to provide a disincentive to investors wanting to liquidate their shares when market stresses are elevated, which is exactly what happened during the frenzied selling of 2008. Back then, the oldest money-market fund in the U.S. (the Reserve Primary Fund), had to reduce its share price below $1.00 ("breaking the buck") as a result of having to recognize losses on certain Lehman Brothers securities it held in its portfolio.

As investors became aware of that loss, it triggered a wave of selling that spread to the rest of the money-market fund industry. To avert a systemic collapse, the federal government began insuring money-market accounts.

BOTTOM LINE ON MONEY-MARKET REFORM

The new rules seek to better align the share prices of money-market funds with the market values of the securities in which they are invested and to more tightly regulate redemptions during tumultuous periods. Money-market reform has garnered quite a bit of press due to the size of the industry, but my sense is that these reforms will relieve market stresses that existed only because the industry had been trying to present money-market funds as being somewhat more stable than they actually were ... like having a good set of parents you later discover were seeing a shrink.

UPDATE ON BRITAIN'S EXIT FROM THE EUROPEAN UNION

As Prime Minister Theresa May continues to address Britain's eventual exit from the European Union (EU), there is some question as to whether that exit will be a "hard" one or a "soft" one. She has argued that Britain ought to formally and irrevocably request to leave the EU by this coming March. Once that's accomplished, Britain would then have to establish a new identity in Europe.

If allowed by the rest of the EU, a "soft" Brexit would be less economically disruptive since it would allow Britain to maintain access to the EU's common economic market (a major economic advantage), but Britain would also be forced to allow the free movement of people and capital across borders (anathema to many Brits).

When Theresa May campaigned, however, she argued that Britain ought to be allowed to maintain access to the EU market while also maintaining sovereignty over regulation, the flow of capital and people across borders. Of course, this combo plate, known as a "hard" Brexit, appeals to British businesses and voters, but it's not on the EU's menu. In fact, all 27 countries that form the EU have indicated that if Britain were allowed to retain access to the EU's common market, it must then also allow the free flow people and capital over its borders. In time, we'll see which thing Brits detest less — losing access to markets in other EU countries, or continuing to accept relatively open borders.

STOCK VALUATIONS SEEM EXPENSIVE …

A recent study by Research Affiliates suggests that, by historical standards, stock valuations are on the expensive side. Research Affiliates looked at the prices of dividend-paying stocks (our favorite kind) in relation to the following objectively determinable financial metrics (because *absolute* stock prices are meaningless):

- Book Value (the theoretical liquidation value of a company), and
- 5-Year Averages (to smooth the data) of earnings, sales, and dividends.

In relation to these financial metrics, Research Affiliates found stocks to be more richly valued than they have been during 80% of the time over the past 40 years.

… OR MAYBE NOT

The conclusions drawn by Research Affiliates are fair enough, but context matters.

If that were not true, the speed limits on highways would be no different than they are near playgrounds.

In order to accept that stock valuations are historically high, one would also have to believe that investors do *not* consider alternatives when considering whether stocks are worth owning. In a world where a 1.75% yield on 10-year Treasury securities seems comparatively attractive versus the negative yields that are now associated with some $13 trillion worth of sovereign debt issued by other countries, a 1.9% dividend yield on the stocks of large domestic companies starts to look pretty good.

WHAT IF BOND YIELDS RISE?

I worry about it. In fact, we have constructed most of our bond portfolios to behave relatively defensively if interest rates were to rise materially. However, because low rates are largely the consequence of a slow-growth environment and because the slow-growth environment in which we've been mired seems to have resulted from already-high debt levels, an aging workforce, and other structural conditions that could persist well into the future, low bond yields could conceivably remain the norm for quite a while. If so, then one might argue that dividend-paying stocks deserve higher-than-normal valuations.

After all, many developed nations are already stretched in their ability to handle more debt and, in many cases, there is no popular will to support higher debt loads. If this were not true, the term "austerity" would not have such a familiar ring to our ears. To the extent large portions of the developed world continue to pursue financial austerity, economic growth is less likely to be accomplished through fiscal (tax & spend) measures.

Demographics also play an important role in the world's slowing economic growth. Declining birth rates and aging populations around the world are two sides of the same coin. Whether that coin comes up heads or tails, slower future economic growth seems likely unless other catalysts develop. Since demographic trends like these can take generations to reverse, slow growth and low yields might be with us for quite a while.

HISTORY SUGGESTS THAT DIVIDENDS *ARE* BETTER THAN INTEREST

First, dividends can, and often have, increased over time. In many cases, dividends have increased at rates that have far exceeded the cost of living. Of course, there's no guarantee that future increases will be as generous as they have been in the past. In fact, I would argue that future increases won't be as generous, but if you concur that we're likely to remain in a slow-growth, low-yield environment for quite a while, a strategy of collecting bond coupons at historically low rates would generate a disappointingly low level of income that seems unlikely to outpace a rising cost of living to any significant degree.

In contrast, dividends *do* have the potential to increase, *can* help meet future income needs, and *can* protect against the erosive effects of inflation. Since 1946, dividends of the companies that comprise the S&P 500 Index have risen in 88% of those years. More importantly, they have increased by an average of 6% per year over that time.

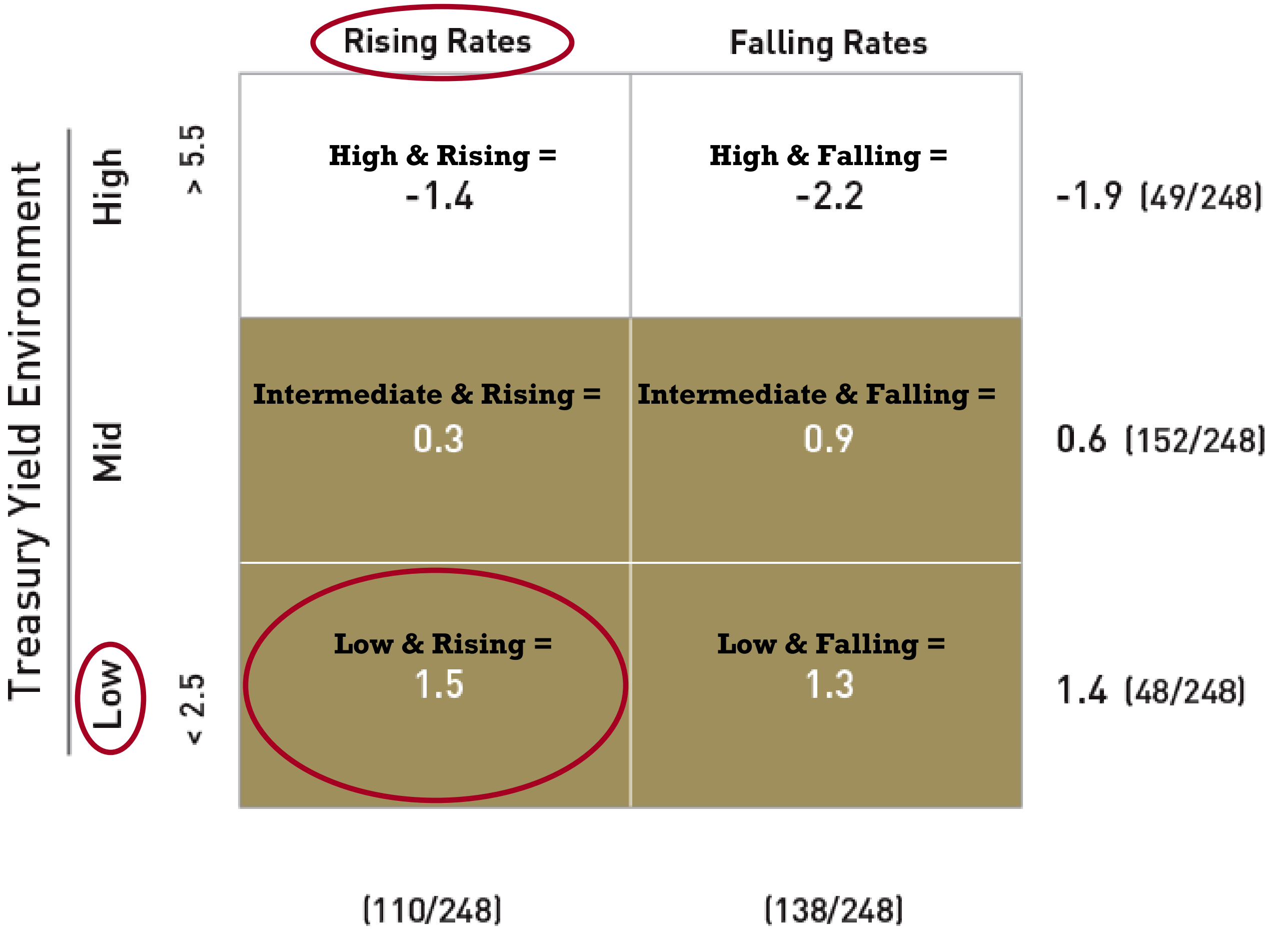
WHAT IF RATES DO RISE?

While high and/or rising interest rates are mathematically erosive to the value of any income–producing security, rising rates that have occurred in low interest-rate environments have actually tended to coincide with stock returns that have *handsomely* rewarded investors with returns that have averaged 1.5% per month.

This is so because central banks are most inclined to allow interest rates to rise *only* when the business climate is improving. In short, the increased earnings that tend to result from an improving business environment have typically done more to bolster stock prices than rising interest rates have done to depress them. While rising rates certainly are a headwind when viewed in isolation, they are also more likely to occur only when conditions are improving.

Over a 25-year period, Lord Abbett (a mutual fund group) analyzed 248 instances where the yield on 10-year U.S. Treasury securities fluctuated. It then sorted those instances into six interest-rate environments as shown on the next page. In short, when rates rose from a low level, stock returns were actually *higher* than they were in any other environment. So while rising rates are an unambiguous negative for investors, investors do have a history of considering those rate hikes in the context of the overall business climate.

Monthly Stock Returns vs. Interest-Rate Environment:



Source: Standard & Poor's, Compustat, Thomson Financial, FactSet, and RBC Capital Markets. Data are collected for the 25-year period ended December 31, 2015. Note: The interest-rate environment is based on 10-year U.S. Treasury; last 12 months' dividend yield; a tertiled factor, industry group neutral. Historical data shown are for illustrative purposes alone and do not represent any specific portfolio managed by Lord Abbett or any particular investment. Past performance is not a reliable indicator of future results. Dividends are not guaranteed and may be increased, decreased, or suspended altogether at the discretion of the issuing company.

TAKING A LONGER VIEW

Because people are apt to forget that the world has always been an uncertain place and because the all-encompassing nature of the media seems to specialize in reminding us of these uncertainties, it is easy to become skeptical about the future. If you feel yourself falling into the grip of that skepticism, or if you just need to be nudged to spend a little less time looking down at your shoes and a little more time pondering the future, it may be helpful to recall the apocryphal quote that has been attributed to the commissioner of the U.S. patent office near the end of the nineteenth century: "Everything that can be invented already has been invented."

Now that scientists have figured out how to detect the gravity waves that Einstein's equations suggested ought to exist, one might be tempted to wonder what could be left to discover or achieve. However, unless one is able to gauge how much humanity has achieved in the context of that which has *not yet been* achieved, it's a little like trying to perform a division problem without having any sense of what the divisor ought to be.

Since the rate of human progress seems to be accelerating, one might also argue that, like an infant, we're still in some early stage of development. For example, democracy, medical care, and human rights have gained ground at an increasing pace over the past century while war and famine have been on the decline. (News headlines would certainly not suggest this is true, but it is.)

I'm certainly no futurist, but as information-sharing technologies continue to catalyze the development of less developed parts of the world, my guess is that plenty of investment opportunities ought to remain in front of us whether we can imagine them, or not.

Since I prattled on about interest rates for quite a while, I'll leave you with a graphic that captures the relative out-performance of emerging market equities when interest rates have risen. I suspect this is a result of emerging areas being less burdened by debt.

RISING RATE PERIOD	AVG. CHANGE	10/15/93-11/7/94	1/18/96-6/12/96	10/5/98-1/20/00	11/7/01-4/1/02	6/13/03-6/14/04	6/1/05-6/28/06	12/30/08-6/10/09	10/7/10-2/8/11	7/26/12-12/27/13	5/2/13-9/5/13
Yield Increase (bps)	175	286	150	263	122	176	134	187	134	157	136
MSCI Emerging Markets Index (%)	29.01	40.96	9.98	96.34	28.08	28.77	33.21	43.43	2.27	14.25	-7.22
S&P 500 Index	15.65	2.22	11.42	46.59	3.07	14.66	6.71	9.41	14.89	42.09	5.43
Barclays Govt/ Credit Index	-3.42	-5.15	-4.08	-3.38	-3.09	-3.64	-1.49	-2.08	-3.94	-2.14	-5.26
10-Year U.S. Treasury	-9.73	-12.55	-7.82	-11.17	-6.77	-9.48	-5.00	-13.59	-9.93	-10.63	-10.35

I originally intended to discuss the upcoming election, but later decided against alienating ??% (sorry) of everyone I know. — Glenn Wessel