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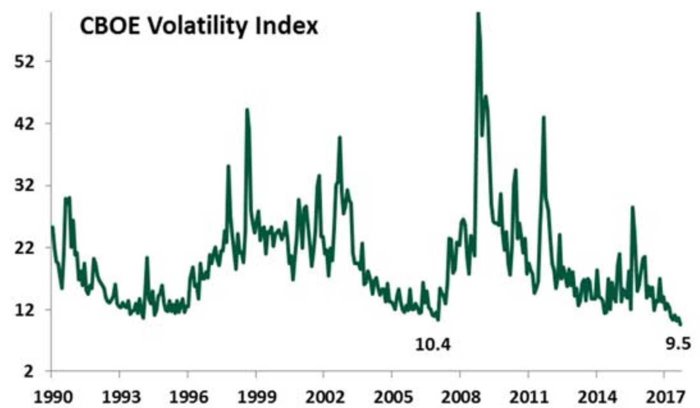
A Review of Risks and Rewards

Economists and market commentators have been touting the increasing risks across asset markets for some time. However, seemingly unflustered by any mounting pressure, major stock markets around the world continue to reach new highs.

Without a lack of potential setbacks, markets have been uncharacteristically stable – shrugging off natural disasters, policy uncertainty and geopolitical tensions. Volatility, measured by the Chicago Board Options Exchange Volatility Index (VIX), is at record lows.



Source: Bloomberg

The VIX shows the market's expectation of 30-day volatility and is a widely used measure of risk. As John Mauldin described in a recent newsletter, "VIX values greater than 30 are generally associated with . . . investor fear or uncertainty, while values below 20 generally correspond to less stressful, even complacent, times in the markets." When the eventual shift in sentiment occurs, periods of abnormally low risk aversion are typically followed by poor asset returns.

While the interest rate tightening cycle has begun, accommodative policy remains the primary fuel for tireless markets. Propelled by a limited set of alternatives, investors' willingness to accept balance sheet and valuation risk is unusually high. As an example, high yield bond spreads have tightened dramatically, nearing some of the lowest levels seen since the financial crisis. Despite receiving very little return for the riskiness of the assets, yield hungry investors continue to push asset values higher. Spreads this low have been unsustainable in the past, suggesting they are highly vulnerable to a shift in sentiment.

The following data (going back to 1926) from Ned Davis Research Group demonstrates why valuations are important. Historically, an extreme price to earnings ratio for the S&P 500 (defined here as a price/operating earnings ratio > 18.2x), has been associated with a median return of -8.4% and -7.7% over the following 6 and 9 month periods, respectively. The price/earnings ratio is currently 21x.

We can't accurately predict when the current bull market will come to an end. It may take substantial time for interest rates and stock valuations to normalize. Whenever a correction does occur, it is important to remember that bear markets are a healthy part of stock market cycles. Painful as they are, they wash away the excesses that build up over optimistic periods. Although the volatility that comes during a market transition is uncomfortable, it is a friend of the long-term investor, providing the valuable opportunity to invest in quality businesses as they go on sale. Going forward, increased volatility seems likely.

The conservative positioning of our balanced strategy reflects the relatively unattractive risk/reward trade-offs we currently see in the market. While, broadly speaking, it is harder to find value today, we continue to find opportunities on a company-specific basis. Share price weakness resulting from what we believe to be short-term headwinds has allowed us to enter new investments and increase several long-held positions. In a weaker market environment, we expect the strategies' stronger balance sheet and profitability characteristics to provide resiliency versus the benchmarks.

Instead of reaching for a higher return by increasing risk levels, we remain disciplined in our risk management process. Admittedly, this is not easy to do. During a bull market, risk management can often mean leaving sizeable returns on the table. However, at the risk of short-term underperformance, our philosophy for long-term success prioritizes capital preservation on the downside. We expect patience and discipline to be rewarded in the long run.