



## HH'S CONVERGENT VS. DIVERGENT APPROACHES ARE PLAYING OUT "AS PLANNED"

"If you fail to plan, you are planning to fail."

— BENJAMIN FRANKLIN

"Everybody has a plan until they get punched in the mouth."

— MIKE TYSON

At Halbert Hargrove, we continuously debate the many ways to approach investing. While there are many ways to skin a cat, in our business it is more like skinning a Jabberwock. Stocks vs. bonds, active vs. passive, alpha vs. beta, short-term tactical vs. long-term strategic: It's critical to evaluate what goes into a portfolio so that you end with something more like coq au vin than witches' brew. Each component should either increase return or lower volatility. And the Holy Grail is investments that can do both.

Consider this rule of thumb: Compounding wealth, in a multi-period framework, is roughly equal to the average annual return of the portfolio minus  $\frac{1}{2}$  the variance of the portfolio's return. Simply, this means that volatility erodes the effect of compounding and can reduce the growth of your wealth in the long run. This why we pay so much attention to volatility and seek multivariate sources of return: option income, reinsurance premiums, crisis alpha, etc. Crisis alpha, specifically, is a term for an investment or strategy that captures a positive return during a market correction. This is different from moving to cash to avoid a loss; these instruments profit when there's a dislocation. When some things in the portfolio are not working, others should be.

### CONVERGENT VS. ....

Convergent risk takers believe that the world is well structured, stable, and somewhat dependable. What has happened in the past is likely to continue to happen in the future. There is absolute wisdom in Ben Franklin's quote, "If you fail to plan, you are planning to fail." And there's a good reason why Benjamin Graham and David Dodd's 1934 book *Security Analysis*, which gave birth to value investing, still sells for \$42.47 on Amazon more than 80 years after it was published.



Convergent strategies are those that most people are familiar with. In the long run, stocks will earn more than bonds, and bonds will earn more than cash. In the long run, it is further believed that small stocks will outperform large ones, and value beats the broad market. Right?

If we look back to the last 20 years, value beats the broad market more often than not: 53% of the time, and handily when it does, by an average of 9.6% per year. However, since 2009, coinciding with the start of Quantitative Easing and the inception of the last seven-year bull market, growth (in this case the Russell 1000 Growth Index) has trounced its value counterpart by roughly 10% per year! Value investing may be a tried and true method of long-term success in investing, but how long are you willing to wait until you're proven right? How long can you afford to wait?

#### .... DIVERGENT APPROACHES

Divergent risk takers profess their own ignorance to an easily quantifiable structure of potential risks vs. benefits. They have a healthy level of skepticism for what is or is not dependable. For this camp, there is also wisdom in Mike Tyson's observation, "Everybody has a plan until they get punched in the mouth." Tyson won 12 of his first 19 fights in the first round. Just as a SEAL team never enters a situation without a backup rendezvous, and a backup-backup rendezvous, even portfolios need components that work when nothing else seems to be working.

#### Q1 2016: MANY MARKET WINNERS BENEFIT FROM INTEREST RATE AND CURRENCY MOVES

The first quarter of 2016 saw a reversion in the performance of the categories of investments that fared poorly in 2015—and in this sense, followed the convergent script. Value sectors, led by utilities, telecom and consumer staples, performed quite strongly, far exceeding growth sectors like technology and healthcare. Segments of the commodity space experienced a bit of a recovery, specifically gold and other precious metals, while oil had a reasonable recovery but remained negative on the year. Longer-dated fixed income outperformed shorter term fixed income, and high yield outperformed more conservatively positioned fixed income. And finally, after a three-year string of underperformance, the best performing major asset classes were emerging market stocks and emerging market debt.

In many cases, the winning markets in the first quarter were those that were heavily influenced by interest rates and/or currency moves. Readers may recall the mention in our last quarterly letter that the strength of the U.S. Dollar may have touched a near-term peak, and that the Fed may pursue a slower path of interest rate increases than were currently being forecast. Sure enough, in their most recent update to the "Dot Plot" of the forward path of interest rates, Yellen and her



colleagues' median interest rate forecast for year-end 2016 dropped from between 1.25%-1.5% to between 0.75%-1.00%. Indeed, the entire path of expected interest rates dropped across all time frames (2017, 2018 and "longer term").

To be fair, the Fed's "Dot Plot" has been playing catch up with a much lower expected path of interest rate increases forecast by fed funds futures, but the move was significant enough to further the weakening U.S. Dollar trend that began in late January. Markets appropriately priced the reality that the U.S. cannot raise rates in the face of all other nations reducing theirs. The pause in Fed rate moves was appropriate in the context of a global slowdown. In such an environment, we should be cautious in attempting to cool off the world's largest and most important economy.

#### **NIRP & ZIRP AND THEIR IMPACTS: CONVERGENT AND DIVERGENT PERSPECTIVES**

We are seeing central banks across the globe embarking on a new experiment: Negative Interest Rate Policy, dubbed "NIRP" (the sequel to "ZIRP" – zero interest rate policy). The European Central Bank was the first major central bank to utilize negative interest rates, but it has since been followed by Sweden, Denmark, Switzerland and most recently Japan. Central banks only set target short-term rates that act as a reference point for the myriad of other interest rates that are ultimately priced by the market. They influence rates but do not "make" them. As of February, markets have responded by pricing more than \$7 Trillion of government bonds at yields below zero. This includes sovereign bonds from Switzerland, Germany, Japan, Finland, Netherlands, Austria, Sweden, France, Belgium and Denmark.

How you view these policies and the ultimate consequences of the market's reaction is highly dependent on whether or not you are a debtor or a saver. As a debtor, it's perfectly rational to load up on as much debt as possible (or refinance) at these low rates, particularly if you're getting paid to borrow. As a saver, you may reasonably be concerned about your ability to earn a rate of return that compensates you for the risk, or more simply, to accomplish your retirement goals. A saver might suggest that central banks are just pushing on a string and merely prolonging the reckoning of a long-awaited debt-deflationary cycle akin to the Great Depression. A debtor may believe that these efforts will pay off in increased inflation and asset prices, and embolden risk-taking by signaling that central banks will do "whatever it takes" to support the economy and credit creation.

The outcome of these policies to date? One could argue that both debtors and savers are winning. Witness the results of the two best performing asset classes over the past 15 years: 12% per annum returns for Real Estate Investment Trusts (REITs) and the 8.1% per annum returns of the



high-yield market. Ask yourself if these returns would have been possible without a tail-wind of declining (to negative!) interest rates.

To us, the more important question is whether or not an investment in the current marketplace is still attractive enough to make relative to its risk. Convergent thinking suggests that stocks are still more compelling than bonds from a prospective return standpoint. After all, broad-based stock dividend and earnings yields are still more attractive than intermediate-term corporate fixed income yields. They also have the potential to grow those earnings and dividends while the rate of interest on your bond is fixed. Divergent thinking suggests, however, that we may not be getting paid enough in stocks to stomach the volatility. Case in point: Over the past 15 months (ending 3/31/16), the S&P 500 gained less than one point while moving up and down a total of 4,735 points!

Convergent thinking suggests that the relative discounted values of earnings in Europe, Asia and Emerging Markets are compelling, but divergent thinking acknowledges that negative interest rates may be altering the normal relationships that typically drive the success of those markets. Convergent thinking recognizes that cash is still paying zero (and given “NIRP,” some banks are even charging their clients to hold their money). A divergent approach suggests that we do not know how long investors’ interest in safety and a willingness to receive sub-inflation rates of return will last.

#### **INSURANCE AND OPPORTUNITIES FROM THESE STRATEGIES IN Q1 2016**

The first quarter of 2016 provided a small sample-set of the benefits of pursuing both convergent and divergent strategies. In the first six weeks of the year, investors focused on Large Cap U.S. stocks would’ve seen their portfolios down almost 11% while Small Cap U.S. stock investors’ portfolio were down over 15%! At the nadir of the quarter, our divergent strategies performed as expected. Our managed futures fund was up ~11%. Our moving average strategy, having signaled a move to cash in late summer and November 2015, was flat (not negative). That’s a stark contrast to the broad market decline over that time frame.

By the end of the quarter, Large Cap U.S. stocks were back in the black (+1.2%) and Small Cap U.S. stocks had almost completely recovered. While the divergent pieces buoyed the portfolio as a whole, the dip allowed us to do a round of tax-loss harvesting in those convergent vehicles with double-digit losses and bank a tax asset in our clients’ books—thus offsetting future capital gains taxes.



Having both convergent and divergent systems in your portfolio is prudent. You create a plan and stick to it—but you must always have a plan for when your first plan doesn't work. It's like paying each year for life insurance that you hope to never use. In a portfolio context, these balancing systems exist because you know that it's not a matter of IF, but WHEN you'll get punched in the mouth.

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