The ACM Journal

Critter Litter

I was out of town for part of Memorial Day weekend, but returned on Sunday night. I was doing my evening farm chores, when I noticed that something had been getting into my chicken feed inside the barn. I put out a trap that evening, and sure enough, the next morning I had caught myself a raccoon.

I had a number of kids' activities to get to on the morning of Memorial Day, so I quickly grabbed the trap, threw it into the back of my truck, and drove to a nearby park. I released the raccoon, and noticed as it waddled off that it was pretty fat. I thought it was a good thing that I got rid of that critter before she gave birth and multiplied the problem.

Four days later, my oldest went into the finished part of our barn and heard a high-pitched squeal. He told me he thought we had a mouse, so I opened up the barn to investigate. Three baby raccoons were skittering about making all sorts of racket. Poor Omar was a little unnerved that a rabies-infested varmint was going to get him. I grabbed a large Tupperware bin and collected the raccoons. Omar got them a bowl of milk, but they mostly just ran through it and spilled it.

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Portfolio Review

The stock market performed quite well in the second quarter, earning 2.5%. This is surprising, because had the quarter ended two days earlier, the market would have been down 2.9%. The much-ballyhooed Brexit event wreaked havoc with the stock market late in June, and drove the Dow Jones Industrial Average down roughly 900 points over two days.

Overblown Brexit

Most pundits warned that a breakup in the EU could have calamitous political and economic implications. Indeed, even Alan Greenspan has called the Brexit vote the "worst period I recall since I've been in public service." However, just a few trading sessions after the two-day market slide, virtually all of the losses had been recouped. How is it possible that impending global economic meltdown could have such a muted response from the stock market? Probably because it was all hyperbole.

British Prime Minister David Cameron is resigning because of the "Brexit" decision. He has stated that the actual withdrawal from the EU will be done under the watch of his successor. The new Prime Minister will likely take office in October, and he or she will then have to decide on when to invoke Article 50 to formally pull out of the EU. Article 50 begins the process of withdrawal, but apparently takes two years to complete. So even if the new Prime Minister begins the process immediately upon taking office, an actual British exit from the EU is more than 28 months away.

A lot can happen in a dynamic global economy over the course of 28 months. It may be that Britain goes into a recession for reasons completely unrelated to "Brexit". It certainly has plenty of other economic concerns currently. Conversely, it may be that the recent drop in the British Pound that occurred as a result of the "Brexit" vote makes British exports more competitive, and thus helps boost the economy. Or, it may be that events we can't even begin to imagine will transpire that impact the British economy in unforeseeable ways.

The point is, there is absolutely no way to forecast what will happen, positive or negative, and any potential impact will not be felt for over two years. Thus, the impact from the "Brexit" for most of us on this side of the pond is immaterial.

Mixed Bag Overseas

The impact on international stocks has been more pronounced, and developed world international stocks again finished the quarter in negative territory. International stocks have languished for the past several years as economic problems continue to confront most of Europe

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and Japan. The emerging markets, on the other hand, have started to rebound. They are one of the best performing asset classes so far this year, despite significant headwinds from an appreciating U.S. dollar. There is still a lot of growth potential in emerging economies around the world, and their stock markets trade at very reasonable levels.

Bonds Continue to Surprise

One of the biggest surprises for the quarter was that bonds rallied significantly. The bond market is up 5.3% so far this year, which is much more than most of us would have anticipated. The ten-year Treasury bond yield is only 1.4% currently, the lowest ever on record. The fact that bonds could return so much with such paltry yields has been the source of much discussion among economists and strategists. At some point interest rates will rise, and bond prices will come down. While many of us have expected that to occur by now, the low interest rate environment could certainly continue for some time.

Alternatives Reduce Risk

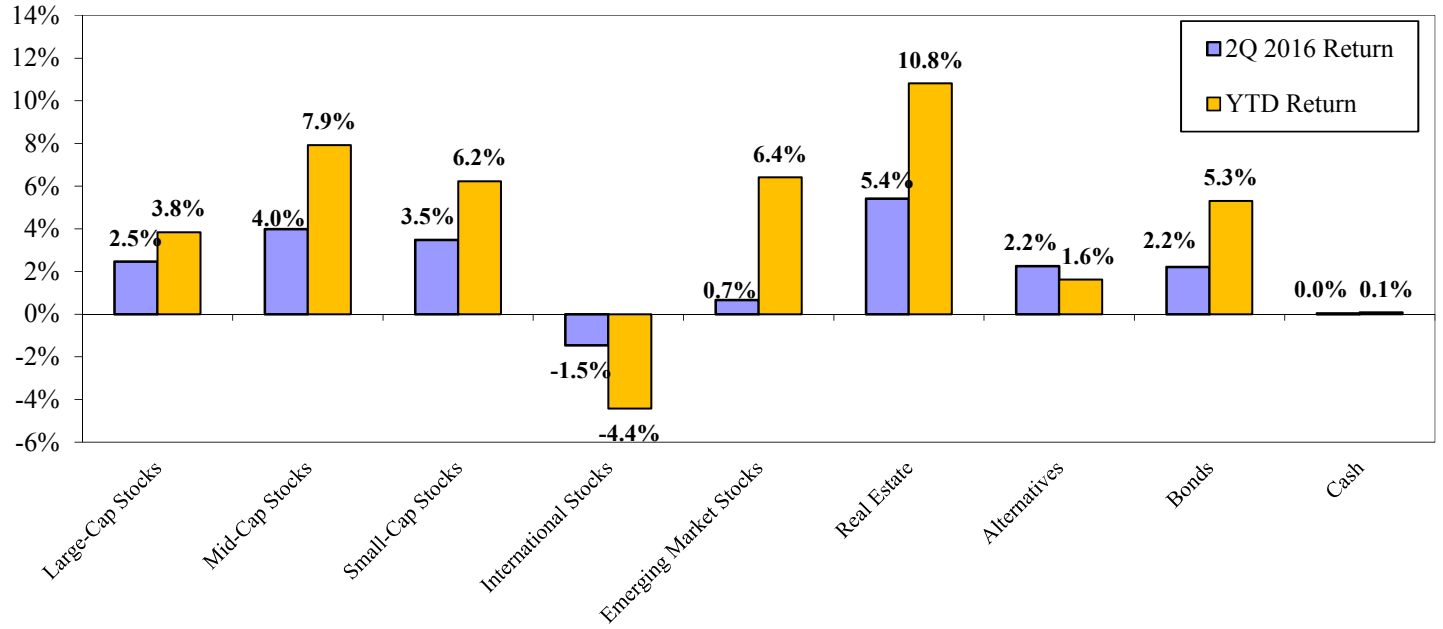
The article on the 4% rule in this newsletter discusses the impact low bond yields could have on expected investment returns, and we've been doing a lot of work on other approaches that could potentially help offset the damage. Alternative investments are a core part of that strategy.

Alternative investments were up 2.2% in the second quarter, and have done a decent job at moderating risk during market downturns. We saw this most recently during the "Brexit" scare. The alternative funds we invest in appreciated as the stock market declined. This lack of correlation is the cornerstone of diversification, and can help build a portfolio with better risk and return characteristics.

Conclusion

Despite a hiccup at the end, the second quarter was generally good to investors. For the year-to-date period, returns are generally in-line with or ahead of historical averages. The stock market has historically performed well during election years, and so far that pattern appears to be repeating.

Second Quarter 2016 Asset Class Returns



Large-cap, mid-cap, and small-cap stocks are represented by the S&P 500, 400, and 600 indcies. International and emerging market stocks are represented by MSCI indices. Real estate is the Dow Jones Real Estate index. Bonds are the Barclays Aggregate Bond Index. Cash is the yield on the 30-day T-Bill.

The 4% Rule Revisited

The basic rule of thumb in the financial planning industry is that during retirement, you can draw 4% of the value of your portfolio annually without impacting its long-term purchasing power. That means you can supplement your retirement income, but still keep the principal value of your investments intact while keeping pace with inflation.

There has been a lot of debate in academic circles about the 4% rule, resulting in a number of proposed corollaries over the years. We generally use 4% as a starting point when thinking about retirement withdrawals, but recognize that it is a guide rather than an absolute.

A 4% withdrawal rate implies that you need to earn a total portfolio return of around 7%. Here's the math on that: you need 4% to cover your withdrawal, another 2% of return to keep ahead of inflation, and roughly 1% to cover total investment costs. Historically it was possible to earn long-term average returns of 7% with even a fairly moderate risk profile. In fact, looking at data from 1927 until now, a portfolio with just 30% in stocks and 70% in bonds would have generated a total annualized return of 7.4%.

Over that same period, bond returns averaged 5.2% annually. Today, the environment is much different. The ten-year Treasury bond yields less than 1.4%. The current yield of the bond market has been a very good predictor of future returns. In fact, historically, the return on bonds for any prospective ten-year period has been very close to the starting yield. So, the outlook over the coming decade is for returns that are well below the historical average.

What this means for investors is that total portfolio returns will likely be protracted in the future, and it may not be possible to earn annualized returns of 7%. Thus, the 4% rule may not be as secure a bet as it has been in the past.

Most articles I've seen on this topic suggest that those still working should be saving more, and those who are already retired will need to learn to get along with less. While those things may help, I think there are investment actions that can be taken to help boost returns somewhat.

Keeping costs and taxes low is certainly a good starting point. We always want to make sure that we invest as efficiently as possible so that costs and taxes don't consume an undue portion of returns.

Also, we try to capture stronger returns in the stock market through diversification and factor-based investing. Valuations are currently much lower overseas than they are in the U.S. Low valuations tend to lead to higher future returns, so making sure we have an allocation to foreign developed and emerging markets could help boost returns over the coming decade.

We also buy funds that give us "factor" exposure. That involves investments in value stocks, small-cap stocks, and momentum stocks. Historically these strategies have outperformed the overall market, and while past performance is not indicative of future returns, there is good academic support that suggests future long-run returns could be strong as well.

However, the real anchor on portfolios is likely to be bond returns. I have been a fierce advocate of high-quality bonds in most portfolios my entire career because of the risk mitigation characteristics they bring. However, with the outlook for very low returns, we have started recommending that some clients move money away from bonds and into a diversified mix of alternative investments.

The alternative investment funds we use invest in a variety of asset classes, including catastrophe bonds, private real estate, currencies, commodities, derivatives, private loans, and others. While each of these funds has a risk and return profile that is not too dissimilar from stocks, a portfolio of these investments can significantly reduce overall portfolio volatility.

Our alternative investment portfolio has a much higher expected return than bonds, and we think the risk profile is similar over time. However, the availability of data for some of these funds is not as great as we would like it to be, which means we are not able to perform as robust an analysis as we would like. We also do not always have data on how these funds perform during truly nasty bear markets, when diversification is most important.

Costs and taxes can be higher with alternative investments, which is a contradiction to the advice above about reducing such frictions. Sometimes taxes can be mitigated by holding these funds in retirement accounts. However, even with their higher expense ratios and

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It was past 9:00 pm at this point. We called the DEC, but had to speak with their statewide officer, as the local office was closed. They indicated that they wouldn't accept raccoons, but would give me the number for a local animal rehabilitator. There was only one in Monroe County. I called her, and she too indicated she would not accept raccoons (something about rabies risk).

It is illegal to keep wild animals in New York State, so I was left with a couple options: obey the law and leave these little guys for dead, or break the law and see what I could come up with. Being a law-abiding citizen, I left them to their fate.

However, hypothetically speaking, since I always obey the law, if I had decided to take the alternate route, this is what might have happened: I might have done a little internet research on raising raccoons. I might have learned about replacement formula for babies that are not yet old enough to eat for themselves. I might have run to the grocery store, only to find it closed, and then run to a second more-distant grocery store at 10:00 pm for baby supplies. I might have called my wife on the way to the store to let her know what I was doing, and she might have grown angry and noted that I was doing more for these raccoons than I did for our children when they were infants. True to Nipa's words, I might have appeared clueless like a first-time dad as I scanned for bottles, syringes, etc. in the baby aisle. I might have also learned that Wegmans sells cat's milk (fortunately not in the dairy section). I might have then gone home to hand-feed reluctant raccoons, who would have squirmed and caused a fuss while I spilled cat's milk all over myself. I might have then woken up at 4:30 am the next morning to repeat the feeding process, clean out the chicken brooder, and fill it with fresh straw to make a critter nest fit for a litter of raccoons. I might have also come home from work at lunch for another feeding. Then, I likely would have called the local DEC and found the name of an animal rehabilitator who would have asked me to bring the raccoons out to Webster so that she could take over their care.

Had all this happened, my daughter would have been upset that we couldn't adopt the raccoons as our new pets, but she would have enjoyed playing with them while they were with us. It also would have been a little bittersweet to see them go to a clearly better home than we could have provided.

The 4% Rule

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tax inefficiency, the expected net returns of alternative investments should still be higher than what bonds produce.

Liquidity is another issue. Not all of the alternative funds we invest in trade every day the way stocks and bonds do. The private investments sometimes have required holding periods, and even a couple of the publicly-traded mutual funds only offer trading windows a few times per year. Most of our clients do not need to have all of their portfolios immediately liquid, but this is a concern for some.

Bonds still have a role in most portfolios, but we're starting to think that those who are reliant on meeting certain minimum return targets will need to move some of their bond allocation toward other investments. While they are not perfect, alternative investments may be worth a harder look, and may help generate sufficient returns for the 4% rule to continue to be effective. We would be happy to discuss your portfolio at any time to determine if these strategies may be appropriate for you.

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