WEALTH STRATEGIST PARTNERS

"We're in a Low Return Environment":

So What's An Investor To Do?

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For many months now, Wall Street pundits, other financial experts, and casual observers have been pronouncing "We're in a low return environment" with conviction and certainty. They assert this belief as a statement of fact with which everyone obviously does or should agree. But in reality "We're in a low return environment" is simply an opinion, not a fact; we confuse the two at our peril. And this belief only describes one of many potential outcomes.

Predictions frequently diverge from actual outcomes. This prediction in particular also implies stability, lack of risk, and profitability. The phrase "a low return environment" is often assumed to suggest a benign environment with tolerable asymmetry – sure, your upside is constrained, but there's little or no potential for loss. And since the environment is benign, taking more risk to achieve your objectives is a prudent course of action. This sounds like a pretty good deal for those who aren't overly greedy; modest upside, no downside. Who wouldn't want some of that? You can just hear the refrain: "Sign me up, and give me just a little extra of the upside so I can meet my objectives." Of course, this is what the Federal Reserve wants investors to do, and it's working: today, the S&P is rubbing 2000 and credit spreads are near historic lows. History suggests that markets at times like this are not benign; they have considerable downside risk, even if the risk isn't apparent in the moment.

Low return environment assumptions are particularly dangerous for taxable investors. Most investors wrongly assume that market returns bear a constant relationship with the returns achieved by investors. Management fees and expenses change the relative beneficiaries of market returns as those returns rise and fall (for more detail, see my article, "The 50% Rule – April 2014[1]). In a high return environment everyone benefits, and managers and investors share portfolio returns more or less proportionately. **As market returns decline, especially into the middle and low single digits, managers' share of total profits rise dramatically while investors' share of the profit declines.** When returns go below zero investors bear all of the market loss, after also paying management fees and expenses. In short, a low or negative return environment changes the distribution of profit between the investor and the manager to the investor's detriment.

Of course, the relationship between market returns and investor returns also depends on the type of management fee in question. **In low return environments, investors pay a greater penalty for investing in high fee structure portfolios like hedge funds and private equity funds relative to low fee vehicles like index funds and low-cost ETFs.** Management fees are usually fixed as a percent of assets,

[1] http://wealthstrategistpartners.com/assets/images/documents/The_50_Percent_Rule_(CFA)_April_2014.pdf

not a percent of profits. As gross profits fall toward zero, high management fees eat up a higher and higher percentage of profits than low fees. At 4% gross, a 2% management fee takes half the profit; an index fund's 0.2% fee takes one-twentieth of profits. At 2% gross profit, the proportions are 100% and 10% respectively. In a low return environment, for that high-fee manager, it's "heads I win, tails you lose". Carried interests add to the manager's return. If the investment is in a separate account or limited partnership, many wealthy investors cannot deduct the management fees from taxable profit. In other words, you pay tax on your gross profits (after carried interests), not your net profits.

I am not making a value judgment about fees. They aren't going away and some managers deserve them. We hire low-fee managers. We also hire high-fee managers when our research gives us confidence that they will add value significantly in excess of their fee. Investors take on an often-hidden risk with high-fee managers: to justify their fees, these managers may feel pressure to generate more value added (as measured by alpha) in a low return environment than in a high return environment. This may lead some managers to expose their portfolios to more risk per unit of expected return – not out of a perception of opportunity or a sense of prudence, but in response to pressure to justify their fee. **The more you pay a manager, the more discerning and accurate your assessment should be, especially in a low return environment**.

Individual investors' returns are also affected by taxes. In a low return environment, the impact of taxes is more straightforward. First, there are no taxes on losses. In fact, under many circumstances the government shares a portion of the losses and softens the blow. Second, the tax rate on gains depends on the character of the gain (short-term, long-term, qualified dividends, income) but is essentially proportionate regardless of the amount of profit an investment generates.[2] Current interest and short-term capital gains are taxed at higher rates than long-term gains and qualified dividends. Long-term investments can compound their gains tax-free until they are sold. Because of these differences in tax rates and timing, the type of investment vehicle and the manager's investment strategy can have a big impact on the amount and the timing of taxable income.

The combined effects of fees and taxes in a low return environment can wreak havoc with standard perceptions of risk and return, especially for taxable investors. Let's look at an example. Today, low interest rates are driving investors to look for alternatives to low-risk, low-fee components of their portfolio that are also generating low returns. For example, an investment grade municipal bond mutual fund paying, say, a 2% after tax and fee yield may not meet an investor's return objectives in a benign interest rate environment and he is concerned about the potential impact of rising interest rates. So the investor looks to an "absolute return" hedge fund with a 2% management fee and a 20% carried interest as an alternative. The hedge fund must generate 8% gross profit just to earn the same net return to the investor as the muni bond fund[3]. How much risk do you think the hedge fund has to take to put 2% in the investor's pocket? More or less than the muni bond fund? Given the risks, which investment is more likely to meet the investor's goal?

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[2] The tax code is graduated based on an individual's overall level of income, but the top marginal rate or the alternative minimum tax rate will apply to most people who have substantial investable assets.
[3] http://wealthstrategistpartners.com/assets/images/documents/The_50_Percent_Rule_(CFA)_April_2014.pdf

Let's look at another example. An investor is trying to decide between a broad based equity index fund, a long/short equity hedge fund and a private equity fund. His goal is to generate 5% compound annualized profits net of fees and tax over a long period of time. The index fund must generate annual returns of 7.2% on a gross basis, the private equity fund 11.7%, and the hedge fund more than 14%. All three invest in equities and they have different features, but which is most likely to achieve the investor's objectives?

Of course, having a goal of achieving 2% or 5% return is no guarantee that markets or managers will actually deliver. If a low return environment actually turns negative for a period of time, investments in index funds will surely lose money, whereas some private equity or hedge funds will generate positive results over the same period. Some investors crave this kind of downside protection, and have faith that it will be delivered. In exchange for protection from an uncertain downside, they give up a huge portion of their upside return, especially when gross returns are mediocre but positive. For taxable investors, is the volatility dampening promised by alternative investments worth the cost?

Other investors turn to hedge funds and private equity to get "just a little upside" in a low return environment. In contemplating this approach, they should remember that these vehicles are also typically less liquid. Low fee products like ETFs and low cost mutual funds have at least daily liquidity; limited partnerships occasionally have monthly liquidity. This liquidity makes it possible to be opportunistic if some financial markets fall while others maintain their value. Most hedge funds have quarterly, semi-annual or annual liquidity, often with extended notice periods. Private equity funds lock up capital for up to 10 years, sometimes more, and investors have no control over when the cash is returned to them. **Illiquidity limits flexibility** to opportunistically swap out of investments that have held value and into others that decline and become attractively priced.

One of the riskiest aspects of a low return environment is how we get out of it and into an environment with lots of upside potential. Today, corporate profitability is high, and public equity valuations are somewhere between modestly-above-average and "getting expensive". Bond yields are low, credit spreads are tight, and institutional and individual investors alike are searching worldwide for the returns they need to meet their objectives. Our world is awash in financial capital; hedge funds, private equity funds, sovereign wealth funds, and family offices compete aggressively for deals and for returns.

Going from this type of environment to one with greater upside typically requires pain. The most favorable transition that I can now imagine is a multi-year consolidation process: slow, steady growth in productivity, employment, housing and profits accompanied by financial markets that go more or less sideways for several years during which equity valuations trickle down, bond yields rise slowly, steadily and not very much, and annual returns on both asset classes remain close to zero. That would actually be the hoped for low return environment! More likely, volatility and uncertainty will return to financial markets, and valuations will fall for a time. The prediction of a "low return environment" implies modestly asymmetrical investment returns to the upside. **Today, I fear that the asymmetry will be to the down side.**

So what is Wealth Strategist Partners doing today to navigate this challenging environment and to invest our clients' capital?

- **Remain uncertain**: remain skeptical of how much we can know; be patient and disciplined; and have ready cash with which to be opportunistic.
- **Be a value buyer**; better yet, find growth opportunities where we can also make money "on the buy".
- **Resist reducing hurdle rates on private equity and hedge funds due to temporary market conditions or a shortage of qualifying product.**
- **Underwrite new investments assuming debt will be less abundant and higher priced when it comes time to sell.** We only invest if we are satisfied with the baseline return.
- **Put a premium on liquidity and current after-tax cash flow.**
- **Put a premium on low-cost, tax-efficient investment vehicles.**
- **Find investments that are resilient,** with the capacity to withstand dislocations and with multiple paths to a successful outcome.
- **Bring capital and differentiated skill sets to growth opportunities that are starved of both.**

Howard Marks, Chairman of Oaktree Capital, writes wonderful letters which you can download from the Oaktree website (http://www.oaktreecapital.com/). In a recent one, titled "Dare to be Great II", he states "Only if your behavior is unconventional is your performance likely to be unconventional... and only if your judgments are superior is your performance likely to be above average." His quote gives me some solace that thinking analytically but differently than most investors and feeling out of step with market sentiment are part of Wealth Strategist Partners' job. At times we express unconventional judgment when assessing managers and markets. Although the impact of taxes and fees are knowable, analyzable, and substantial, few people consider them in evaluating investment opportunities and strategies. Some even dismiss their importance "if you have a great manager". But they are wrong. **To generate superior long-term performance for taxable investors, their advisors must have good judgment about investments *and* how their results are impacted by fees and tax. It is the marriage of good fundamental investment analysis and careful thought about fees and taxes that sets Wealth Strategist Partners apart.**

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