

# ADKINS SEALE CAPITAL MANAGEMENT, LLC

Investment Commentary

April 6, 2015

## Dear Clients:

As the first quarter of 2015 drew to a close, much of what has concerned investors over the last couple of years remained unresolved. Seemingly intractable conflicts among struggling nation states in the Muslim world represent the potential for significant market deflating events. All the while, the developed economies continued the blind devotion to easy money policies as the cure all for economic malaise brought on by moribund, highly-regulated economies in a highly-competitive global marketplace for goods and services. Investors across the globe ignored such concerns and bid up prices for global equities and bonds fueled in large part by the latest new commitment to “Quantitative Easing” and falling energy prices, with only non-US bonds suffering in USD terms from the continued appreciation of the greenback. As Herbert Stein once said – “If something cannot go on forever, it will stop”.

## Investment Market Returns as of March 31, 2015

Global stocks generated positive returns during the first quarter, with the total returns (USD) on the MSCI-EAFE Index and S&P 500 Index of 4.9% and 1.0%, respectively. The net return on foreign stocks in developed countries was all the more impressive given a nearly 6% rise in the US dollar for the quarter, as evidenced by a 10.9% total return on the “EAFE” in local currency terms. Total return on small US stocks also outperformed their larger brethren, with the Russell 2000 Index up 4.3% for the period. For the twelve months ended March 31, 2015, US large cap stocks remained at the top of the world's stock markets with a total return of 12.7%. In contrast, the EAFE Index generated a total return (USD) of negative -0.9%, as a nearly 19% rise in the US dollar negated a 17.7% total return in local currency terms.

Bond investments continued to benefit from falling interest rates as indicated by the 1.6% total return for the recent quarter from the Barclays US Aggregate Bond Index, despite having a quarterly yield of only 0.5%. Although somewhat less frothy, the US municipal bond market also returned more than its yield for the same reasons. The reward from investing in foreign bonds was decidedly negative, as the rise in the US dollar contributed to the -3.3% negative total return on the Barclays G7exUS Bond Index. For the recent twelve month period, US bond returns were slightly below 6% for investment grade taxable bonds and slightly above 6% for investment grade municipal bonds; these returns also benefited from continued declines in forward bond yields.

To sum up the results for the most recent quarter, Keynes' “animal spirits” remain firmly in place as investors across the globe are pushing up prices of risky assets in pursuit of higher returns, while at the same time driving down already- paltry interest yields on supposedly safe bonds to hedge against steep equity market multiples and political unrest. Perhaps Professor Stein's quote will apply to tomorrow's markets.

## Portfolio Diversification: Why Bother?

Many investors have asked the question: does asset class diversification work? If one looked solely at investment returns since April 1, 2010, the casual observer might conclude that putting one's entire portfolio into the broad US stock market was the simple and optimal solution to portfolio management. For over that relatively short time period, the compound annualized total return from the broad US stock market was approximately 14.7% per year, more than double the “pedestrian” returns from non-US stocks. Some of the return advantage for US stocks came from the relative strength of the US dollar, which rose about 3% per year over the last five years. Aside from the currency affect, US stocks benefited from the combined effects of an improving domestic economy, helped by a revolutionary expansion in energy production, and a tsunami of foreign

capital seeking safe harbor. We argue that the experience of the last five years can not be extrapolated into the future and the recent observation is a very “short” time horizon for evaluating investment returns.

Consider that US large cap stocks and non-US stocks (EAFE) have delivered similar average returns over the long term (30+ years); but, as we have seen recently, the annual return patterns can differ widely. A fellow named Harry Markowitz received the Nobel Prize in Economics for developing the mathematical model to estimate the value (return benefit) of constructing investment portfolios with more than one asset class. Assume the average annual geometric return from both US and non-US stocks is around 10.1% and that standard deviation of annual arithmetic returns for both sets is 20.2%. We estimate the long term correlation of returns between these two assets at about 0.7, which, using Markowitz's model, suggests an expected return of 10.4% from a portfolio with a 50/50 mix of these two assets. If two such asset classes had a correlation of *zero*, the expected return of the 50/50 portfolio would be about 11.1%. We use these illustrations to demonstrate the power of combining multiple asset classes with reasonable returns and correlation factors less than 1.0. In general, returns from stocks and bonds have a correlation of near zero, but of course the portfolios with a mix of stocks and bonds will have lower weighted average returns and less dramatic return benefits from correlation effects. Our usage of the asset class referred to as “Alternatives” is motivated in part by our belief that such assets will have moderate returns versus stocks, somewhat higher returns than bonds, and relatively low correlation factors versus both stocks and bonds.

Bottom line: we believe asset class diversification works eventually.

### **Our Look Forward**

Not much has changed in our outlook over the last twelve months. We continue to tilt our clients' portfolios to less than normal equity allocations, continued use of non-US stocks and bonds, lower than normal durations for bond holdings, and a small but meaningful allocation to alternative assets. We view the earnings yield of 5% on US large cap stocks as less than desirable given the lower growth trajectory of the economy. Similarly, we view a 2% yield on 10 year UST bonds and a 0% yield on money market assets as uneconomic and unsustainable. If we are right in our views, better buying opportunities await investors with patience and fortitude.

### **In Closing**

We look forward to visiting with each of you about your investment results and expectations for the future and to make sure your portfolios are aligned with your specific circumstances. We greatly appreciate the opportunity to serve as your investment adviser and pledge our best efforts to meeting your expectations.

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