BWM

Baystate
Wealth
Management

John Cogswell CFA
Chief Market Strategist
Portfolio Manager
Baystate Wealth Management
200 Clarendon St, 25th Floor
Boston, MA 02116
jcogswell@baystatefinancial.com

Setting Expectations

One of the more important responsibilities for those of us in the financial services industry is setting investment return expectations. Although setting expectations about future returns is important at the beginning of an investment, it is very much an ongoing process for two main reasons.

First, as time progresses, and as an investor's financial situation changes, it is likely that their investment strategy and risk tolerance level will also change. This type of change should alter the assumptions for returns going forward.

Second, as markets rise and fall above their longer-term average returns, investors should adjust their near-term expectations. History provides an abundance of examples of certain types of investments, or asset classes that have performed above average for a given period tend to revert and perform below average at some point in the future. Conversely, the "dogs" of a market can often turn around and be at the head of the pack in the future for some period of time. This dynamic is referred to as "reversion to the mean."

The last two calendar years proved a perfect example of this shorter-term phenomenon. Equity markets were so strong in 2017 that at Baystate Wealth we were careful to advise investors who initially invested with us at the beginning of the year that their returns would not likely continue to be as high as they had been over their first year. Indeed, when stocks are up 10% to 20% for any period of time, most investors are going to experience above-average returns and should consequently lower their nearer term expectations.

Thus far, the calendar year 2018 is, not surprisingly, a very different story to 2017. Whereas investors experienced above average returns in 2017, with one month to go, it looks like investors will experience below average returns in 2018.

Given the recent fall in aggregate stock prices, we will use this month's report to revisit what we believe to be reasonable expectations for the three high-level asset classes (equity, bonds, alternatives). Recognizing we have done this exercise in prior reports, this month we will

concentrate on expectations for returns when risk assets are falling, while paying special attention to the equity market.

Equities

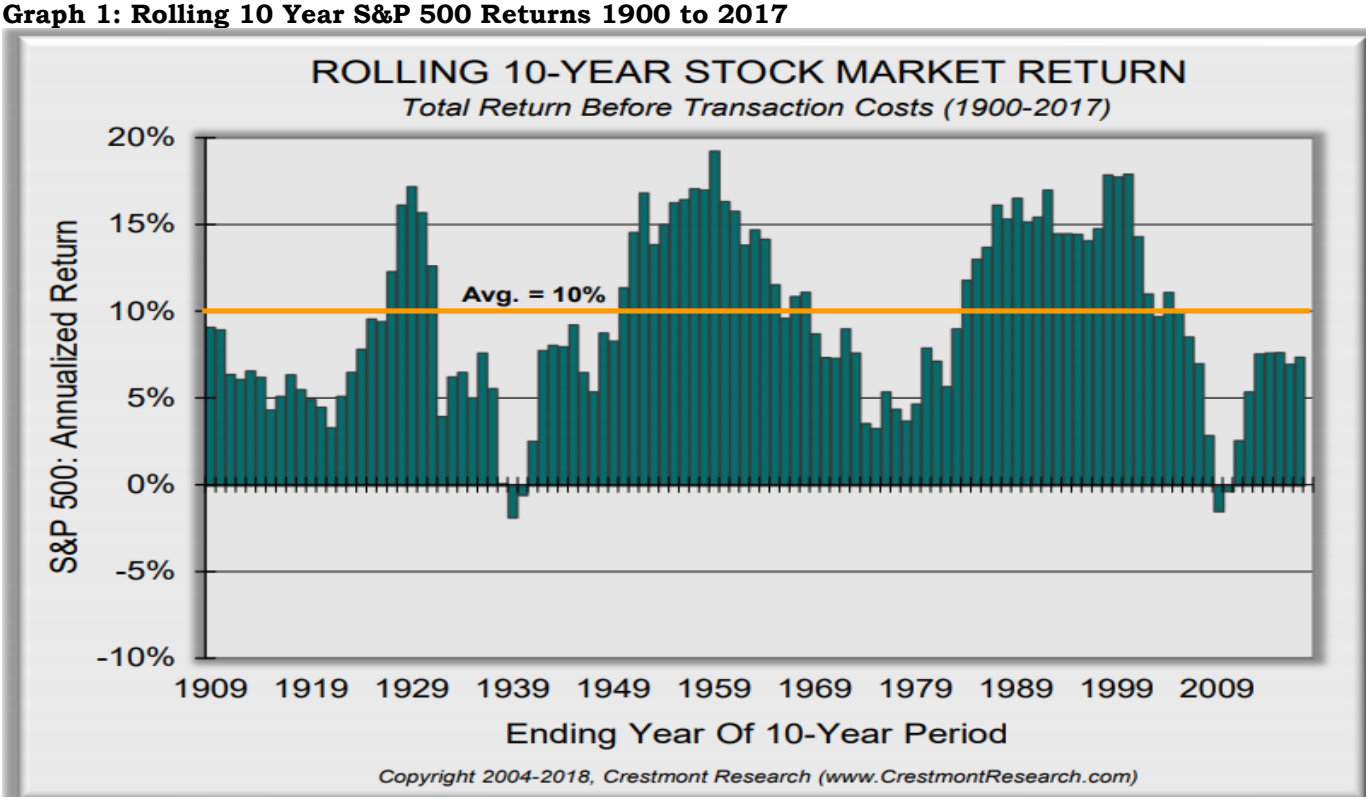
At Baystate Wealth we believe a reasonable long-term total return expectation for a diversified portfolio of only stocks is high single digits. To be more specific, by "long-term" we mean 10+ years and by "high single digits" we mean 7% to 9%.

There are two main reasons for our assumption about future returns. The first involves the reason companies, and therefore their stock prices, have value in the first place. Corporations, both private and public, have value to owners because of current income (dividends) and profit (**E**arnings **P**er **S**hare). Currently, most developed stock market indices, like the S&P 500 and STOXX 600, have dividend yields of about 2.5%. Historically, and on average, corporate EPS increases by about 6% a year. A simple, yet historically solid, method of setting return expectations is to add the dividend yield to the EPS growth rate. In this case, adding 2.5% to 6% would equate to a high single-digit return of 8.5%.

At the risk of getting "too deep in the weeds", there is another straightforward method that incorporates valuations and produces similar results as the prior calculation. Specifically, adding the dividend yield to the "earnings yield" will generate a return expectation. An earnings yield is simply the inverse of the PE Ratio, or **P**rice-to-**E**arnings ratio. Using the S&P 500 as an example, the current PE ratio is about 16x, which is close to its long-term average. The inverse of 16, which is 1/16, equals 0.625 or expressed as a percentage is 6.25%. Adding 6.25% to 2.5% computes to 8.75% - a high single digit number.

The second reason we believe "high single digits" is a reasonable long-term annualized equity return expectation is based on history. In reviewing the S&P 500 as an example, rolling 10-year returns going back to the beginning of the 20th century we can see that the average annual return was 10%.

Graph 1: Rolling 10 Year S&P 500 Returns 1900 to 2017



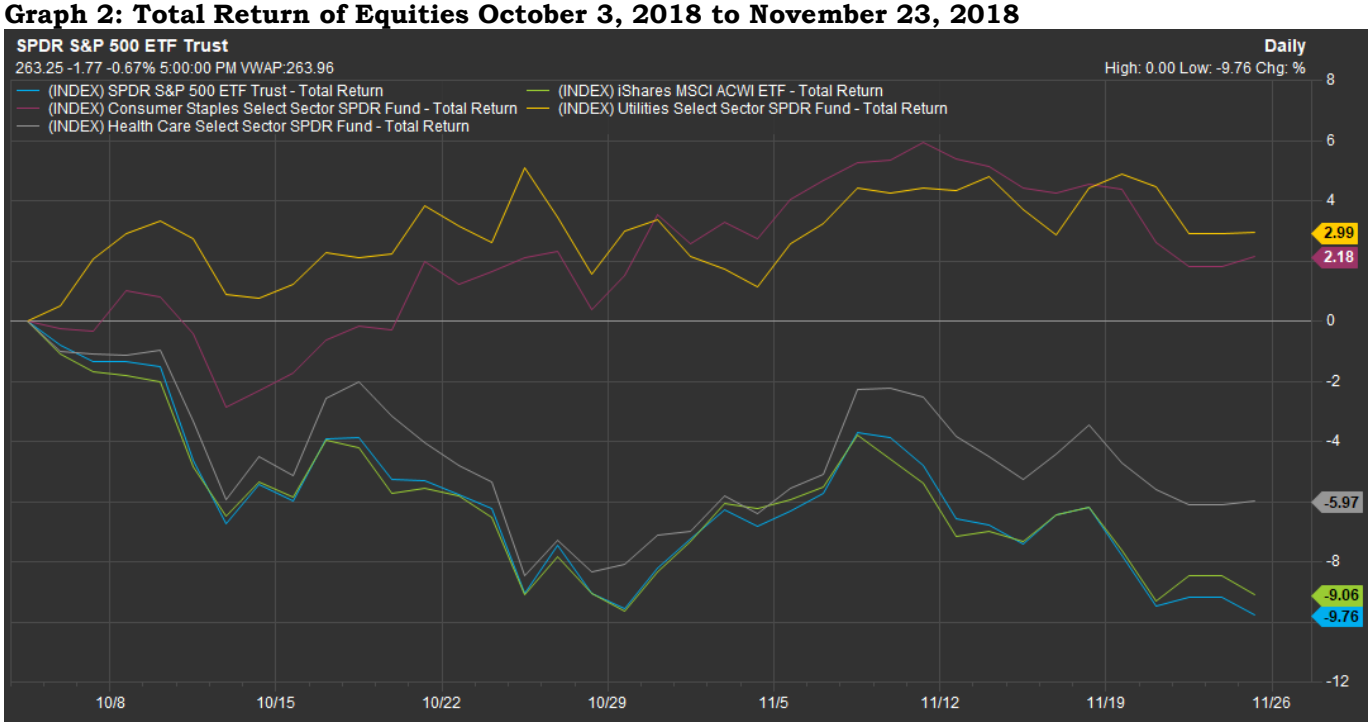
The graph above (Graph 1) from Crestmont Research shows that on average this index has actually averaged a little more than high single digits. The reasons our expectation for average equity returns is slightly lower than 10% is because of the math referenced earlier, and we have found being modestly conservative on financial planning assumptions is prudent. The graph also provides insight into multiple 10-year periods and the annualized return of the S&P 500 during those periods. In our view, it is remarkably important for both Financial Advisors and investors to understand that it is possible for ten years to come and go and equity returns can be much lower than high single digits. Stock returns can, and have been, negative for an entire decade. That all said, on the brighter side of the average are annualized 10-year returns of more than 10%, and even more than 15%.

Make no mistake about the fact that stocks are a risky asset. That risk should compensate equity owners with higher returns than less risky investments provide. However, that is not always the case. The stock market is under no obligation to produce returns commensurate to their inherent risk. Hence, the words "no guarantee" appearing in most investment disclaimers.

In the short-term, when risk assets are falling, the expectation should be that there is little room to "hide". For truly diversified equity investors it should be expected that when the overall stock market is falling, your stocks will fall similarly.

For equity investors taking a less diversified and more concentrated approach, there is both opportunity and risk. In a falling equity market, some areas will fall more than the overall market, and some will fall less. There may even be sectors or individual companies that find themselves in positive territory.

Graph 2: Total Return of Equities October 3, 2018 to November 23, 2018



Source: Baystate Wealth Management, Factset

Graph 2 shows the performance of a variety of ETFs from the recent high on October 3rd to November 23rd. The ETFs representing broad-based market indices include SPY (S&P 500) and ACWI (All Country World Index). As can be seen, the more diversified indices are down 9.06% and 9.76%, showing that stocks, on average, are down a little less than 10%. "Defensive"

sectors, like Utilities, Consumer Staples and Health Care, which have often historically fallen less than the aggregate equity market did provide a relative safe haven. Since October 3rd, Health Care has fallen about 6% (about 40% less than the market), and Consumer Staples and Utilities are actually positive by 2.18% and 2.99%, respectively.

Based on my experience working with investors, I am confident there are some investors reading this report wondering why the simple cure for a falling equity market isn't to move into defensive sectors before stock prices fall. This is a logical question and certainly some investors do take a more concentrated approach and attempt to "time the market". A classic example of this strategy would be an investor attempting to move all, or a majority, of their equity holdings into defensive sectors, or even cash, before broad based equities fall.

There are a few problems with the aforementioned strategy. First, predicting when markets will correct, or fall into a bear market, has been historically challenging, and arguably impossible. Second, in the recent past equity markets have fallen and recovered in a remarkably short period of time. Finally, there is no guarantee that defensive sectors will fall less, or increase in value, during periods of market stress. Once again, in the short term, equity markets are under no obligation to follow the rules.

As a relevant side note, and to be clear, in our view, there is a difference between trying to time the market and taking a tactical allocation. Increasing or decreasing an allocation to a particular area of the market for a variety of reasons, including being concerned about equities falling, can be a perfectly reasonable and appropriate approach to take. At Baystate Wealth Management we often increase or decrease all categories within our portfolios and refer to it as our tactical allocation. The difference, in our view, is the magnitude of the allocation change. For example, recently, and fortunately, we removed our overweight allocation to U.S. large cap growth in favor of an overweight position in U.S. large cap value. We did not sell out of our equity allocation to large U.S. growth completely though. Instead, it was a modest tactical allocation.

The bottom line is that for a truly diversified equity investor, when the stock market is falling it should be expected that their equities will have a similar experience to the broader market averages.

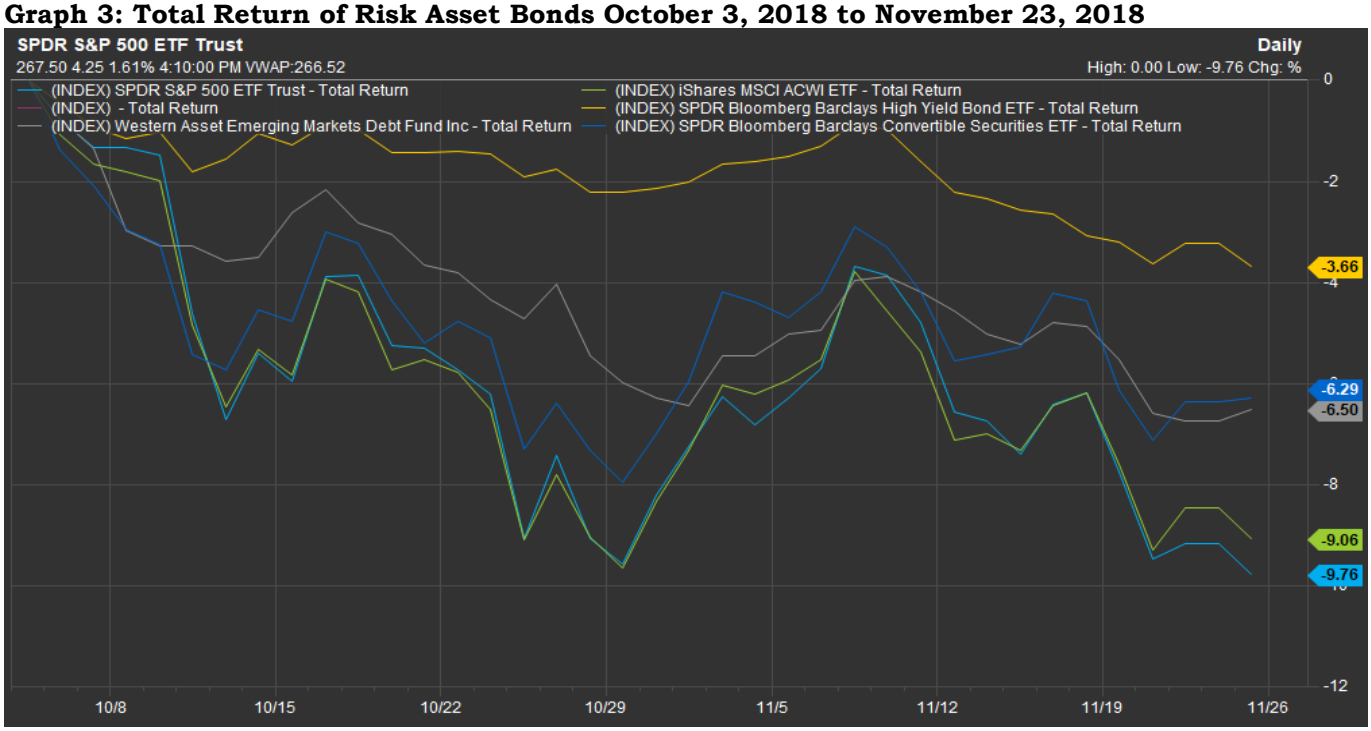
Bonds

For a bond investor that owns one or more bonds with the same maturity, and assuming no default, the expected return is simply the yield to maturity (YTM). For a diversified allocation of bonds with different maturities, credit qualities, coupons, etc., setting expectations for returns is a little more complicated. Adjustments must be made for the shape of the yield curve, expected changes in interest rates, credit spreads and even the velocity of those respective changes. However, to keep this month's report a reasonable length, we will save that analysis for another day. To that end, we believe that given the current low level of interest rates, relatively tight credit spreads and the expectation that rates will gradually rise, a diversified allocation to bonds should return low to mid-single digits over time.

Estimating expected bond returns when risk markets fall requires an extra step not necessary with equities. Specifically, we must break apart what we refer to as risk assets and diversification assets within the bond market. This is not necessary with stocks as they are all risk assets in our view. Examples of risk assets in the bond arena would include high yield bonds (a.k.a. "junk bonds), emerging market debt and convertible bonds. On the other hand, examples of diversification assets within bonds are high grade corporate bonds, U.S. government bonds, and agencies.

A baseline expectation for any risk asset, including those that happen to be bonds, is that they will fall with the equity market in periods of stress.

Graph 3: Total Return of Risk Asset Bonds October 3, 2018 to November 23, 2018



Source: Baystate Wealth Management, Factset

Graph 3 shows the recent market decline for the period in Graph 2. The difference is graph 3 shows three ETFs that own high yield bonds, emerging market bonds and convertible bonds. As in Graph 3 the equity markets, as measured by either ACWI or SPY, are down 9.06% and 9.76%, respectively. Over the same time, high yield bonds were down 3.66%, convertible bonds down 6.29% and emerging market debt down 6.50%.

Fortunately, all three bond categories fell less than the market during this period. Yet, they didn't provide the type of diversification benefit one would normally expect from a "traditional bond" during a period of market stress.

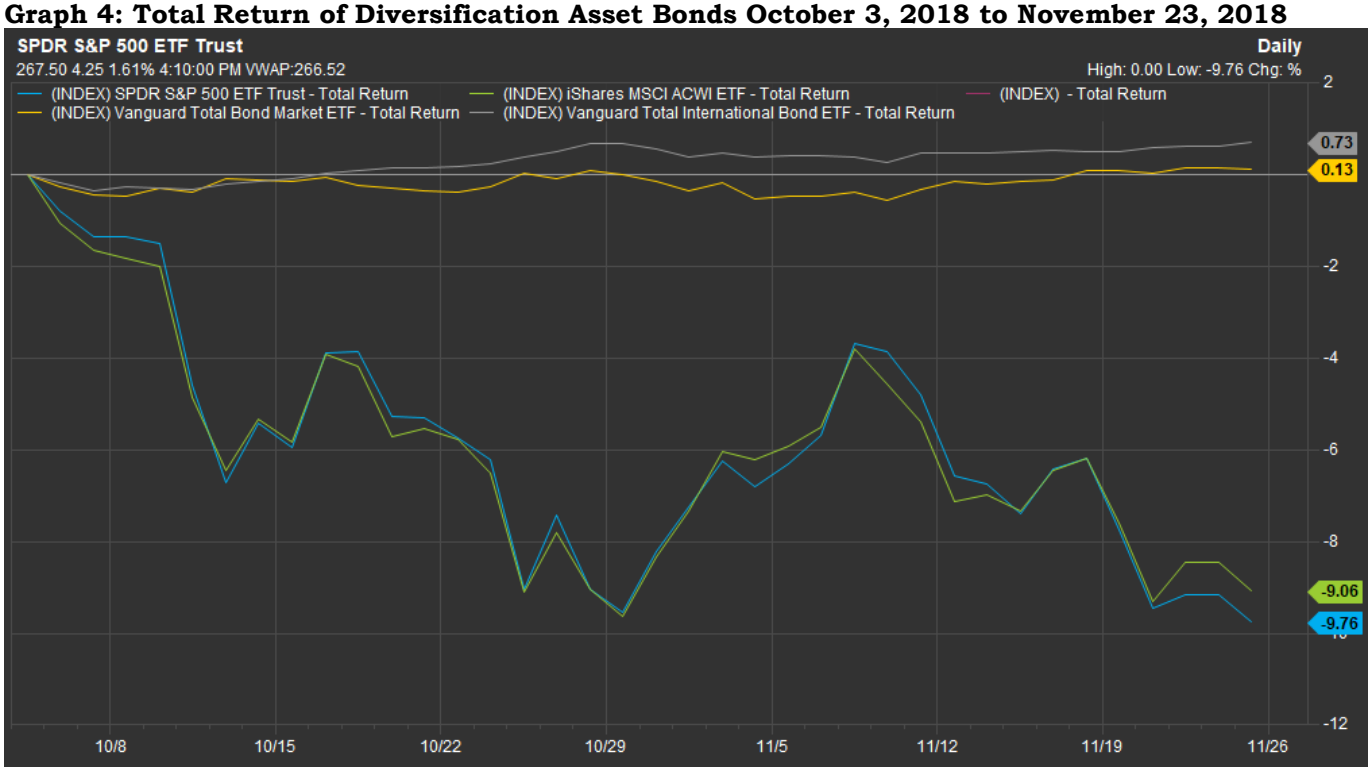
The bottom line is that we call them risk assets for a reason. Although they typically don't fall quite as much as equities in risk market "sell-offs", it's possible that they can. Our advice for risk budgeting purposes, and expectations is to assume they will fall as much as stocks.

We find that most investors believe bonds are both safer than stocks and a potential piece of a diversified portfolio to cushion the blow of a falling stock market while collecting interest. Luckily, this is true for many areas of the bond market and as luck would have it, we have yet another graph to aid with the discussion.

Graph 4 shows the ACWI and S&P 500 for the same period as the previous graphs, but this time includes two ETFs that represent the U.S. bond market and the international bond market. Both ETFs follow indices that track mostly investment grade corporate bonds and developed country sovereign bonds. As can be seen, both have experienced positive return with the U.S. bond market up 0.13% and international bonds up 0.73%.

Once again, there is a reason we refer to some bonds as risk assets and some as diversification assets. We believe the combination of graphs 3 and 4 explains that narrative well.

Graph 4: Total Return of Diversification Asset Bonds October 3, 2018 to November 23, 2018



Source: Baystate Wealth Management, Factset

The bottom line is that it is reasonable to expect that bonds that are diversification assets will likely be the best performing area of the portfolio when risk markets are under stress. The flip side of is that over time it should be expected those safer, diversifying bonds will provide the lowest returns.

Alternatives

Investments outside of the universe of stocks and bonds require the same categorization process as bonds; specifically, risk alternatives and diversification alternatives. Setting long-term return expectations for alternatives is unfortunately even less straightforward than with stocks or bonds. The reason is that some alternatives do not have consistent correlations with other asset classes. As a high level and general rule, at Baystate Wealth we tell clients that a diversified portfolio of alternatives that fall into both the risk and diversification asset schemes should have returns, over time, somewhere between the investment grade bond market and the aggregate equity market.

In a risk asset drawdown, return expectations for an allocation to alternatives should be a function of the current allocation of those alternatives across the risk spectrum. Once again, this is similar to a bond allocation. If a portfolio of alternatives is all, or mostly, risk assets like MLPs, commodities or REITs it should be expected that allocation will rise and fall in line with equities, which are also risk assets. On the other hand, if an allocation of alternatives is all, or mostly, diversification assets and inherently more conservative, it should be expected those assets will rise and fall less than the broader risk markets. Once again, given the sometimes low to negative correlations found in alternative asset classes, it is possible for those investments to experience positive returns when risk assets, in general, have fallen in price.

In our final graph, which shows the same time frame as graphs 2-4, we plotted three alternatives that many Baystate Wealth clients are familiar with as they are in some of our strategies. Specifically, the three examples of alternative investments used in Graph 5 are:

1. Alerian MLP ETF – an ETF that tracks an energy infrastructure index comprised of Master Limited Partnerships.
2. Gateway Fund - a mutual fund owning U.S. stocks and a combination of long and short S&P 500 options.
3. IQ Hedge Multi-Strategy Tracker – an ETF that attempts to replicate the total returns of a common hedge fund index.

The three alternative investments are listed in order of their level of risk with MLPs being the most aggressive and the hedge fund ETF being the most conservative. As can be seen in the graph below, MLPs, an aggressive risk asset, fell more than the overall market as measured by either the ACWI or S&P 500. At the same time, the Gateway Fund fell about half of the market and the hedge fund index fell by -3.04%.

Graph 5: Total Return of Alternatives October 3, 2018 to November 23, 2018

Source: Baystate Wealth Management, Factset

All of the returns of the alternatives are in line with what should be expected during a broad-based pull back in risk assets.

The bottom line is that expectations for alternatives that are risk assets require a little more calculus, but the same general rules should apply. In other words, risk assets are risk assets and diversification assets are diversification assets.

Summary

Understanding that there is still one more month left in the calendar year, it's safe to say 2018 will be remembered as a stressful year for most investors. The year started with a strong positive trend and then pulled back about 10% into February. Markets then recovered about 7% into March and then fell another 7% into the beginning of April. From that point, risk markets experienced some volatility, but in general, did so with prices increasing. Though rising prices were seemingly short-lived, as markets experienced another 10% fall from October into November. It is understandable why investors would be stressed about market volatility.

To that end, this month we wanted to focus on expectations when markets, particularly the equity market falls. Remember that when risk markets fall the bottom line is:

- Truly diversified equity portfolios are going to fall in a similar manner as the broad-based indices. Taking concentrated risk via sectors or individual equities may help, but it may also hurt. Historically, these types of concentrated and market timing strategies have not been widely successful on a consistent basis.
- Bonds are a mixed bag. It is not the case that all bonds are "safe" and will protect a portfolio in stock market decline. Some bonds will experience negative returns when risk markets are under stress.
- Alternatives are even more of a mixed bag than bonds. Not only are some alternatives risky and others are conservative, but intra correlations can change. Our advice, and our approach for clients at Baystate Wealth, is to assume the worst-case scenario in your risk budget.

As always, we hope this helps and if there is any way that we can be of additional service, please let us know.

John P. Cogswell, CFA
Chief Market Strategist, Portfolio Manager
200 Clarendon Street, 25th Floor
Boston, MA 01226
(T)781-876-4112
jcogswell@baystatefinancial.com

-please see disclosure on the following page-