BOSTON ADVISORS

Quarterly Investment Letter

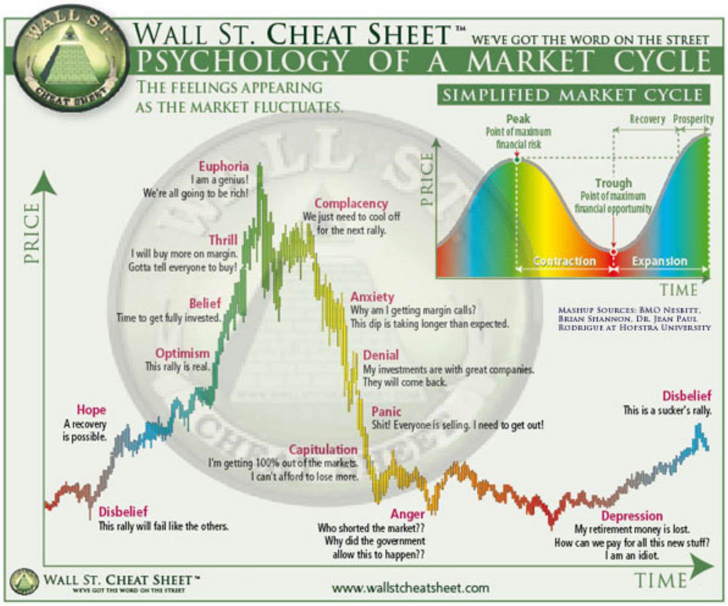
Investment observations from the CIO
Michael J. Vogelzang, CFA

"Come gather 'round people wherever you roam
And admit that the waters around you have grown
And accept it that soon you'll be drenched to the bone
If your time to you is worth savin'
Then you better start swimmin' or you'll sink like a stone
For the times they are a-changin"

- Bob Dylan

We received an interesting email this past quarter from an intellectually curious client. In the correspondence, the client included the "Psychology of a Market Cycle" (below). The graphic depicts the various psychological peaks and valleys that investors experience as markets fluctuate, from the highs of soaring prices, to the depression of a market crash. In fact, it's so beautifully detailed and so widely distributed that it has almost become a cliché; investors are genetically programmed to do the exact opposite of the old bromide, "Buy low, sell high."

The client asked where we see ourselves in this cycle. With the U.S. stock market setting new highs almost weekly, the mood should be euphoric. Investors should be clamoring for more equity exposure. Bond investing has become an oxymoron with yields at artificially low levels. So you have to buy stocks, right? Historically, at this point of the bull market, most of Wall Street would be partying like it's 1998 – but believe me, that's not the case this cycle.



While the mood seems mired in the "Disbelief" phase, steady, low-profile and persistent buying has caused U.S. equity markets to grind higher in the face of high valuations, economic uncertainty and policy dilemmas that have no defined solution. The market and investor reactions seem to have changed over the last 15 years. Skepticism dominates the collective psyche—even at all-time highs—and unusual behavior is the norm in today's market.

Suffering two 50% bear markets in the last 18 years has much to do with investor reticence and skepticism, of course. But the current investing environment has changed within recent years, changes impossible to envision. We believe the main changes stem from a number of factors, including new types of investors, new technology, product innovation and a new generation of market participants. Many of these differences make understanding psychology and potential outcomes more difficult. For example, almost every client has interest in the next correction or how to sidestep the inevitable drawdown in prices. Larger institutional clients continue to pare back equity exposure, a smart and thoughtful move, but one that's not predicated on past psychological patterns.

Investors generally seem highly allergic to volatility of any kind, yet the search for high returns remains front and center. Has everyone gotten too smart? Has the game changed? Is it even possible to bend the risk/return curve to be friendlier? (The answer is no, by the way…)

Here we detail a few of the changes we've seen in the stock markets over the last few years. Some are new; some aren't, but have taken a larger role recently.

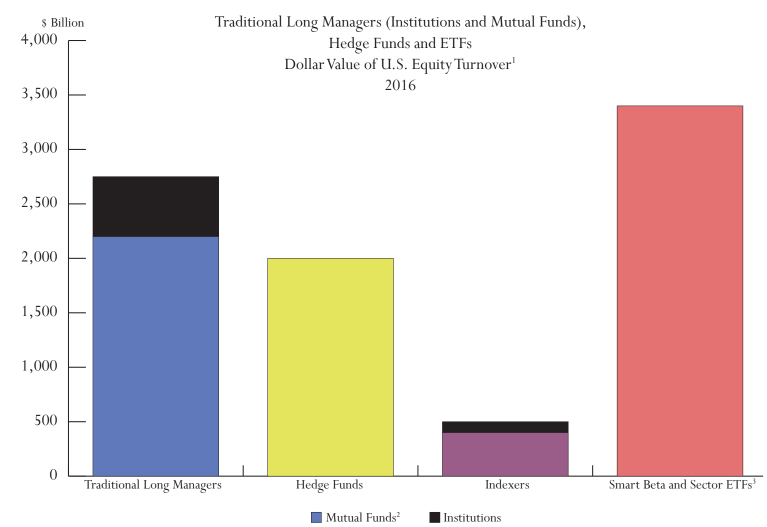
1. Market structure: As investors, we face off against new market players everyday who use different technology and have different time frames. Historically, equity markets have been dominated by long-only institutional and retail investors. That equation has changed radically:

    - Short-term "quants": "High frequency traders" have taken over 40% of the volume on the major exchanges. These investors look for opportunities in the market crannies that might make them 1/10th of a penny per transaction. The use of high speed networks to work with massive amounts of data provides the advantage to scalp a few cents here and there and become profitable at the expense of other investors. When your time frame consists of micro-seconds, the S&P 500 is not your benchmark.

    - Hedge funds: In funds that hold both long and short positions of stocks, the investors often focus on long-term returns but with the limitation of short-term volatility. This is a very tricky and dangerous game, one frequently referred to as "picking up nickels in front of a steamroller." Most hedge funds, given this mandate, act almost immediately to sell anything that begins to fall in price. That, of course, snowballs the price impact, creating over-reactions and mispricing.

    - ETF investors: Never before have we been able to sell so many stocks with one mouse click. Exchange Traded Funds (ETFs) allow for almost immediate purchases and sales of broad baskets of stocks. The supposedly long-term and stable investor base boasted by ETF sponsors is anything but. On a recent call, an analyst stated that, "the ETF is the perfect vehicle to exacerbate performance-chasing behavior." As an example, smart beta and sector ETFs account for more trading volume than either hedge funds or traditional long-only managers. Investors are increasingly using these funds as replacement vehicles for exposure to certain market attributes, but not to invest in successful companies. Want to buy technology? Just buy the QQQ (NASDAQ Index fund) and don't worry whether Facebook or Snapchat will be the next winner. Do you think interest rates are going up? Just buy XLF, the Select SPDR Financial Sector ETF that covers all financial companies and provides exposure to higher interest rates. This change in investment approach fundamentally alters the description of owning a good company – and the time frame in which to realize investment performance.

The Marginal Buyer and Seller Has Changed



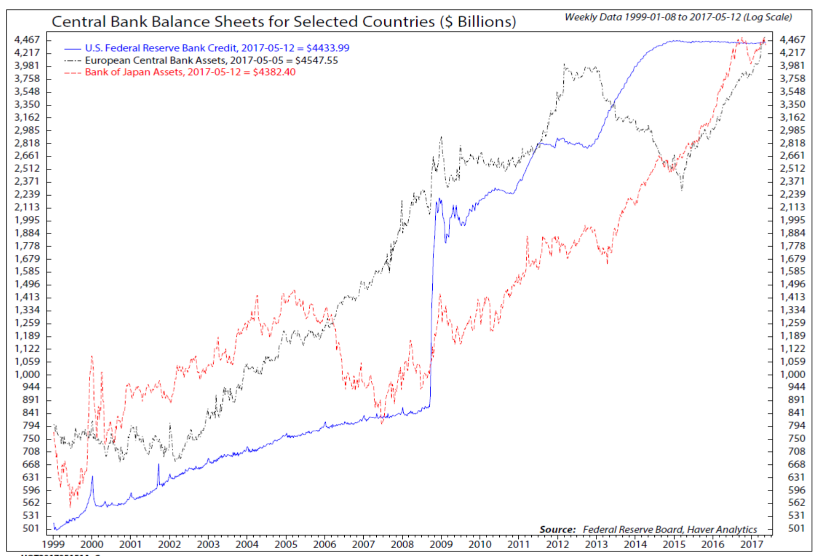
[1] Measured one-way.
[2] Including the equity portion of target date and balanced funds.
[3] Includes value, growth, yield, other smart beta products, and all sector-focused ETF

Source: Empirical Research

2. <u>High valuations</u>: By all measures, the S&P 500 sits in the top 10% of historical valuation. That means that at a current trailing P/E of 21.8, it's really expensive. However, by itself, high valuation doesn't mean prices will fall. Over time prices revert to normal value, but that happens at an unpredictable pace. For example, stocks carried approximately the same P/E today as in June of 1997. Had an investor sold then, scared of valuation, he or she would have missed a 75% rally through March 2000. What we do know, however, is that low returns generally occur in the ten years following expensive valuations. In the seven years since 2010, the stock market has provided an average return of 15% per year. It's highly unlikely that the next seven years will experience that same level of return. Rather, we expect something far lower. Investor behavior indicates that we're not alone in that belief.

3. <u>0% interest rates, rising</u>: Since the GFC (Global Financial Crisis, for those of you needing a reminder), the Federal Reserve has kept short-term interest rates at effectively zero percent. Last year, the Fed began to gradually raise those rates (they're now at about 1%), with another increase in the works for this year. Long-term interest rates haven't risen much though, spoiling much of the Fed's impact. Assuming that short-term rates keep rising with a motivated Fed, it's anyone's guess how stocks will react.

4. <u>Shrinking balance sheet</u>: Hand in hand with higher rates, the Fed has announced its intention to begin paring its bloated balance sheet from the trillions of dollars in bonds it purchased in the open market over the last five or six years. With roughly $4.5 trillion of U.S. Treasury and corporate bonds, how quickly the Fed shrinks this massive portfolio is the unanswered question for equity investors over the next five years. It's no coincidence the S&P 500 is up 15% per year for the last seven years while the balance sheet was expanding. How will the market react as the balance sheet shrinks?



5. Facing <u>uncertain tax and business policy</u>, investors and companies simply don't know how to plan. Will investment in infrastructure become a priority? Will some type of medical insurance reform change the ACA? Will the business tax environment change and allow repatriation of billions of dollars locked up overseas? These massive questions (and others) weigh on businesses and investors in those businesses as capital allocation questions are put on hold.

6. <u>The collective American psyche</u>: perhaps the government dysfunction of today simply reflects the deep dysfunction of our modern society. Every study of the American psyche or social mood illustrates our enormous lack of trust across societal lines. Never have Americans collectively distrusted each other and our large institutions as much as today. Whether it's universities, churches, the government, Wall Street and American business, or political parties, younger people particularly mistrust the "establishment" (to use a '60s phrase – look it up, kids.). Deep suspicion may lead to the outright rejection of the basic premise that a growing and thriving business culture is good for the country. Very little thought seems to be given to the competitiveness of our country and economy, putting the U.S. at risk of losing its longstanding prominence and leadership. This matters – to long-term prosperity, education, social welfare and, to the point of the letter, successful investing.

This sour summer essay skips over many positive aspects of our economy – growing corporate profits, a business sector as efficient as ever, lower violence levels, better educational prospects, a slowly greening planet, the first place Red Sox, etc. – but that will have to wait for another quarter and another letter.

So, back to the original question: where are we in the investor psychological cycle? While the price chart seems to say we should all be euphoric, the mood and investor sentiment argues for at best complacency and at worst disbelief. Client comments and questions are historically a good measure of sentiment – we usually get many more questions when things aren't going well. Notwithstanding the market at all-time highs and volatility (the VIX or "fear" index) at historic lows, the mood seems skeptical and distrustful – a highly unusual combination. Maybe it's just that the Yankees are only three games behind the Sox…either way, time will soon tell.

Best personal regards,

Michael J. Vogelzang, CFA
President & Chief Investment Officer