# 2019 Annual Investment Forum Summary Notes

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*The notes below are a summary of the remarks and views expressed by the speakers at the 2019 Annual Investment Forum and do not necessarily reflect the views of Canterbury.*

## MACROECONOMIC OUTLOOK: Joachim Fels, *PIMCO*

### The Story So Far: Growing, but Slowing

— Peak growth is behind us; we reached it around the beginning of last year.

— Industrial and manufacturing data is weaker, but the indicators are still running above the 50 line, which indicates that manufacturing is still in expansion.

— Core CPI inflation is bumping sideways and U.S. inflation is at, if not slightly below the Fed's target.

— The global policy rate is higher, but real rates are still historically low. Most developed markets are still in negative real rate (inflation-adjusted) territory; U.S. real rates are slightly positive.

— Tightening financial conditions have led to more volatility. 2018 market volatility was in line with the historical trend. The markets became complacent with a low-volatility environment.

### Cyclical Outlook: Synching Lower

— PIMCO expects to see the impact of volatility play out over the course of this year.

— 2018 was the year that growth between the U.S. and the rest of the world started to diverge. The fiscal boost (i.e., tax reform) in the U.S. delayed the downside. In 2019, the U.S. should experience a slight deceleration of growth along with the rest of developed markets.

— Five key debates will shape the outlook for the economy and markets.

- How late is it in the cycle?
  - Recession models are flashing orange, but not red. We are in the later stage of the economic expansion.
  - The Fed will continue to run down their balance sheet, which will lead to more monetary tightening.
  - The probability of a recession in the U.S. and Europe is close to 30% for 2019. While a lower probability than previous recessions, the percentage is the highest than any other time in the current expansion.
  - The private sector still has positive savings, whereas savings were negative prior to the last recession.
  - The late cycle timeline could last for quite some time. As an example, Australia has not had a recession in 20 years, but has experienced bouts of volatility. It doesn't take a recession for turmoil to roil financial markets.
- The end of U.S. economic exceptionalism?
  - The Fed outperformed market expectations in 2018 by raising rates at their schedule. As a result, the dollar appreciated versus every other currency and U.S. equities outperformed non-U.S. until the third quarter.
  - The process of U.S. equities catching the rest of the world has started. Fiscal stimulus is still positive, but fading. Oil importers will continue to benefit at the expense of oil producers.

- Will inflation ever return?
  - Yes and no. There are signs of life in developed economies, as inflation is returning in both real and nominal wages.
  - However, CPI is still held down by USD appreciation and a global slowdown, which reduces pricing power. The Fed can be patient as a result. PIMCO is not expecting a large change over the cyclical horizon.
- The Fed pauses, then what?
  - The Fed has arrived in PIMCO's "New Neutral" Fed Funds range. A rate-hiking pause can be difficult to communicate, but markets now believe that the Fed is done for the moment.
  - The global savings glut partially leads to lower inflation and a lower new equilibrium real rate. No one, including the Fed, knows what that true rate is.
- U.S. versus China: truce or peace?
  - Both countries are fairly close to a deal. China's economy has continued to slow given tariff uncertainty, but they need to continue to provide stimulus to their domestic economy.
  - The new NAFTA deal still hasn't passed in Congress. There is a risk that Trump may withdraw from existing NAFTA to force a vote for the new NAFTA, which could potentially fall apart. It's quite likely that auto tariffs will be introduced, which will force the EU's hand in negotiating a deal.

### Secular Outlook: Rude Awakenings

- The next five years could look radically different. More volatility, a recession, and productivity surprises are likely.
- Artificial intelligence and other technological advancements could lead to rising unemployment, but higher productivity.
- Monetary and fiscal policy mixes, along with populist backlash and geopolitics, could be very disruptive. The next wave of populism could be much more negative for markets than previous waves, and a redistribution of capital from wealth to labor could lead to unrest.
- The history of UK gilts has shown that low interest rates are a normal occurrence. The aberration is what happened during the 1970s and 1980s.
- PIMCO still prefers U.S. duration. Bond yields in Europe are likely to rise. The significant flattening of developed market yield curves is likely behind us.
- The firm remains cautious on corporate credit and is not re-allocating after the recent spread widening.
- Consumer balance sheets and the housing market are still healthy. PIMCO prefers agency and non-agency mortgage-backed securities.
- It is too early to go all-in on emerging markets, but there could be an opportunity later in the year if the Dollar and Chinese economies stabilize.

### Q&A

- Timing of the balance sheet unwind?
  - The Fed is constantly discussing the timing of reducing the balance sheet. They usually run excess reserves around $1 trillion and will reach that level by the end of this year. The Fed has communicated that they will be flexible.
- Further deregulation?

- Prospects for further deregulation in the banking sector are reduced, given the Democrat's control of the House. Regulation will likely move sideways for now.

— Bond bear market?

  - There is a good chance that the U.S. keeps growing at a decent level. We are not at the cusp of a major bear market in bonds; however, they would be wrong if debt sustainability became out of hand. PIMCO expects debt to GDP to decline over time.

## BEHAVIORAL FINANCE: Raife Giovinazzo, Ph.D., CFA, *Fuller & Thaler*

### What Is Behavioral Finance?

— Behavioral finance combines finance with psychology, and is the study of how people actually behave versus how they should behave.

— It is about knowing when people are likely to make a mistake and what mistake they are likely to make.

  - Example: If a baseball and a bat cost $1.10 together and the bat costs $1 more than the ball, how much does the ball cost? People consistently make the mistake of answering $0.10.

— Classical finance states that random mistakes cancel out.

— Behavioral finance states that some mistakes are not random and follow a pattern.

  - Example: A dart that is heavier than average would result in a consistent pattern of underthrowing.

### How to Apply Behavioral Finance

— Defensively, it helps investors avoid mistakes. The S&P 500 returned 8.2% during a 20-year period, but actual investor returns were 2.1% because people do the wrong things, selling low and buying high because of emotional investing, social investing, and ego investing.

— Offensively, it helps you invest where others stumble. The behavioral edge (as opposed to an informational or analytical edge) is understanding how other investors make mistakes in analyzing information.

— Investors make two types of mistakes: overreaction and underreaction.

### Overreaction

— Overreaction occurs with vivid, emotional stories (e.g., losing money, bad news, etc.).

  - Availability: Managers make decisions based on memorable stories.

    – Example: What is the ratio of fatalities from tornados to lightning strikes? Most people guess there are more deaths from tornados, even though the truth is they are about the same. There is 30 times more press coverage of tornados.

  - Stereotyping: People make decisions based on first impressions.

    – Example: "Tom W." study. The student sounds like a computer science major based on his description, but people ignore the base rate that he is four times more likely to be a humanities major.

  - Loss aversion: Losses have twice the emotional impact of an equivalent amount of gains.

    – Example: The same group of people upped their allocation to stocks versus bonds from 41% to 70% when they looked at the same return data yearly instead of monthly.

- Overreaction leads to value opportunities when investors become too pessimistic. Thaler found in 1985 that "loser" stocks outperform "winners" over the next five years, and these results were confirmed 30 years later in a separate study.

## Underreaction

- Underreaction occurs with dull or unexpected information (e.g., higher than expected earnings).
  - Disposition effect: Investors tend to sell shares whose price has increased.
    - Example: Investors are 1.5 times more likely to sell a losing investment than a neutral investment, and three times more likely to sell a winning investment.
    - Reasons for selling winners early include anchoring on past prices, anchoring on old data, mental accounting, and cognitive dissonance (i.e., booking a gain shows "I am smart").
  - Anchoring and adjustment: Analysts use a target number and subsequently adjust, but fail to adjust enough.
    - Example: "Doctors in London"—a group of portfolio managers was asked to guess the number of doctors in London after writing down the last four digits of their phone number. The phone number significantly biased their guesses.
    - Even if an anchor is completely irrelevant, it is difficult for the human mind to remain unaffected.
    - There are many numbers analysts tend to anchor to: their own estimates, their peers' estimates, company guidance, etc.
  - Overconfidence: People ignore the facts in favor of their own opinions.
- Underreaction leads to investment opportunities around positive news, such as company earnings surprises.

## Final Thoughts

- "The most important lesson of behavioral finance is not that other people make mistakes. It's that you make mistakes."
  - "If you've been playing poker for half an hour and you still don't know who the patsy is, you're the patsy." — Warren Buffett
- Play defense by being aware of your own biases, and play offense by exploiting others' overreaction and underreaction mistakes.

## Q&A

- What do you think about the private equity world today with rumors of over $1 trillion in dry powder?
  - Not a PE expert, but the sentiment around venture capital seems highly exuberant.
- Is the tendency to sell early influenced by the practice of rebalancing?
  - Rebalancing will lead to some of this effect, but the bias is much greater than rebalancing would suggest. For example, people tend to rank order winners and sell the top winner disproportionately.
- How do your results compare to the market?
  - Fuller & Thaler has been in business since '93 and has outperformed by 2–3% in its various strategies using behavioral finance insights.
- As computers do more of the trading, are we concerned that the arbitrage will close?

    - Human beings will always be involved, whether it be in choosing or writing the algorithms. Where humans are involved, there will always be biases.

- Are you diminishing the alpha from these strategies by talking about them?
    - There is a long history of these biases and they are very hard to overcome, just like optical illusions. In studies of addicts, the ones who are most convinced they will never be addicted have the highest rates of recidivism. Even if people become more rational and the effect diminishes, it won't completely go away.
- Most CEOs are optimistic people. How do you compensate for the overconfidence bias when relying on insider purchases as a buy signal?
    - You have to look at when they are investing. Contrarian insider buying (i.e., buying when the price drops) is more powerful; combine this with fundamental research.

## ENVIRONMENTAL, SOCIAL, AND GOVERNANCE PANEL

*Panelists include: Ophir Bruck, Principles for Responsible Investment; Lisa Richter, Avivar Capital; and Blaine Townsend, CIMA, Bailard, Inc.*

### The History of ESG

- In the 1950s, a set of faith-based values around the premise of doing no harm or evil became investable concepts. This later transformed into investing in what you believe in.
- In the 1960s, faith-based investors tried harder to implement their values. In the 1970s, investors pushed their managers to create mutual funds that divested from companies that created napalm.
- Joan Bavaria was one of the pioneers of social investing. She was one of the few investors that left traditional finance to start values-based investing.
- There were 100 people working in the industry in 1990, with $1B invested. Today, $12 trillion is managed with socially responsible investing (SRI)- or ESG-related guidelines.
- Climate change was a huge catalyst for ESG investing. Traditional Wall Street analysis did not account for this risk and was not set up to examine the long-term ramifications from a financial perspective.
- Corporate governance was not accurately assessed by traditional investment firms. A large amount of research began from large institutional investors. This led to the formation of ESG integration.
- Impact investing seeks return directly in the private markets. Outcomes should have a social or an environmental benefit.

### Performance

- Principles for Responsible Investment (PRI) was established to build an understanding of the risk/return implications to generating sustainable long-term returns. It's the largest representation of sustainable investing.
- ESG disclosures need to be timely and measurable. The SASB organization is an example of this standardization.
- Thousands of studies have looked at the relationship between ESG and performance. The vast majority have shown a positive link between management and financial performance.
- The University of Oxford analyzed 200 of the most prominent studies on ESG. Their review showed that

highly rated ESG companies were linked to lower costs of capital, lower volatility, and better risk-adjusted performance.

- Through the frame of materiality, ESG factors can be assessed. ESG momentum and tilt strategies have shown potential alpha opportunities.

### Fiduciary Risk

- Two ways to approach this: Use investment capital to drive social outcomes, and divest from sectors or companies that don't align with the investor's values.
- Program-related investment was developed by the Ford Foundation to drive social justice and community development. Its primary purpose was charitable, not lobbying or financial returns.
- Performance of these investments has been very strong, as underwriting was disciplined. They can drive holistic change within a specific region or geography.
- Now, a much more flexible regulatory regime allows investors to take advantage of program-related investments, which can be implemented anywhere across the risk/return spectrum.

### Interests from Investors

- Venture capital and financial technology have resulted in disruptive change within ESG. There has been rapid growth to drive health outcomes, diversity, arts, and culture.
- Matured investing strategies include faith-based; low-carbon, fossil-fuel free; animal-welfare.
- Fossil-fuel free is the strongest trend from clients today; however, requests have been wide-ranging. ESG is not an "off-the-shelf" product.
- PRI is putting more emphasis on ESG analysis and is assessing how they can integrate into financial investment. They are not telling investors what they can or can't invest in.
- Two-year study by CFA to understand the commitment to ESG analysis came away with three drivers: risk management, client demand, and fiduciary duty.
- The European model on sustainable finance will be brought to attention for the 2020 U.S. election.
- Governance is the most advanced topic, environmental and social are gaining attention, but from a low base.
- Portfolio managers aren't adjusting their forecasts and models with ESG characteristics, but are incorporating them at a high level.

### Implementation

- A tsunami of research and available data has helped best-in-class and suitability screens.
- Questions to ask when implementing ESG: What do you want to avoid? What service providers to use? What is your mission statement?
- Investors need to have the ability to be more intentional on issues that can drive their mission forward. They can be flexible and use community-based lenders that aren't tied to a bank.
- There has been a massive proliferation of products that are off-the-shelf. Investors can use them if they don't want to go the handcrafted route.
- The PRI is empowering asset owners to assess the ESG characteristics of their portfolios. This can be used as a starting point to have a conversation between advisor and client.

### Q&A

- Can you use governance as a factor to generate sustainable alpha?
  - Companies that have a better workplace will ultimately have a lower cost of capital. Environmental management eliminates fines over time and has led to outperformance.
- Some of these risks are longer term, but many are very short (e.g., cybersecurity). As the regulatory environment changes, how are investment managers interpreting and understanding these trends?
  - The climate-scenario analysis tool on the PRI website will generate a stress test on where the transition risks lie.

## POLITICAL ENVIRONMENT: Greg Valliere, *Horizon Investments*

### Current Economic Climate

- One can argue that in mid-December of last year, there was irrational fear that a recession was imminent.
  - Greg does not think there will be an economic slowdown in the near term, due to continued strong economic fundamentals: unemployment is below 4%, gasoline prices are cheap, real disposable income has increased.
  - In 2018, the economy grew by 4%. That will not happen this year, but the economy is projected to grow 2.0–2.5% this year, which is still good.
- The Fed tightening interest rates in December 2018 caught the markets off guard.
  - It was the markets, not President Trump, that influenced the Fed to tone down the rate-increase rhetoric and be more accommodative to the markets.

### U.S. Trade War with China

- The fears of a continued trade war between the U.S. and China have subsided. Both sides engaged in negotiations two weeks ago, and they are making progress. Negotiations consist of China importing more U.S. products, particularly agricultural products.
- One area of importance is how the U.S. can verify that China is acting in accordance with negotiated trade terms.
  - Must ensure that China does not steal U.S. technology and hack into U.S. firms.
  - This is an area that still needs to be worked out by both sides.
  - Overall, President Trump and Xi want a deal. The Chinese economy is weakening, with manufacturing underperforming. As a communist country, the last thing the Chinese government wants is social unrest due to poor economic conditions. Trump wants a happy market going into the next election cycle.
  - The markets want the trade war to calm down.
- A continuation of the trade war is neither in the best interest of the U.S. or China.
- There may be a deal in principle around early March.

### Government Shutdown

- Many economists viewed the government shutdown to have only a negligible impact on the economy. However, the government shutdown still remains, with no signs of progress.

- Polls indicate that the public does not oppose the shutdown and that they do want better border security. However, the public wants to see the shutdown end.
- There is agreement that each week the government is shut down, GDP can decrease 0.15–0.20%. Most of this can be made up in Q2.
- What can be done to get out of this mess?
  - Nancy Pelosi is not totally blameless and does not seem at all concerned that 800,000 government workers are out of work.
  - Trump can declare a national emergency to get border wall funding, and he thinks he has the executive authority to do that. However, it will get litigated.
  - Trump can end government shutdown by fighting for the wall in the court system in order to make it look like he is delivering on his promise, all while putting government employees back to work.

### Topics to Worry About

- It is egregious and appalling that no one cares much about the budget deficit.
  - We currently have a $1 trillion budget deficit.
  - We are on pace to have a $1 trillion-dollar-a-year deficit in the next decade. If a recession were to occur, we may have a couple years where there is a $2 trillion-a-year budget deficit.
  - Markets do not seem to care about this issue. That is why congress does not care. Congress will not take action on an issue that may cost them reelection.
  - There is despair that there is no way to grow out of this.
  - Net borrowing costs in 10 years will exceed all spending on domestic programs. There are concerns about a Japanese-type scenario where deficits will crowd out spending.
- Europe
  - In London, no one knows what will happen with Brexit. In late March, there were concerns that there might be economic instability in the UK that could spread to Europe. It would be difficult to rescind Brexit.
  - There is current French social unrest taking place. A great deal of resentment is focused on President Macron, who seems out of touch with the general public. Unrest might spread across Europe.
  - Greg sees a period of instability and meager economic growth in Europe.
- Mueller investigation
  - Consensus among Republicans that he will finish his investigation.
  - Mueller has spoken to a lot of people who do not want to go to jail, and they are cooperating.
  - Big question is what Michael Cohen has on Trump. Greg thinks that information will be damaging to Trump.
  - Mueller does not have the authority to indict a sitting president, but this does not rule out the House from impeaching Trump. However, the Senate will not convict.
  - The caveat of all of this is that Trump has a temper. If Trump sees a family member get indicted or investigated, he could fire Mueller, sparking investigations by Congress.
  - There is strong support of Trump among Republicans on Capitol Hill, but they disparage Trump in private so they don't alienate their voters.

  - The only Republicans to openly criticize Trump are the ones not seeking reelection.
- Trump was the overwhelming favorite to win reelection.
  - But that all changed during the midterm elections. Support in the rust belt states and upper Midwest declined. There is deep antipathy of Trump among college-educated women.

### Democratic Party Concerns

- There has been a noticeable, growing rift within the Democratic Party. Moderate democrats are at odds with “Bronx” socialists. Bronx socialists seek guaranteed income and universal healthcare for all, without a credible way of paying for it other than confiscatory taxation, but even that won’t be enough.
- A lot of party leaders are getting old.
  - Nancy Pelosi is 78.
  - Joe Biden and Michael Bloomberg are both 76.
  - The party needs fresh blood — Beto O’Rourke, for example.
- Top-tier Democratic presidential hopefuls include:
  - Joe Biden:
    - Front-runner in national polls and in Iowa
    - But, not had a new idea in 25 years
  - Kamala Harris of California
  - Sherrod Brown of Ohio
  - Amy Klobuchar of Minnesota
  - Kirsten Gillibrand of New York
  - Elizabeth Warren of Massachusetts
    - Polarizing, but had two great weeks in Iowa
    - Hostility towards investment industry
  - Michael Bloomberg of New York
    - Concerns about being too moderate for the party
    - Has $50 billion

### Q&A

- When will Mueller’s report come out?
  - Still 3–4 weeks away.
  - The Clinton-Lewinski probe lasted two years; this investigation has lasted 1.5 years.
- What is the probability of Trump not running for reelection and any credible alternatives?
  - Greg does not see anyone unseating Trump.
  - If Trump does not run, Mike Pence is a real possibility.
    - He has a lot of support from evangelical Christians.
- What are your thoughts on Nikki Haley?

- She is very talented, articulate, and knowledgeable.
- She comes from the right part of the country, that being South Carolina.
- She may run in 2024.
- Marco Rubio and Ted Cruz might also run in 2024.

— How long will the shutdown last?

- It will become intolerable if it lasts 2–3 weeks more.
- Mitch McConnell will receive a lot of pressure from his party if they do not resolve this.

— What trend may threaten markets down the line?

- Aggressive young socialists capitalizing on polls that millennials see socialism as more popular than capitalism.
  - They want a 70% top tax rate.

## GLOBAL MARKETS PANEL

Panelists include: Ardra Belitz, *Lazard Asset Management;* Jack McIntyre, CFA, *Brandywine Global; and* Steve Shapiro, *GoldenTree Asset Management*

### Reflecting on 2018

— Ardra Belitz: A defining moment came in the complacency in prices in the first three quarters in 2018. There had (and has) yet to be a solution to the tariff debate between the U.S. and China. In the U.S., we are currently experiencing near-zero real policy rates, and it's important that investors prepare for volatility in the coming years.

— Jack McIntyre: The broad-based global growth theme went away fairly quickly and caught the market by surprise. Jerome Powell as Fed chair has come off as more hawkish than his predecessor Janet Yellen.

— Steve Shapiro: Powell during the year was 0 for 7: The market went down every time he had a Fed announcement. In his latest announcement, however, Powell came off as more dovish and has been looking to speak more constructively so as not to spook the market. Impending regulations are likely for Facebook and other tech stocks that have been market leaders; it was a shock to learn that people didn't understand the business models of these companies.

### Federal Reserve Communication

— Ardra Belitz: The Fed's shifting rhetoric is concerning. The market is now demanding no rate hikes in 2019 and, potentially, a cut in rates. This may be a learning-curve issue, but from a global mandate, it's now inherently difficult for the Fed itself—and for investors—to predict where the Fed is going from here.

— Jack McIntyre: Powell has shown poor communication style. Powell claimed that winding down the balance sheet is on "auto-pilot." Powell had then mentioned that the Fed is far away from neutral and then backpedaled. The Fed is still wrestling with the idea that the economy is doing well, employment is strong, but inflation is not where they want it to be.

— Steve Shapiro: The market at the beginning of the year seemed to be in a position of broad global growth. There was then a sudden market change and by the fourth quarter, it appeared things are perhaps not so good and that we may be facing a slowdown.

## Opportunities and Challenges over the Next 12 Months

- Ardra Belitz: Stabilization of the U.S. Dollar (USD) is reflationary for the U.S. economy. A re-widening of growth differences between emerging markets (EMs) and developed markets presents a great investment opportunity for EMs. EMs are also trading at greater-than-historical discounts versus developed markets, and if complimented with a USD decline over the next 12 months, we can expect to see strong performance in EMs to the detriment of the U.S. markets.
- Jack McIntyre: 2018 was a year of USD strength following strong U.S. growth and tax cuts. If we are to see the USD weaken in 2019, earnings can improve in both the U.S. and abroad, assuming the rest of the world can stabilize. The key here is China—more stimulus by small and incremental means, to create stability, will be key.
- Steve Shapiro: Expect increasing negative sentiment and lower growth going forward. There are pockets of opportunity. In certain industries it is hard to find qualified workers, so there is a need to keep an eye on wage inflation, which can ultimately put pressure on margins and prices. Currently, companies are doing better than the market is seeing.

## Corporate Debt

- Ardra Belitz: Great opportunities can be found in EM debt, in particular on the short end of the curve. In short-duration high yield, there is an opportunity to capture 8–12%. Real yields of around 3–4% in sovereign EM debt provide attractive yields relative to the 0% real yields across much of the developed markets.
- Jack McIntyre: Companies are doing well and can sustain their debt. However, there are issues to consider. As wages move higher, whether or not companies can pass on their higher costs to customers and maintain strong margins and ultimately cause inflation, will take center stage. If they can't pass on higher costs, margins will be squeezed, the Dollar will weaken, profits will drop, and inflation will remain low.
- Steve Shapiro: The BBB market has doubled in size. Companies that are borrowing are doing fine and generating sufficient free cash flow. From a company perspective, it's not currently worth the effort of having a higher rating when you can borrow at attractive BBB rates. However, in the future, it may become more costly to reissue at similar yields, and thus the cost of capital may increase for companies.

## Changes in the Marketplace

- Ardra Belitz: Buy fear and sell complacency. There are opportunities across the capital structure in EMs. Borrowing in EMs has come from the corporate or private side and less from the sovereign side. There are pockets of risk, which present opportunities for active management to select appropriate risk assets.
- Jack McIntyre: Investors witnessed the problems within Turkey and Argentina in 2018, and we experienced a big sell-off in EMs. The sell-off has created opportunities in the space from a fundamental standpoint. There will continue to be plenty of noise and political news, including headline risk in the trade and tariff discussions.
- Steve Shapiro: Finding opportunities in EMs and within sovereigns; regional debt appears to have an even better risk/reward trade-off than sovereign debt.

## Illiquid Markets

- Ardra Belitz: The team has been able to sit in cash but at a discount, which has presented great opportunities. Investors that have to meet daily liquidity are under more pressure and may be forced to sell at any price, which presents great opportunities for a buyer.
- Jack McIntyre: Because banks are less likely to use their balance sheets to create liquid markets, it's important to try and buy in weakness and sell in rallies. The willingness to be patient on trades has become

more important.

- Steve Shapiro: Securities will get to the right price; however, given the increased illiquidity, there is a more volatile ride getting to fair value. This volatility has presented market opportunities. The team can buy a big block of paper at a discount because investors are looking to get out. If you understand liquidity and have a good feel for value, it can present buying opportunities.

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## About Canterbury

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