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LATEST ARTICLES

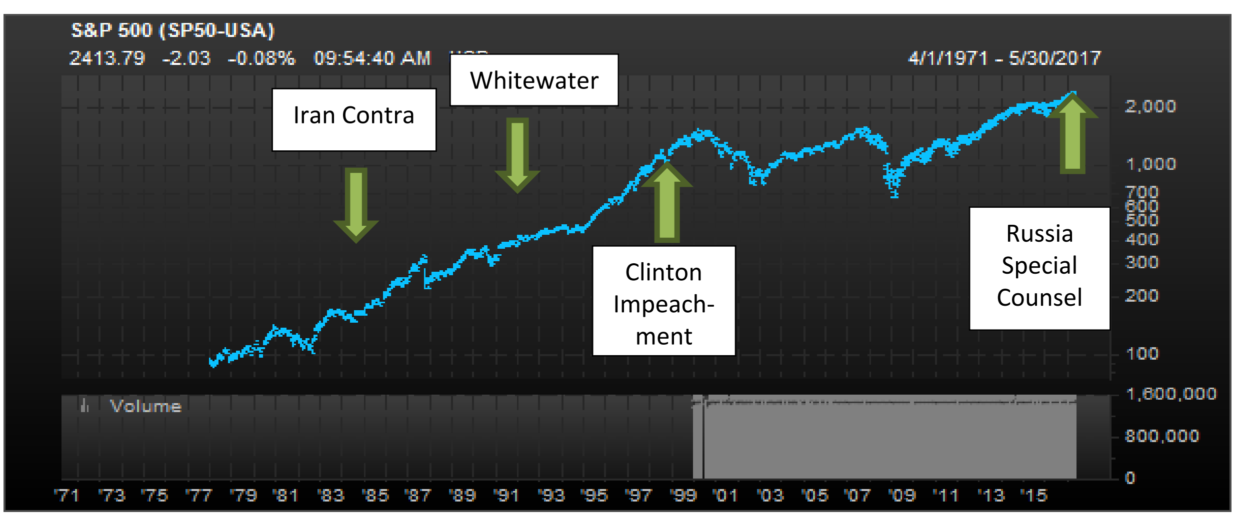
What Really Drives Markets?

John Micklitsch, CFA, CAIA

Chief Investment Officer

Special Counsels, calls for impeachment, global threats, today we face them all. In order to address our own curiosity and perhaps alleviate yours, we went back and looked at the performance of the S&P 500 during other periods where these sorts of stories dominated the daily headlines. Watergate ('73), Iran Contra Special Counsel ('86), Whitewater Special Counsel ('94), Clinton impeachment ('98), Valerie Plame leak Special Counsel ('03) all provide a rich set of data points to analyze in the context of the current appointment of a Special Counsel to investigate Russian interference in the 2016 election. Our initial assessment is that despite stirring deep emotional reactions, these events have little impact on the direction of the markets given the prevailing economic conditions of the day.

Some may believe that the Watergate investigation ushered in the miserable performance of the markets during the 70's. A closer analysis, however, reveals that it originated from macroeconomic policies, such as going off the gold standard and the subsequent devaluation of the dollar, artificially low interest rates, and wage and price controls, rather than from the Watergate spectacle itself. While the Iran Contra affair came to be just as 24-hour news was being born and therefore was a TV ratings bonanza, the findings of the Tower Commission were largely inconclusive and in no way derailed the bull market that started in 1982 on the heels of the Reagan tax cuts. The contentious period of the 90's that included both a Special Counsel for Whitewater and a Presidential impeachment was no match for the Internet revolution, welfare reform and budget surpluses that drove markets to euphoric highs.



S&P 500 Index, Source: FactSet

The point is that in all of this, whether we are in a bull or bear period, the cause for the market's underlying trend is rarely the headline grabbing, politically charged events of the day. Rather it is prevailing monetary and fiscal policy decisions and their impact on *future* earnings and interest rates that largely drive markets. While the temptation is high to read into emotionally charged news, we caution investors against altering their long-term plans as a result. The media outlets that promote "breaking news" are far more interested in their bottom line than yours. The more fruitful exercise during times of headline grabbing political news is to pick a handful of stocks you know, hold or would expect to hold in a mutual fund or ETF, and ask yourself what has really changed in terms of their long-term business outlook. More than likely, you will picture the goods and services they provide as enduring and reach the conclusion that they are best held for potential future gains. It is when we view the holdings in our accounts as numbers on a page, detached from real businesses, that the noise can become distracting and disruptive to one's long-term wealth. So now that you are armed with some history, sit back, grab some popcorn and enjoy the political theatre, but remain focused on economic and business fundamentals, along with your long-term plan, rather than the emotions the political spectacle creates.

The FED Called and They Want Their Punchbowl Back

Jim Bernard, CFA

Managing Director, Fixed Income

Beginning in the later months of 2008 the U.S. Federal Reserve Bank (FED) began to expand their balance sheet, which at that time was in the range of $800 billion. Over the next 5+ years, 3 quantitative easing programs, where the FED bought U.S. Treasury Securities and government guaranteed Mortgage Backed Securities in the open markets, exploded the size of the FED balance sheet to over $4.2 trillion, close to where it is today.

It is widely thought that the FED would like to reduce the size of their balance sheet to somewhere in the $2 trillion range in coming years. The question is how quickly should the FED reduce the size of their balance sheet and what effect will that have on prices in the various securities markets. Conventional wisdom indicates that if the FED were to reduce their balance sheet over a similar 5+ year time frame interest rates could return to levels seen prior to 2008. In other words, closer to 3% short term rates and 4%-5% longer term treasury rates. While this would be in line with the interest rate outlook indicated recently by FED members, it would be, in our opinion, an overly aggressive balance sheet reduction program.

A more likely program would involve the reduction of the balance sheet over a longer time frame with the hope that any impact on interest rates and securities valuations would be minimal. As is typical we expect "well hedged" comments by the FED on this subject and commentary such as "our reduction of the size of the balance sheet will be data dependent and thus the timing of this program could change".

So why does this balance sheet reduction announcement matter so much to the various securities markets? The principle "commodity cost" of the securities markets is the cost of money/level of interest rates. When investors can borrow at very low rates even modest returns can produce sizable returns, especially in leveraged portfolios. When interest rates are higher (or at more historically average levels) fixed income investments become a more viable alternative to higher risk equities, commodities, etc., and it becomes more difficult to earn returns well above these lower risk securities. This in turn may lead certain investors to demand better/lower valuations in order to risk their capital.

How to Prepare for the Next Market Downturn

Jeff van Fossen, CFA

Managing Director, Chief Equity Strategist, Portfolio Manager

The current bull market in stocks (defined by prices that continue rising without interruption by a 20% or more decline) began for the S&P 500 just over eight years ago in the depths of the 2009 recession. Since that time, the benchmark index has gained 255%, with just four corrections (defined as a decline of 10% or more), the last of which occurred at the beginning of 2016, according to Standard & Poor's. Although not the longest bull market on record, this is a remarkable run by any standard.

So how much longer does this bull market have to run? No one knows for sure. But one thing is certain: another bear market will eventually revisit us at some point in the future. What can intelligent investors do now to prepare for this day?

Cover known or predictable cash needs now: Cash needs could come in the form of needing a new car, a home, tuition, a wedding, or taxes, or many other things. Substantial expected cash needs over the coming 12-18 months that can be reasonably estimated today should be covered now. This avoids the possibility of being forced to sell stocks in the midst of a serious decline.

Ensure that your portfolio is properly balanced: Be sure that your mix of cash reserves, bonds, and stocks is properly tailored to your unique personal situation. The mix should reflect your long-term investment objectives, time horizon, risk tolerance, and overall financial circumstances. Cash reserves provide stability and liquidity for financial emergencies. Bonds offer steady (although currently modest) income and can dampen overall portfolio volatility.

Stocks, at the cost of greater price volatility, have historically provided the highest long-term returns and the best opportunity for building and maintaining family wealth over the long run.

Consider that if an investor determined three years ago that a 60-65% allocation to stocks was appropriate, and the markets have now carried that exposure to 70-75% today, rebalancing is likely in order. This discipline is vital to successful investing. Also, keep in mind that while today the concern is that the level of stock exposure may have become too high, at other times, in other markets, we may well be in the reverse situation, where bonds should be pared back and capital added to stocks. This is disciplined portfolio management around a plan, not market timing.

Maintain Diversification: Reduce your exposure to industries or stock positions that have grown too large. This element of portfolio rebalancing involves maintaining equilibrium around economic sectors, industries and individual stock positions. Portfolio concentrations of any kind are a double-edged sword, and should be carefully analyzed and monitored. While they can be extremely lucrative, they can at other times be tremendously damaging or even ruinous to one's financial health.

For example, if we were prescient enough to invest in Amazon in the first quarter of 2009 at $50 per share and at that time it represented 2.5% of a 40-stock portfolio, left unaltered it could easily represent 20% of the same portfolio today. Is 20% the ideal weighting today? Clearly, paring the position and taking some profits here is sensible, despite the exit requirement of paying some capital gains tax to Uncle Sam.

Keep portfolio quality high: Maintaining high quality portfolio positions will reduce portfolio volatility. Numerous studies show that higher quality stocks tend to exhibit less volatility and perform better during corrections and bear markets. This is precisely one reason why the stocks of high quality businesses are often more expensive from a valuation standpoint. Paying a premium to invest in higher quality businesses is worthwhile, as the quality acts as a kind of portfolio insurance against behavioral finance biases during bouts of volatility. Upgrading the quality of your portfolio before the bear comes can help one stay the course and thus achieve long-term financial goals.

Keep your emotions in check: Because no one can predict the timing of market tops or bottoms, we encourage investors to take a long-term view. This means resisting the temptation to abandon a sound, long-term investment plan, dramatically alter one's investment mix, or make emotional investment decisions based on what's currently happening in the news. Remember that you are investing to achieve a long-term goal, not avoid a short-term loss.

It's natural to be nervous or alarmed when the value of one's portfolio declines. The generous rewards of long-term investing often come with price fluctuations that can be both severe and unpredictable, giving even the most stoic of investors' second thoughts. But this is the price of admission to the greatest show on earth. So mentally prepare yourself now to stay the course by adhering to your investment plan and refraining from making emotionally-charged decisions that are likely to be financially self-sabotaging.

Plan to continue regular investing: If you are working, plan to continue regularly investing a portion of your income. This strategy, called dollar cost averaging, enables you to work a bear market to your advantage by lowering the average price you pay for investments. Again, the point is to stick to your plan.

Set realistic expectations: Over the years, each of the three major asset classes has played an important role in portfolio construction due to their unique risk/return characteristics. Just as generals err by "fighting the last war," it's easy for investors to err by assuming that the best projection of future returns is a replay of the recent past. We believe that you should plan to expect less generous returns in the coming years. Setting reasonable expectations for your investment plan will also help you to keep future market corrections in perspective.

Is it Time for International Equities to Shine?

Michael Santelli, CFA

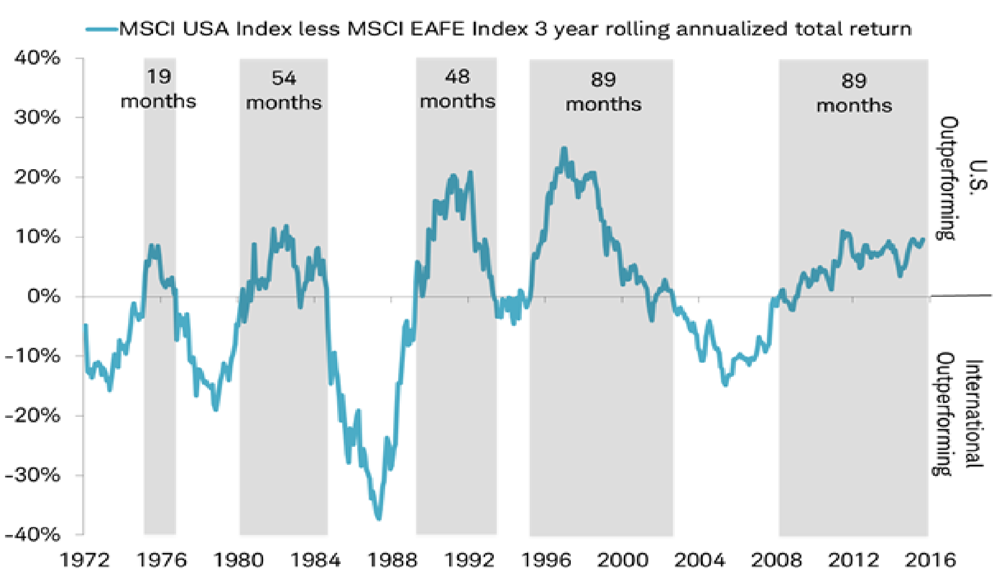
Director, Chief Portfolio Strategist, Portfolio Manager

Another article on international investing? Doesn't the U.S. market always outperform? Aren't there lots of problems overseas? Why do we need to deal with those issues?

All good questions. The short answers are: yes, we are writing another article on the benefits of international investing. No, the U.S. market doesn't always outperform foreign markets. Yes, there are lots of problems overseas. As for why we should deal with those issues, read on.

Historical performance

First, to set the record straight, while the U.S. market has outperformed international markets in six of the last seven years, relative performance between U.S. and international equities tends to be cyclical. Take a look at the chart below.

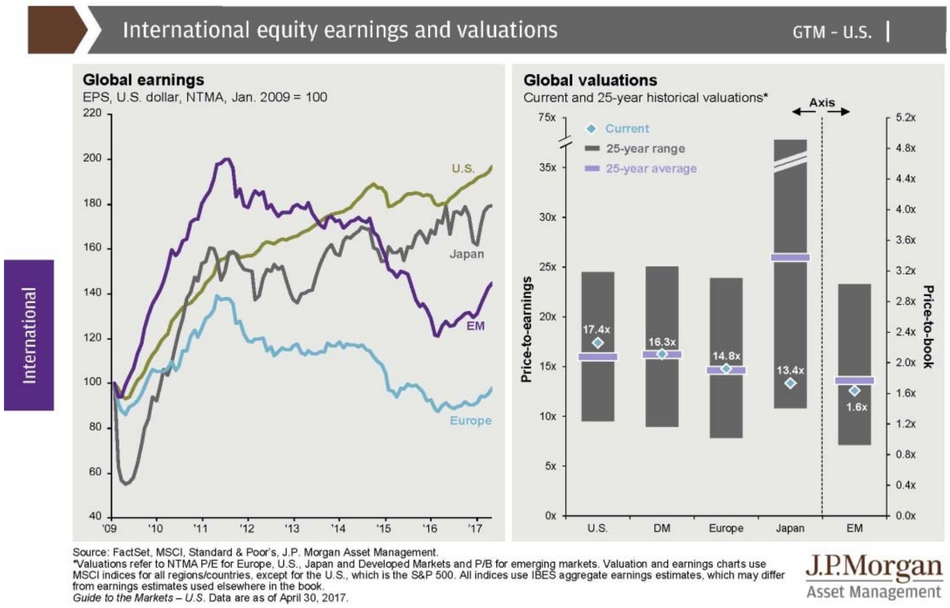


Source: Charles Schwab, Bloomberg data as of 7/10/2016.

It shows that there are multi-year periods when the U.S. wins and multi-year periods when international wins. Are we about to embark on a period of international outperformance? We don't know for sure, but the potential exists for international to start outperforming because of the wide valuation difference that has resulted from recent underperformance and the cyclicality of returns.

Valuation

There is an old adage: price is what you pay, value is what you get. At this point in the cycle, we believe investors are paying less and getting more in the international equity markets than in the U.S. equity market. What is the basis for that belief? Take a look at this next chart from JP Morgan.



The graph on the left shows profits in four markets indexed to their levels in 2009. Notice that in the U.S., profits have about doubled from the Great Recession and Global Financial Crisis, and in fact have gone on to new highs versus their prior peak. Also, note that developed international profits, Europe in particular, have made little recovery over the same time period. Finally, emerging markets (EM) are about halfway between the U.S. and Europe after a quick recovery and reversal. It is likely that the International markets have a longer way to go in terms of earnings growth than the U.S.

The graph on the right shows valuations, with the purple bar marking the 25-year average. The U.S. price/earnings multiples are higher than their historical mean, while developed international price/earnings multiples are closer to their long-term mean, and emerging markets are below the long-term mean.

We would argue that in the U.S. equity market, investors are paying a premium multiple on profits that are likely closer to a cyclical peak. In the international markets, investors are paying an average multiple on profits that have a higher likelihood of experiencing further gains. As a result, we believe that investors are paying less and receiving more in the international equity market than in the U.S. equity market at this point.

Diversification

International investing provides investors benefits of diversification. Some academics have likened diversification to the only "free lunch" available in finance. What are those benefits? Without getting too much into statistics and math, it comes down to correlations between asset classes. In short, international equities may zig while U.S. equities zag. Because of that, adding international equities to a portfolio is likely to reduce the risk (as measured by volatility) of the portfolio and may even increase the return in the long run. Reduced risk and/or increased returns are the benefits of diversification.

Conclusion

Now that we have (hopefully) convinced you that international exposure in a portfolio is a good thing to have, we don't want to go overboard. Being U.S. based investors, we have a natural “home country” bias. That means that when we add international equity exposure to portfolios, we will still be mostly invested in U.S. equities. In addition, none of the conclusions above are written in stone, the financial markets are too uncertain for that. We do believe, however, that there is a strong case building for international exposure in a diversified portfolio at this point.

As always, we thank you for your support and encourage you to reach out to us with any questions you have.

About Ancora Holdings Inc.: Ancora Holdings, Inc. is a Cleveland, Ohio based holding company which wholly owns three separate and distinct SEC Registered Investment Advisers, Ancora Advisors LLC, Ancora Inverness LLC and Safeguard Securities, Inc., which oversee assets under management in excess of $4 billion in aggregate. Ancora Advisors, LLC is an institutionally focused investment manager with dedicated equity and fixed income strategies as well as acting as the investment manager to both mutual funds and alternative investments. Ancora Inverness LLC is a leading, regional investment and wealth advisor managing assets on behalf families and high net-worth individuals. Safeguard Securities, Inc. is a dual registrant SEC Registered Investment Adviser and FINRA member broker dealer focusing on open architecture Retirement Plan Services. For more information please visit www.ancora.net.