PATHSTONE FEDERAL STREET

SUMMARY

The current environment of low interest rates and elevated equity valuations has many investors in a tight spot, as return expectations are lower than usual for both bonds and domestic stocks.

Unless investors broaden their horizons to consider regional diversification and the inclusion of alternative strategies, satisfactory portfolio returns may be hard to come by.

Stuck Between A Rock and a Hard Place

According to American lore, the expression "stuck between a rock and a hard place" quite possibly originated from mineworkers in the early part of the 20th century. Around that time, miners in Arizona were extremely unsatisfied with their harsh working conditions. To make matters worse, the mining companies they worked for had imposed new wage reductions on their employees. The miners went on strike, but their demands were rebuffed by the mining companies. The miners had a hard decision to make—they could continue to uncomplainingly work the mines in dismal conditions for low pay (the "rock") or be locked out of employment and forced to find a new job in a perhaps undesirable location (the "hard place").

While most of us are not literally stuck between a rock and a hard place, life is nevertheless often full of tough dilemmas where no option is particularly compelling. Some are rather inconsequential (should I skip lunch or work late?), while others can relate to matters of great importance. In many cases there are no clear answers.

Investors too are sometimes faced with difficult choices between a set of seemingly unsatisfactory options. Currently, the "rock and a hard place" expression is epitomized by the rich multiples and low yields that hinder the intermediate-term return potential for conventional asset classes (i.e. U.S. stocks and bonds).

For much of the past century, the conventional asset allocation framework has primarily involved a trade-off between stocks and bonds. By varying the mix between these two mainstream asset classes (which constitute the bulk of many portfolios), investors have sought to take advantage of the differing risk, return and correlation characteristics to generate suitable risk-adjusted portfolio returns. If one can tolerate increased volatility and risk of losing capital, a larger allocation to the typically higher returns of stocks is in order. If one is more risk-adverse, greater exposure to the stable income stream of bonds is appropriate. Taking into consideration client-specific objectives and risk tolerances (and factoring in the diversification benefits of combining uncorrelated assets), an appropriate mix could be tailored to either a short-term (tactical) or long-term (strategic) horizon.

Unfortunately, we may be entering a subpar return environment for both U.S. stocks *and* bonds. Investors who rely on old-fashioned U.S.-centric allocation approaches may indeed be between a proverbial rock and a hard place, with any trade-off between these assets unlikely to deliver satisfactory outcomes. Fortunately, a simple broadening of investment horizons can help deliver a way out of a tight spot.

Stuck between Low Yields and High Valuations. Let's quickly recap why we believe the 3-5 year return outlook for both U.S. stocks and bonds is somewhat limited. This is not meant to be a market timing call, but rather a review of our macro perspective.

Bonds, of course, are commonly regarded as the stable component of a portfolio. Core bonds (investment grade municipal, taxable government, and corporate bonds) generate steady income in most environments and typically have a low risk of default. While they certainly can be subject to price volatility (as a result of changing yields), at the end of the day you generally get back both your principal and some level of interest. As an added bonus, when things get rough for stocks, core bonds usually hold on to their value much better. As such, they certainly have a place to varying degrees in most portfolios. That said, the primary determinant of future bond returns is their starting yields, and that is bad news given today's current interest rates. If yields stay low (or fall further) then bonds offer scant income. If rates rise, bonds' commensurate boost in income would be more or less offset by a decline in prices. It is a lose-lose situation—given today's low yields there is almost no way over the next 3-5 years that bonds can generate their historical average nominal returns that investors have previously relied on.

U.S. stocks are also in a bit of a bind. Investors often use valuations (which compare stock price against some underlying financial metric) to determine whether equities are reasonably priced. An ironclad law of investing is that, on average, cheap valuations tend to generate better forward returns and vice versa. While valuations are not necessarily a precise market timing mechanism, their starting point can be a primary factor in determining prospective market returns over intermediate-term timeframes. Unfortunately, by many metrics U.S. equity valuations are currently quite high compared to their historical levels. The implied returns for U.S. stocks are well-below average looking out over the next decade.

It should be noted that we do not see anything dire on the immediate horizon and U.S. stocks and bonds still warrant a place within portfolios. That said, in all likelihood we are in a somewhat rare situation where both of these traditional asset classes now offer much lower intermediate-term expected returns than usual. It is a disheartening situation for investors who rely on narrow, domestic-oriented allocation approaches. Talk about a rock and a hard place—they can either accept lower returns or take on more risk in an attempt achieve portfolio objectives. Neither option sounds particularly appealing.

Heading in a New Direction. Fortunately, there are solutions to supplement traditional exposures within a portfolio. And while many of these bring their own set of risks and considerations and are not appropriate for all portfolios, their usage may lend to a greater probability of successfully meeting investment goals than that of adhering solely to mainstream U.S. stocks and bonds.

Credit. With regards to core bonds, many investors may be wise to embrace what we refer to as credit risk alternatives. This may include allocating to strategies such as income-oriented closed-end funds (which can trade at wide discounts to their Net Asset Value (NAV). Multi-strategy hedge funds, which can take advantage of less liquid arbitrage strategies, may also be beneficial. Other approaches, such as non-investment grade debt (high yield and emerging market bonds), bank debt, and mortgages may also be utilized. The return streams of many of these credit risk alternative strategies may be less impacted by the overarching low yield environment that hinders core bonds (hence the name, as they provide an alternative to risks typically associated with interest rates and credit quality). And while on the surface they may *sound* hazardous as compared to traditional fixed income, alternative strategies in actuality encompass a variety of risk and correlation profiles. Within a portfolio context, their lack of interest rate sensitivity and low correlation to equity markets can make them suitable counterparts to both traditional bonds and stocks and in some cases actually improve a portfolio's overall risk/return profile. Of course, the appropriateness of any of these strategies in lieu of core bonds should be carefully considered, especially with regards to fees, liquidity, volatility, and transparency. Proper vetting, selection, and understanding of these strategies is of utmost importance.

Equity. On the equity front, a variety of options are available. Investors should first and foremost consider diversifying both globally and strategically. Certain regions (emerging markets in particular) are priced at a discount to U.S. equities. While the outlook for domestic stocks is muted, the prospects for overseas equities are more favorable (though they may be subject to currency fluctuation and increased volatility). Likewise, some sectors such as energy remain beaten down. A thoughtful allocation in these areas, such as via Master Limited Partnerships ("MLPs"), can provide indirect energy exposure that incorporates both a substantial yield and in some cases generous tax benefits.

Equity risk alternatives are also available. These growth-oriented strategies seek to generate stock-like returns while being less dependent on traditional equity drivers. Trading of closed-end funds across a variety of strategies can take advantage of price discounts to NAV. Equity-oriented hedge funds, meanwhile, can take both long and short positions (as well as activist stances) and thrive in a variety of markets.

If volatility is of concern, structured notes may be set up to constrain downside risks while leaving intact an ability to capture (to varying degrees) upside participation in the market. Finally, active management may be of benefit. While passive approaches such as ETFs have been flourishing as of late, they have also contributed to narrowly-driven market performance that is dependent upon a handful of mega-cap stocks. If these stocks falter and dispersion amongst equities increases, security selection based on fundamentals may gain increased importance versus indiscriminate buying and selling.

Summary. There is no way around it—the combination of low yields and rich equity multiples could leave many investors in a tight spot, making it challenging to generate sufficient portfolio returns without taking on a lot more risk. Fortunately, investors have more options at their disposal than those turn-of-the-century miners. While old-fashioned portfolio strategies may indeed be stuck between that proverbial rock and a hard place, thinking outside the box and branching out into alternative strategies can open up new directions.