Asset Class Commentary - 2/5/2019

by Robert G. Kahl, CFA, CPA, MBA

General Comments

I currently recommend a more risk-averse allocation than investors might have over a longer time horizon due to high equity valuation levels and high debt levels throughout the US economy. The equities allocation reflects a US dollar bias to some extent with a 50% allocation to US equities and 50% allocation to non-US equities. For the fixed income portion of the portfolios, I have an emphasis on high credit quality and a relatively short weighted average duration. All portfolios include an allocation to precious metals bullion ETFs as I believe it offers protection against higher inflation and/or a US currency devaluation. Precious metals are likely to be negatively correlated with other asset classes in the future. Supply and demand for physical precious metals also appear to be favorable.

US Equities (Negative)

The current CAPE (cyclically adjusted or Shiller PE) ratio for the S&P 500 is 29.9. The Shiller PE Ratio is calculated by dividing the price of an index or common stock by the average of inflation-adjusted earnings for the last ten years. The S&P 500 has a dividend yield of 1.97% and the Russell 2000 (small cap stocks) has a dividend yield of 1.53%. At current valuation levels, potential returns over a 10-year horizon are modest. Research Affiliates currently has 10-year expected real returns (compound annual growth rates after inflation) of 0.7% and 1.3% for US large cap and US small cap stocks, respectively.

Tri-Continental (TY) is a closed-end fund that has the flexibility to invest in a variety of securities. It currently sells at a discount to net asset value of 11.0% and has an operating expense ratio of 0.49%. As of September 30, 2018, it had 67% common stocks, 8% convertible bonds, 7% convertible preferred stocks, and 15% corporate bonds. It has a dividend yield of 3.7% which is higher than most equity mutual funds and it has less downside risk due to the security holdings that have a fixed income component.

The Vanguard High Dividend Yield ETF (VYM) has a very low operating expense ratio of 0.08% and a dividend yield of 3.2%. The ETF is designed with a tilt to large cap value stocks and a higher dividend yield relative to the S&P 500.

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Foreign Equities (Neutral)

The current CAPE ratios for developed Europe and emerging markets are 16.5 and 14.5, respectively. Research Affiliates currently shows real expected returns (after inflation) of 5.7% and 7.5% for EAFE (21 developed markets in Europe, Australasia and Far East – large and mid-cap stocks) and emerging markets, respectively over a 10-year time horizon. Although there are potential economic problems associated with high debt levels and the potential dismantling of the European Union, foreign equities are included as a source of income, currency diversification, and protection against potential inflation.

The Schwab Fundamental International Large Company Index Fund (SFNNX) is a large cap value fund that uses the Research Affiliates Fundamental Index (RAFI) methodology to establish weights in the portfolio. It currently has a geographic distribution of 25% in Japan, 15% in United Kingdom, 9% in France, 9% in Germany, 7% in Canada, 6% in Switzerland, 6% in Australia, and the remainder in developed Europe. Its current distribution yield is 3.3% and it has a low expense ratio of 0.25%.

Wisdom Tree International Small Cap Dividend ETF (DLS) is a mid/small cap foreign stock ETF with 48% of their assets in Europe, 27% in Japan, and 22% in Australasia and Asian countries excluding Japan. The weighted average P/E ratio is 10.1 and it has a dividend yield of 3.4%. DLS includes only stocks that pay dividends.

Real Estate (Neutral)

Research Affiliates assigns a low expected real return of 1.7% annually over the next 10 years for US real estate investment trusts, primarily due to expectations of a reduction in valuations. Returns in the asset class have historically been volatile, partly due to concerns about availability of refinancing during times of financial stress.

iShares Global REIT (REET) is an ETF that invests in real estate investment trusts on a global basis. Holdings are geographically diversified with 68% in North America, 13% in Europe, and 18% in Asia. It has a low operating expense ratio of 0.14% and a dividend yield of 5.2%.

US$ Taxable Fixed Income – Short and Intermediate Maturities (Neutral)

The Federal Reserve raised the fed funds rate by another 25 basis points on December 19. It appears that the Fed plans to raise the fed funds rate by 50 basis points (0.5%) during 2019. The current yield on the 10-year US Treasury bond is 2.72%, down from a recent high of 3.19%

on November 9. The portfolio models reflect an emphasis on high credit quality and relatively short duration.

Doubleline Low Duration Bond Fund (DBLSX) has a yield of 2.96% and a short duration of 1.2 years. The fund currently has a broad mix of fixed-income securities. As of December 31, the fund had 7% US Government, 19% residential mortgage-backed securities (MBS), 16% commercial MBS, 7% asset-backed securities, 14% collateralized loan obligations, 7% investment-grade corporate bonds, 14% emerging market (US dollar denominated) bonds, and 7% bank loans. It has a low expense ratio of 0.43%.

Doubleline Total Return Fund (DBLTX) holds primarily mortgage-backed securities. It currently has a dividend yield of 3.7% with a weighted-average duration of 4.2 years. The institutional class shares have a relatively low expense ratio of 0.47%.

Doubleline Core Fixed Income Fund (DBLFX) has a yield of 3.4% and duration of 5.0 years. As of December 31, the largest categories in the portfolio were: 23% US Government, 25% residential MBS, 8% emerging market (US$ denominated) bonds, 12% investment-grade corporate, 8% commercial MBS, and 5% bank loans.

Vanguard Short-Term Investment Grade Fund (VFSUX) has a yield of 2.8% and a short duration of 2.4 years. As of December 31, the fund's largest categories were: 55% in investment-grade corporate bonds, 10% in US Government/Agency securities, 14% in asset-backed securities, 11% in commercial mortgage-backed securities and 9% in foreign bonds. It has a very low expense ratio of 0.10%.

US$ Taxable Fixed Income – Long Maturities (Negative)

Given the past suppression of interest rates by the Federal Reserve and other central banks and a relatively flat yield curve, the probability of higher long-term interest rates remains high. I believe that long-dated fixed income securities are currently unattractive. I do not include any long maturity taxable fixed income funds in the model portfolios.

US$ Tax-Exempt Fixed Income (Neutral)

Tax-exempt municipal bonds have historically had much lower default rates than corporate bonds as tax revenue of many government entities is less sensitive to the economic cycle. I include tax-exempt fixed income funds in portfolios which are taxable at marginal tax rates of 15% or higher. The core municipal funds that I use have a slightly longer duration than the taxable fixed income funds listed above but the additional after-tax yield justifies a slightly longer duration. Closed-end tax-exempt funds are not included in portfolios at this time due to their longer leverage-adjusted duration and use of leverage.

AB Muni Income National Fund (ALTVX) has a dividend yield of 3.14% with a weighted average duration of 4.9 years. Nearly all the fund's municipal bonds are in the investment grade category (credit ratings of BBB or higher). Only 4% of holdings are rated below BBB and 6% are not rated. There is little credit risk with this fund and moderate interest rate risk based upon the weighted average duration.

Vanguard Intermediate-Term Tax-Exempt Fund (VWIUX) has an average duration of 5.3 years with a slightly higher average credit rating. The current yield is at 2.87% and the expense ratio is only 0.09%.

Foreign Fixed Income (Neutral)

The European Central Bank and the Bank of Japan have actively suppressed interest rates, so bonds in these regions are not attractive. However, some other countries around the world have more rational central bank policies and lower debt/GDP ratios.

I include a modest allocation to the Templeton Global Income Fund (GIM) in most portfolios. GIM has a negative average duration of -1.3 years. It has an operating expense ratio of 0.68% and currently sells at a 12.5% discount to its net asset value. As of December 31, it held local currency government and agency bonds, with the largest geographic exposure to: Mexico 20%, Brazil 13%, India 12%, and Indonesia 9%. The fund uses a variety of currency derivatives to reduce foreign currency risk.

Precious Metals (Strong Positive)

Given the monetary and fiscal policies of the US, Europe, Japan, and other countries, I continue to believe that portfolios should maintain an allocation to precious metals despite occasional intervention in the markets to suppress the price.

Sprott Physical Gold and Silver Trust (CEF), Sprott Physical Gold Trust (PHYS), and Sprott Physical Silver Trust (PSLV) currently sell at small discounts to net asset value. The Sprott Trusts hold physical bullion and use the Royal Canadian Mint as custodian. The prices of the Sprott Trusts are normally close to net asset value because it is possible to tender shares in exchange for delivery of physical bullion. Operating expenses are reasonable at 0.40%, 0.38% and 0.45% for CEF, PHYS and PSLV, respectively.

If you have any questions or comments, please contact me.

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