FIDUCIENT Advisors

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Quarterly Quick Take: Market Updates and International Diversification with Brad Long

[00:00:00] Welcome to Nonprofit Investment Stewards with Bob DiMeo and Devon Francis from Fiducient Advisors. Bob and Devon are passionate about helping nonprofit organizations prosper. Whether you oversee endowment foundation or retirement plan investments, this podcast exists to help stewards improve performance, reduce costs, and discover strategies that enable your charitable organization to prosper and advance its mission.

[00:00:26] Now onto the show. Hello, and welcome back to the Nonprofit Investment Stewards podcast. I'm Bob DiMeo. Great as always, to be joined by co-host Devon Francis. Well, it's quarter end and I must say that so far this year, market performance feels pretty outstanding. Devon, I imagine you feel the same. Would you be kind enough to introduce our returning guest?

[00:00:48] Of course. Back and better than ever we have our Chief Investment Officer, Brad Long. He's going to share insights on our quarterly quick takes episode. So today we'll not only address [00:01:00] what happened and what we expect to happen, but we'll also dedicate some time to international investing, essentially answering the question of whether or not international diversification continues to make sense.

[00:01:11] So Brad, welcome back to the show. We're thrilled to have you. Thanks Devon, though you said better than ever. So now I'm nervous. I gotta, I gotta really step it up. You've got a high bar to, to exceed. So, Brad, let's set the stage first by reminding listeners of Fiducient's three main themes heading into 2024. So as, as everyone knows, or those that know us, right?

[00:01:32] So each year we'll compile key themes we think are gonna be driving prices in the year ahead. Uh, and those are really derived from our capital market assumptions process where we're building our assumption of various asset classes across the globe. Coming into the year, we really thought there was, uh, three things that we wanted to implement in portfolios.

[00:01:51] One was a nod to the no-show recession of 2023. So, it was prepare, not predict, right? This kind of false narrative we have to time the market, we have to [00:02:00] time a recession, uh, in order to be successful. And we don't think that's the case. We should build resiliency into our portfolios, and we'll talk about some of those positionings, uh, that we've taken to help establish that positioning.

[00:02:10] The second is inflation kind of entering a new phase. You know, the messy middle is what we've dubbed this, but you know, above the fed's target of 2%, which is a bit of a misnomer target in our view, uh, but probably below where they really need to step back on the break and start raising interest rates again.

[00:02:28] So it provides a potential path, uh, for rates to be moving lower structurally. And then the third is concentrated consequences. We've got a ton of questions from the magnificent seven. So, a handful of stocks, especially here in the United States, driving the vast majority of the output. You know, it is, it's an important story to follow and the fragility that that creates in markets, the opportunity it creates in markets and how we position kind of ahead of and around, uh, those.

[00:02:55] So those are our three positionings kind of coming into the year. And then happy to talk about, you know, [00:03:00] what we've done since. Great. And Brad, just to follow up on the concept of that messy middle with regard to inflation, we've already seen a couple new inflation prints this year, and can you talk a little bit about what those numbers have been and how the market has reacted?

[00:03:15] I mean, you can see it, uh, across fixed income. Rates have backed up a little bit here in 2024. You know, if we rewind the clock a little bit. So, you know, chairman Powell at the Humphrey Hawkins, uh, conference, all but effectively promised, you know, markets that he would be, uh, lowering rates in 2024.

[00:03:34] And so, markets heard that they were off and running and we had pretty material financial easing. Not because the fed cut rates, but because the markets started to move rates lower on their own in November and December of last year. So, at the time, as we were, you know, recording our annual outlook, um, you know, we said, hey, March is probably unlikely.

[00:03:54] And that was a very outta consensus view. The consensus was high probability that there would be a cut in March. [00:04:00] Well, now here we sit in March, uh, less likely, very unlikely in fact that this week the Fed will be coming out, you know, with a cut. The reason being is that inflation has really continued.

[00:04:11] And February's inflation, that data was released this month. Uh, we saw a bit of a re-acceleration. That's a pretty scary word for, uh, market watchers, where we've been trying to see, uh, inflation move back towards the 2% fed target. And, you know, for economists, it's really been a perplexing environment. It's been very difficult. Uh, markets are difficult to predict.

[00:04:32] Full stop. But it's been a very difficult environment to try to get ahead of some of this economic news. And the reason being is that Covid, I mean, COVID was unique in many ways, but from an economic perspective, COVID was very unique in that you had a material supply side and demand side shock, right?

[00:04:50] We had all these constrictions around supply driving inflation forward. We had revenge spending, massive fiscal stimulus coming in. And so, it's created all these [00:05:00] reverberations and anomalies, uh, in the market that have been hard to understand. So, you know, as economists and market prognosticators are looking at.

[00:05:08] Either lagging, coincident, or leading economic data. There's a bit of noise there and if you go looking for something, you'll find it, right? Recent labor market data is a great example. The headline, uh, payroll growth figures for January and February, they were good. That kind of helps, you know, push that inflation trade that the fed's gonna be, uh, have to be higher for longer.

[00:05:30] But actually, if you look at the revisions of that data, 'cause economic data is actually revised after it's released, it's not a perfect system. Those revisions, uh, were actually show quite a bit of cooling. So, there's kind of this self-selection in the story that you want to narrate for yourself around data.

[00:05:46] Uh, and the market's coming to realize that, you know, the Fed is doing its best to keep inflation in the bottle. Uh, you know, that genie back in the bottle. And that's been, that's been a hard one for them to manage. Brad, I just want to [00:06:00] follow on that messy middle question and it, it's a good term. It's a, it's a great term.

[00:06:04] It's a term that, uh, as we did client meetings in the first quarter and so on, it meant something to folks, but they don't know exactly what it means. And so, I just wonder if you could elaborate from a portfolio construction perspective, what that might mean when an investor hears, uh, we'll be in a messy middle with respect to inflation.

[00:06:26] Yeah, it, it means a couple things. So, principally it acknowledges kind of humility in the idea of trying to time or predict inflation. Inflation is a, there are, you know, if you start to really break down the components, the things that go into it, there are literally millions of things that eventually drive supply and demand dynamics that drive, uh, headline inflation.

[00:06:49] And so as we look at inflation in the messy middle, it really is a couple of important inferences. One is that inflation is not materially accelerating and accelerating beyond the [00:07:00] point that the Fed has to get back on kind of the economic breaks, if you will. So start raising interest rates. The second, the messy part, right?

[00:07:08] We've kind of done the easy work. Inflation falling from 9%, you know, in January of 20, or I'm sorry, in June of 2022. Now to where we are. That was easy, if you will, didn't feel easy, but you know, that was the easy prediction. You know, now it's, it's the kind of last mile is the hardest type narrative.

[00:07:26] And so, you know, we have, uh, February data that was just released to showing a bit of re-acceleration. You have geopolitical potential concerns, whether that's through, you know, a lot of the China-US trade issues, whether that's the streets of Horus or the Suez Canal chaining containering rates, right?

[00:07:43] The cost of shipping goods globally that has both an input price, and a finished goods price inference on us buying things in the United States. So there's all these things that are pretty messy around inflation, and so we shouldn't expect it to be this just simple narrative of inflation falls. [00:08:00]

[00:08:00] Until it perfectly hits 2% and it lands there and stops. So, it gives us the confidence, right, of why do we own real assets in the portfolio? We own real assets for these unexpected environments in which you might have inflation accelerate. Why do we still have confidence that fixed income can perform and may perform well in 2024?

[00:08:18] It's because we think there are more paths towards inflation being moderate and the Fed being able to cut than there are paths where inflation is going to accelerate and the Fed has to continue to raise. While that's possible, we don't think it's as probable. And so, it describes this environment in which we have to have great intentionality and design around portfolio construction because it's gonna be a little rocky.

[00:08:41] Thanks, Brad, and, and, uh, I appreciate the opportunity to jump around a little bit here, but I think we can do that with a colleague. So, you mentioned a bit about the markets and the economy, uh, thus far here. We're recording this in late March. Anything you'd like to add with respect to market and [00:09:00] economic performance, year to date?

[00:09:01] Knowing listeners may be hearing this at various points in time. I realize we just, uh, you know, we just dedicated a reasonable amount of airtime to the economy. But, you know, as we've said many times in the past, the economy and markets, you know, we think of them as related and intuitively they are.

[00:09:18] But in that analogy, they're, they're cousins. They're not twins. And so the economy helps us, it helps us set tone in asset allocation, right? What is the level of risk or interest in risk, both on an absolute basis and on a relative basis, meaning how much to lean into a geography or not, or how to set an allocation policy.

[00:09:40] But again, if you perfectly time the economy, you would mistime the markets. And so, as we then, you know, use this important economic data, it really then comes back to markets. And coming into the year, there's a couple important things we would, we would note, right? So, a lot of those economic headwinds and tailwinds, which we just mentioned, but mostly [00:10:00] leading towards modest or moderate inflation, probably above the fed's target, but not frustratingly so.

[00:10:06] A path towards modest, decreasing interest rates, we don't need five cuts or, you know, what the predictions were at the beginning of the year, but moving in that direction. And so, it helps us establish portfolio positioning. It's also as we think about markets and we think about forward-looking

markets, not rear-view mirror, but looking through the windshield, there's not a whole lot of differentiation across key asset classes in today's world.

[00:10:33] So cash, you know, in today's interest rate environment, it's earning five or maybe a little more. Um, intermediate fixed income, probably earning about the same depending on the strategy. Technically, the treasury curve is inverted, but you know, you're effectively gonna come up with a similar type of return.

[00:10:49] Obviously, you're gonna have a different, uh, duration profile. Which we've, we've said we have interest in. And then when you look at long-term returns on equity, especially US equity, at today's [00:11:00] current valuation, so we traded about 20 times forward earnings. You know, so for those that don't speak market speak, that that's a fairly expensive level, doesn't mean it couldn't go higher.

[00:11:10] But that translates into, call it a kind of a low 6% rate of forward-looking return. So, if you think about you can get fixed income in the mid fives or close to sixes, or you can take on equity risk and get kind of, you know, low sixes, right. Historically there's a bigger gap there. And so that has important inferences to us on, you know, where we're allocating and why and help drive a lot of the positioning.

[00:11:36] You know, as we build into portfolios. And so, as the market has kind of come off that, it has to be a fed rate cut in March, right? That was the narrative in December. In January, you've seen a bit of repricing in fixed income year to date, that's also kind of put that bid back under US equities, the S&P's up, you know, over 8% year to date at the time of this recording.

[00:11:56] And so, the positioning that we employ, again, [00:12:00] trying to stack probabilities in our favor, is using those opportunities to help kind of deploy capital in a prudent way. And that's why we position the way we have for 2024. So Brad, you talked about the expectation of kind of moderate inflation levels, modestly decreasing interest rates throughout the year.

[00:12:19] Are there perhaps any unusual takes or less obvious scenarios or less likely outcomes that investors should think about? Yeah, from an, from an economic perspective, it's kind of a tale of two cities, right? So again, if you go looking for the data, you'll find it. Um, the two cities are the recession camp and the, call it, uh, retail or consumer demand camp.

[00:12:44] You know, what economists and other recession predictors got wrong in 2023 was just the extraordinary spending from households. And that really drove economic productivity and, uh, economic GDP up. It also kept inflation [00:13:00] elevated and you could really make a case for, you know, either of those camps.

[00:13:05] And I think when we think about, I don't know, tail risks are unexpected, you know, those are probably two, you know, on the bookends where they're not out of the realm of possibility, right? You get accelerating inflation or you get, you know, a potential recession. The one I would say that we probably get outside of maybe economy now and getting in back into markets.

[00:13:24] We obviously get tons of questions on the Magnificent seven. So, you know, what does this mean? What does this mean for my portfolio? Is this a bubble? Right? Just like lots of those type of conversations. And I was having a, uh, chat with a friend of mine. He's brilliant. He is a mechanical engineer, but he's, he's not an investor.

[00:13:43] And we were talking about the magnificent seven. And so, I use the analogy of seasons. And that businesses, and sometimes sectors or industries, you know, come into and out of seasons, and oftentimes a business is maybe allowed by regulators or has the opportunity just based on current market [00:14:00] conditions to really out earn its economic value.

[00:14:04] Uh, either, you know, in the literal sense of economic value or maybe its contribution to society. And we don't always know the reason that the seasons change unlike, you know, in the physical world. But they often do. And you could see that expressed where, you know, during the GFC, banks were allowed by regulators to out earn their value by syndicating debt and, you know, creating the housing bubble and doing all sorts of what proved to be pretty, uh, bad things.

[00:14:32] It's not that the Magnificent seven has done anything nefarious in that way but as you look at potential regulation of those businesses, or changes, you know, kind of those seasons, it's unlikely that they will continue to see the succeed at the same magnitude that they have in the past. So, we have no idea when the magnificent seven fall or winter, if you will, to try to carry that analogy, will come.

[00:14:56] But it's, it's logical that new leadership will [00:15:00] eventually take. And so, we just need to make sure that as we position portfolios, as we recognize our exposure to these, uh, businesses in headline indices and others, that it's, it's, uh, commiserate with risk and opportunity, and it's also forward looking.

[00:15:14] That's an exceptional segue into the segment that Devon referenced earlier, and that's international equities. And, you know, whether it's the mag seven or just US equities overall, there's been such a period of domination that committee members and investors in general are scratching their head and saying, boy, does it really make sense to continue to diversify on a global basis?

[00:15:39] Why don't you share your baseline considerations around that? Yeah, it's such a meaningful question and it's one that I, uh, you know, sitting on that side of the table, I completely understand. You know, at the, you know, at the risk of being too high level. And then I promise I'll go, I'll go deeper.

[00:15:59] [00:16:00] Um. If we just, if we sit down and we say, how do we want to construct a portfolio, we would be really narrow in our view to say, the US is the only game in town, right? 96% of the world's population lives outside of the US. 85% of global GDP is outside of the US. 74% of globally listed stocks, things that we could buy in the public markets, exist outside of the US.

[00:16:22] And so, just where would we even begin with a blank piece of paper? We would begin looking globally. We would not begin and say New York, California, that's it. That's the whole investment world. Now, practically, what has happened to the US versus international? Well, if you break down over the long term, markets are driven by two primary things.

[00:16:44] Growth in earnings. So earnings per share growth. And changes in multiples. So, and tech, it's a bit of a technical term, but it's what are you willing to pay for a share of earnings? And the more you're willing to pay, the more, uh, prices can go up. So [00:17:00] over, you know, the last decade, right, EPS growth in the United States has gone up 144%.

[00:17:08] That's pretty extraordinary. And there's been some extraordinary businesses that underlie that. If you look at EFI, which is kind of developed, international, EPS growth has grown by 40%. Now, these are cumulative. They're not annualized numbers. So very big gap there. Now, let's take EM. EM earnings per share growth over the last decade has grown by negative 10%.

[00:17:31] Obviously that is a big component of what has driven total return. So same periods S&P 500 over the last 10 years, cumulatively up 388%. EFI up 92%. Emerging markets up 22. Now that, the gap between earnings per share growth and total return, I think are fairly self-evident. But rewind that to previous points in time.

[00:17:54] So from 2003 to 2010, just kind of through the [00:18:00] GFC. S&P earnings per share grew up 96%. EFI up 170%. Emerging markets up 270%. And you saw commiserate levels of return.

S&P over that time period was up 68 and, or just under 68, the S&P by, uh, emerging markets by way of example, up 378%, right? I realize I'm throwing a lot of numbers at you, but in aggregate, right?

[00:18:23] Earnings per share growth, you know, basically the fundamental output of a business, ultimately drives some of the long-term outcomes that we should expect from these markets. And so as we think about, you know, kind of the forward looking basis, right, on long-term outcomes, you know, if we look at earnings per share growth expectations here in the United States, uh, versus say emerging markets, you know, the two-year forward looking EPS expectations in emerging markets, it's pretty materially higher than the US. So again, at that 50,000 foot level, right on just.

[00:18:57] How would we even think about constructing a [00:19:00] portfolio? It seems very self-evident to us at least, that we should have a global view. And I appreciate that certainly as of late and recently, uh, you know, the, even the last decade, which is not a short amount of time, um, it seems like the S&P is the only game in town.

[00:19:15] But just as we talked about the seasons of Mag seven, there's most certainly seasons in success. Does that mean that's this quarter or this year? We don't obviously, no one perfectly knows. But we think as allocators that we should prudently, and that doesn't mean all of our portfolios. Certainly, it means, as, you know, a small percentage that have a percentage of our portfolio in these markets.

[00:19:39] Because I think there's a pretty large opportunity going forward. I think that really, uh, your last comment underscores one of the most important things that, you know, this is the Nonprofit Investment Stewards podcast. We're talking about long-term, ideally perpetual asset pools. So, the time horizon is very long and we have to acknowledge that [00:20:00] there is a cyclicality to market leadership, and that recency bias can bite you in the behind if you put too much stock in it.

[00:20:09] So I think those are all important points. What would you say about, you talked a little bit about developed versus EM, you can certainly dig deeper into that if you'd like, but I'd also like you to touch upon growth versus value overseas. Any thoughts about style allocation? So style allocation one from a timing perspective, I'll just say this.

[00:20:31] Lord knows we've tried, um, to figure out the right mousetrap for when does it make sense to own growth? When does it make sense to own, uh, own value? And there, there are many factors amongst that. And those are kind of the, the bookends of style. If you step back, both of them, the expected, they both have positive expected economic value, meaning if you choose to buy a value company or something that is.

[00:20:58] Statistically less [00:21:00] expensive, over long periods of time, that should have a positive return associated with it. Same thing as if you buy a business that has above average revenue earnings, you know, uh, growth over time, especially relative to the market, that is a positive economic value associated with it.

[00:21:17] The timing of those is extremely difficult to figure out, and it's, it's quite akin to, you know, trying to time markets, or I'm gonna go to all cash this month, or, you know, those type of, analogies. So, when it comes to value and growth investing, historically what's happened is growth investing tends to accumulate over time and value investing, it tends to accumulate at points in time.

[00:21:41] Right. So if you again, you believe in the positive influence of value over time, if you miss, if you try to time and you miss in value, then you really destroy a lot of the long-term value. And so, you know, just from a return perspective, we think they [00:22:00] both produce strong, positive forward returns.

[00:22:03] Uh, from a diversification perspective, they're complimentary to one another because, I know we are all long-term investors, but success doesn't tend to be linear. It tends to be cyclical. And

so we want to balance some of those periods of return. Just like, you know, investors looking in the rear view mirror would say, I would never own anything outside of the US. One day that will change.

[00:22:23] Same thing with growth and value. So creating that balance and having that balance not only smooths the path and has a positive expected return. And we think that that cumulatively has a big effect on long-term outcomes. Brad, let us ask you to add anything else you'd like to on the benefits of international or global diversification, but then beyond that, and given your earlier points about the importance of diversification, any other asset classes or strategies that investors should be thinking about with this prudent, thoughtfully diversified [00:23:00] mindset?

[00:23:00] Yeah, maybe the only other point on international and just kind of tying through to some of the comments we made on, you know, the economy. You know, we are, and this is a little bit more of like a Brad Long take, not it's, it's embedded in our portfolios everywhere, but we've, we've entered more into, you know, much more of a multipolar world.

[00:23:24] And that the manifestation of that is going to come in interesting ways. It's likely, in my view, it would likely increase things like economic volatility as you get trade wars and spats, or you get, uh, you know, deporting or importing inflation, you get currency debasement or manipulation. And that creates both opportunity and risk across multiple geographies.

[00:23:50] And the, the, taking advantage of those or, you know, avoiding thoughtfully, right, uh, those opportunities does create even [00:24:00] more opportunity across the globe, not just here in the US. So, I'd say that, frankly, that that's hard to quantify. Um, but it's something that's, that's kind of observed anecdotally, and we're starting to see more evidence for, and I think it, it just helps solidify some of that positioning abroad.

[00:24:17] Now that also ties into, you know, if you see a more economic volatility, you might see more, uh, market volatility associated with it. So, you know, the number one, uh, thread to pull there is around portfolio construction, which we largely talked about is the mix of assets and why we're positioning a fixed income.

[00:24:35] But, you know, hedge funds in aggregate, they're a little bit of a dirty word. You know, I think they've got somewhat of a bad reputation. Some of that deservedly so, and some of that not deservedly so. In an environment where you have, you know, kind of this higher structural inflation, I'm sorry, higher structural volatility, maybe modestly higher structural inflation versus 2%, that [00:25:00] does potentially create, you know.

[00:25:02] Shorter opportunities in markets. And hedge funds are really structures that are designed to take advantage of that. So, you know, for long-term allocators that are thinking about, you know, opportunities in markets and how to not simply just take the full risk of the market, right? It's maybe not be appropriate for your portfolio positioning.

[00:25:20] You know, those diversifying strategies while they've been fallen to the wayside a bit, I think as, as of late would be worth another discussion. So as always, you have shared a wealth of information with us, um, and we really appreciate it. Is there anything that you'd like to listen, uh, leave listeners with that you'd like to add or underscore?

[00:25:41] I, I feel like we've, in our short amount of time, we've underscored a lot of the things that we talked about in our annual outlook. You know, so the things coming back to prepare, not predict, right? We're building portfolios with resiliency that, that are, uh, designed with the idea in mind that recessions are a [00:26:00] normal part of economic expansion and contraction.

[00:26:02] They're just, they occur on average every six years or so. They are designed in mind with, you know, the idea that we will go through election cycles like we will this year. In the US that's every four years for a general election. And so, you know, that is not, kind of a new scenario, right?

[00:26:19] So if investors read headlines, and I think as we're going to have a very long, uh, two, candidate runoff in elections. Elections are really designed to elicit emotions and emotions usually don't mix all that well with markets. Realize that kind of with thoughtful and intentional diversification in our portfolio, portfolios are designed to weather those things.

[00:26:42] And there's a higher likelihood that, you know, in the months, uh, to come, especially as we near November, that those emotions will start to run higher. And remember that's okay. That's natural. Uh, but the portfolios that we're building are designed to weather those. And I think we need to, you know, take a breath and try to remember some of that.

[00:26:59] Uh, as we [00:27:00] come into this, what is gonna be a long, two candidate season. Yep. That's a very important message. Well, thank you so much. Always great to have you on the show, and we appreciate your time and your expertise. All right, thanks Devon. Thanks so much Brad, and I will suggest to listeners that you should definitely hit the insight section at fiducient.com to really glean a lot more about what Brad and his team and, and a number of other just great insights.

[00:27:25] So feel free to, uh, to visit the insights section there and then to all our good stewards, thanks for investing your time to help your nonprofits prosper. We'll connect with you soon on the next episode. Thank you for listening to the Nonprofit Investment Stewards podcast. Click the subscribe button below to be notified of new episodes and visit fiducientadvisors.com for more information.

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