Brighton Jones®

How We Are Positioning Portfolios, & Why

December 2021

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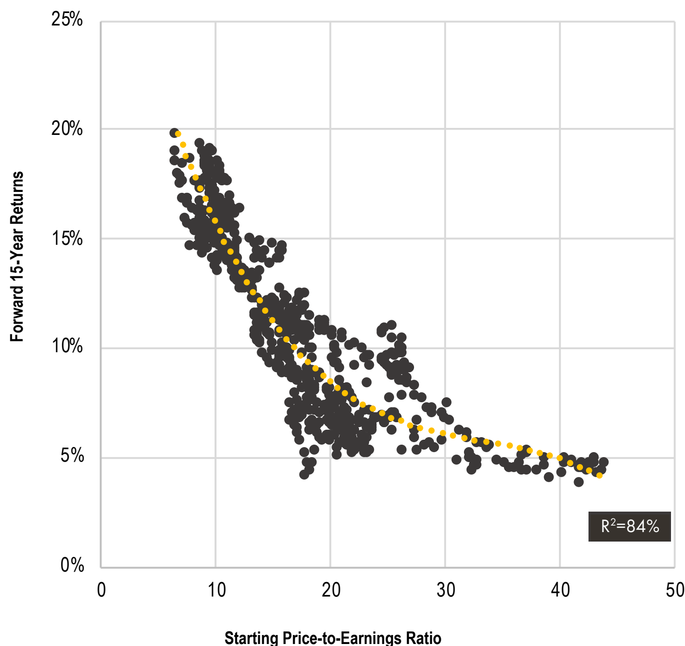
As we approach year-end, many of our clients will be wondering how we are positioning portfolios for the upcoming year and beyond. In this investment update, we (1) revisit the key variables that drive investment returns, (2) compare how the current investment environment relates to past periods, (3) discuss how our portfolios are positioned for the current environment, and (4) identify areas of opportunity to add value.

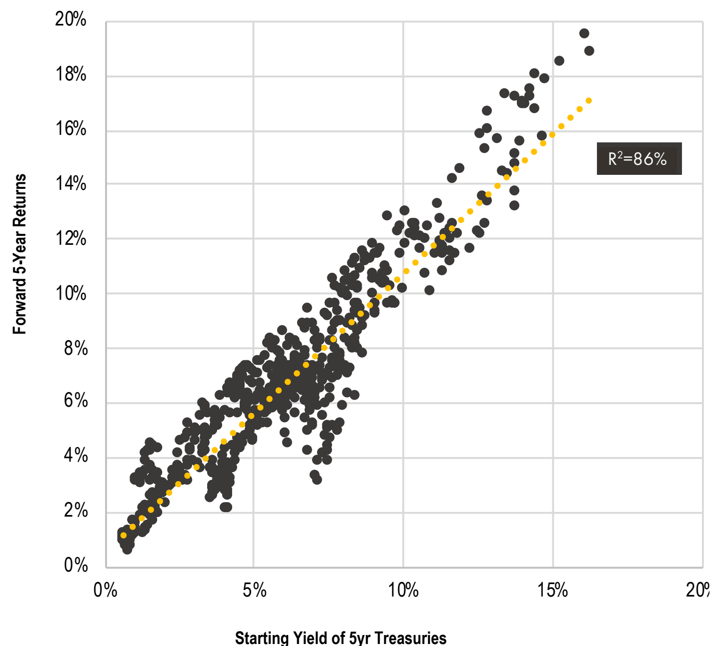
Key Drivers of Investment Returns

Our view of the world asserts that three key variables drive the returns of diversified investment portfolios over an intermediate time horizon: starting equity valuations, interest rates, and inflation. Consider the two charts below.

On the left, we plot starting equity valuations (as indicated by the Shiller price-to-earnings ratio) on the horizontal axis against forward 15-year returns on the vertical axis for the S&P 500 Index since the end of World War II. Visually, it is clear there has historically been an inverse relationship that suggests low starting valuations are indicative of above-average future returns, and vice versa.

On the right, we plot the starting yield of 5-year treasuries on the horizontal axis against forward 5-year returns on the vertical axis. Here, we observe a positive relationship between starting bond yields and subsequent bond returns when the investment period matches the average maturity of bonds held.





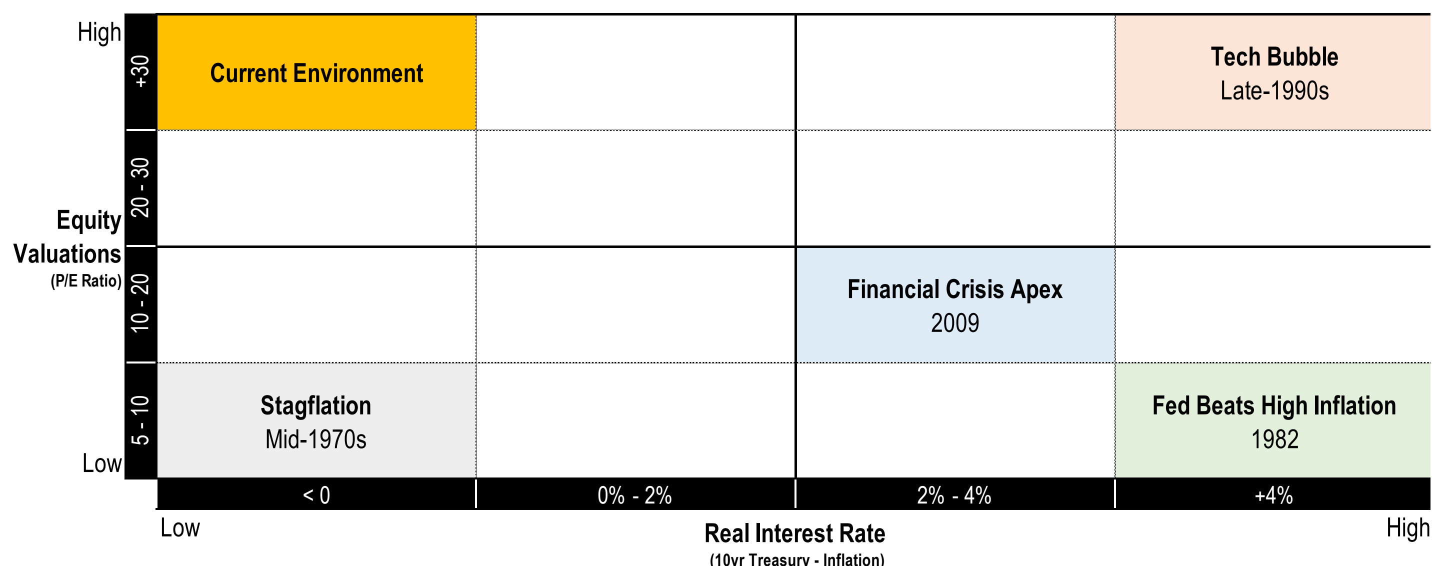
Defining the Investment Environment

Having established that starting equity valuations have historically been inversely indicative of future equity returns and starting bond yields have been positively indicative of future bond returns, we can benchmark today's investment environment against prior periods. This exercise can help us understand the challenges and opportunities that exist today relative to the challenges and opportunities that have existed in the past.

In the first diagram below, we characterize the investment environment using a quadrant chart with inflation-adjusted treasury yields on the horizontal axis and equity valuations on the vertical axis. Along each axis, we denote the breakpoints used for segmentation; and within each quadrant we identify at least one period that stands out as having historical significance so we can highlight similarities and differences relative to the current environment.

In the second diagram below, we calculate the percentage of time past market conditions have fallen within each sub-quadrant. When setting the breakpoints for each section, our intent was to identify extreme market conditions on the outer edges and for most of the data to fall in the center region.

Investment Enviroment



Investment Enviroment Frequency Table

Equity Valuations (P/E Ratio) \ Real Interest Rate (10yr Treasury - Inflation)	< 0 (Low)	0% - 2%	2% - 4%	+4% (High)	Subtotals
Subtotals	18%	32%	35%	14%	
+30 (High)	2%	2%	5%	1%	10%
20 - 30	4%	15%	14%	1%	35%
10 - 20	8%	13%	15%	8%	44%
5 - 10 (Low)	4%	2%	1%	4%	11%

With the Shiller price-to-earnings ratio registering approximately 40x and real interest rates moving into negative territory due to higher inflation readings throughout 2021, today's investment environment is unlike any other we have experienced in the post-war era.

In the mid-1970s, investors were faced with deeply negative real interest rates, but prospective returns for domestic equities were attractive because valuations were depressed. In the late-1990s, investors were faced with stretched equity valuations, but prospective returns for fixed income securities were attractive with prevailing interest rates well above inflation. Hence, the lower left and upper right quadrants can be characterized as environments where investors could find attractive entry points in either fixed income or equity securities.

In the last of our historical comparisons, the years 1982 and 2009 marked the end of severe recessionary periods and the beginnings of strong bull markets in fixed income and equity securities. For example, from 1982 through 1999, long-term government bonds returned 12.08 percent per year, the S&P 500 Index returned 18.53 percent per year, and inflation registered just 3.29 percent annually. Hence, when your starting point is in the far bottom right quadrant, history shows it is hard to go wrong with asset allocation decisions—a dream scenario for investors.

With the current investment environment landing in the upper left quadrant, this framework is suggestive of below-average prospective returns for both fixed income securities (low single digits) as well as the broad U.S. equity market (mid-single digits). In the following sections, we explain how we want to position portfolios in this type of environment, and why.

Our Asset Allocation Framework

We believe the key to assuming risk responsibly in pursuit of investment returns is to give each market segment an adequate amount of time to achieve its long-term performance target. This requires that we (1) know the timing and amounts of anticipated cash needs for each client, and (2) determine a minimum holding period for each asset class, understanding that more volatile market segments, such as equities, should be given more time to perform according to expectations.

Putting these two concepts together, our Cash Needs Analysis computes a running total of annual withdrawal needs for each client portfolio, and our Investment Committee sets guidance for how capital is allocated among a range of fixed income and equity market segments.

In assigning holding period targets, we want to give riskier market segments enough time to endure a bear market period, recover temporary losses, and then provide a positive return commensurate with our expectations for the asset class. Applying what we discussed earlier about the drivers of investment returns, we also want to give equity investments a longer time horizon to produce desired returns when valuations are high, and vice versa.

In the quadrant chart below, we detail how we think about positioning portfolios in a way that considers (1) the cash flow requirements of our clients, (2) the volatility of each market segment, and (3) prevailing market conditions.

Asset Allocation Framework

Equity Valuations (P/E Ratio)	Real Interest Rate (10yr Treasury - Inflation): Low (< 0 / 0% - 2%)	High (2% - 4% / +4%)
High (+30 / 20 - 30)	**Moderate Conservative** Protect 10-15 Years of Cash Needs, or a Minimum of 20-30% Fixed Income	**Conservative** Protect 15-20 Years of Cash Needs, or a Minimum of 30-40% Fixed Income
Low (10 - 20 / 5 - 10)	**Aggressive** Protect 5-10 Years of Cash Needs, or a Minimum of 10-20% Fixed Income	**Moderate Aggressive** Protect 8-12 Years of Cash Needs, or a Minimum of 15-25% Fixed Income

Interpreting the Asset Allocation Quadrant

It is important to emphasize that our portfolio positioning quadrant is a framework, not a formula. We use the framework as a way of scaling our risk exposure up or down at the margins based on our intermediate-term expectations for fixed income and equity market returns. It is not a market timing tool that signals if or when we should make wholesale moves in and out of stocks or bonds. Underlying the framework are a few basic principles worth highlighting:

1. We want to incrementally dial up equity exposure when we can expect to be compensated with above-average returns.

2. We want to incrementally scale down equity exposure when prices are high and prospective returns are low.

3. Scaling our risk exposure as described here sounds easy enough, but it will be extremely difficult in real time. In general, prices will be high only when investors are feeling optimistic about the future and they will be low only when it seems as if the world is falling apart around us.

4. We adjust our exposure to fixed income and equities by quantifying risk as a function of time. For example, when equity valuations are high, we increase our minimum holding period for the asset class. In turn, this reduces the amount of exposure we have to equities within our portfolios.

5. Market cycles are inevitable and they will influence our performance as investors, but they are largely unpredictable in terms of magnitude and timing. This is why we use this framework to scale our risk exposure incrementally as the investment environment evolves and not as a formulaic market timing tool.

6. We fully expect to encounter investment environments in the future that differ from anything we have seen in the past. We are prepared to adapt as our experience and common sense suggests we should.

7. We believe that paying attention to market cycles and scaling our risk exposure in response to changes in the investment environment is the right approach for most of our clients. Still, some may prefer to remain heavily allocated to equities at all times. This is OK, it just takes nerves of steel (as the pandemic-driven sell-off reminded us once again last year) and a longer-term mindset.

Investing in a Low Return Environment

Financial markets are not accommodating; they will not provide high returns just because we want them. When elevated equity valuations imply that high returns are not reasonable to expect, we do not want to invest as if they are. When safe investments appear unlikely to provide the returns we want, we do not want to rush into riskier investments to obtain the returns we seek. It is important to recognize these circumstances for what they are, to plan accordingly, and avoid the temptation to chase returns.

In today's investment environment, we favor a Moderate Conservative stance towards risk. While the economic growth cycle appears to be on solid footing, we do not believe the current environment is indicative of a generational buying opportunity that is likely to produce the type of returns we saw coming out of the recession in 2009. At the same time, near-zero interest rates can be supportive of higher equity valuations, so we do not believe stock prices are irrationally exuberant (at this time), as they are often described to have been in the late-1990s. Hence, our framework calls for portfolios to be positioned more conservatively than in 2009, yet more aggressively than in 1999.

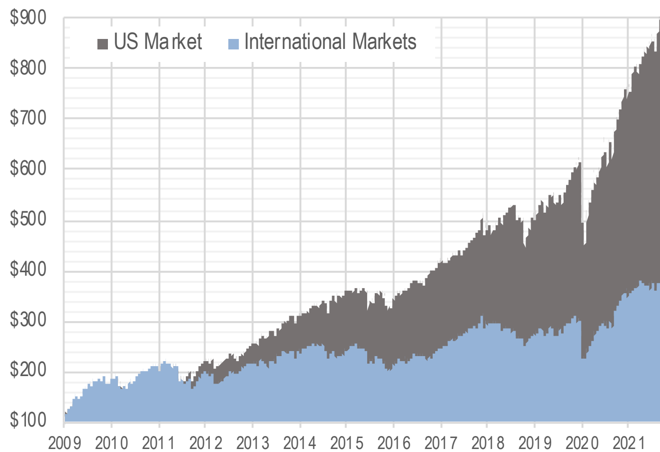
More specifically, we currently aim to protect 14 years of anticipated cash needs in fixed income securities, thereby giving our equity investments a 15+ year time horizon. In contrast, we protected 10 years of anticipated cash needs coming out of the 2009 global financial crisis. In cases where clients have no/negligible anticipated cash needs, we recommend a minimum allocation of 30 percent to a combination of high-quality and higher-yielding fixed income securities. In contrast, we recommended a minimum allocation of 15 percent to fixed income in the early years of the last economic expansion.

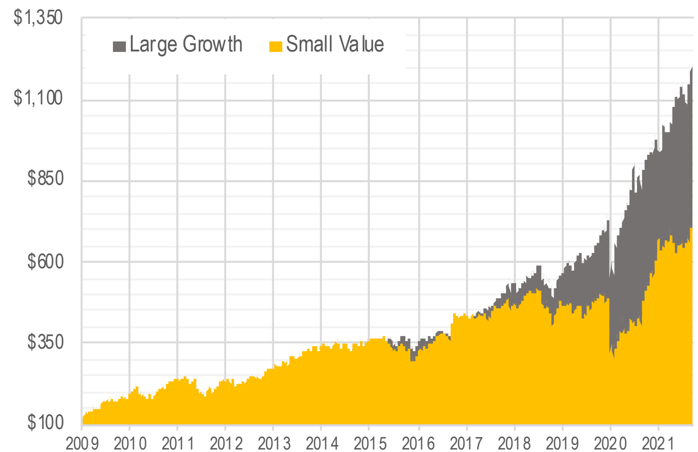
Pockets of Opportunity

While it might be the case that broad domestic fixed income and equity market indexes are priced to deliver below-average returns in the coming years, we continue to see areas where we can enhance outcomes for clients:

1. Rotate Profit from U.S. Large Cap Growth to International, Small Cap, and Value Companies

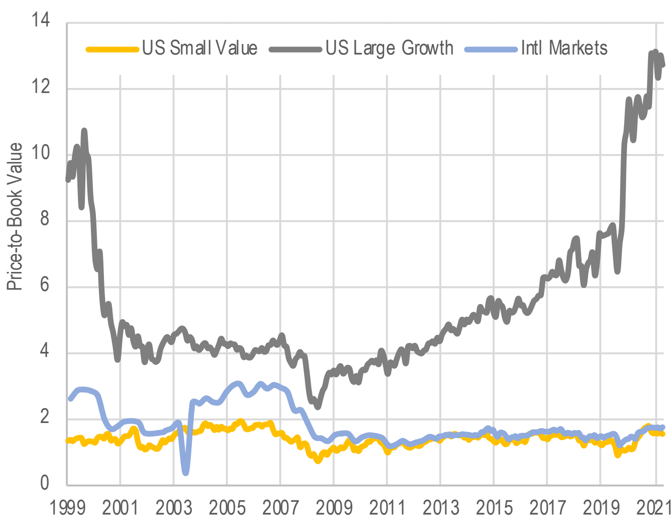
In the two charts below, we compare the performance of the U.S. stock market vs. foreign markets (left) and U.S. large cap growth companies vs. U.S. small cap value companies (right) since the end of the global financial crisis in March 2009. Visually, we can see that U.S. stocks started to pull away from foreign stocks in 2011, and U.S. large cap growth companies started to pull away from U.S. small cap value companies in 2017.

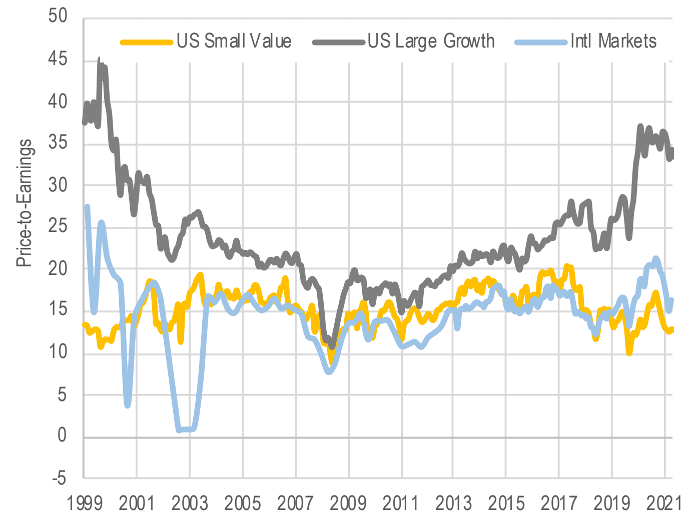




Now, past relative performance does not in and of itself indicate where the best or worst opportunities might be in the future. Sometimes, outperformance of a company, sector, or broader market segment might be justified with stronger growth in revenue, earnings, profitability, or some other metric of operational performance that can be found on an income statement or balance sheet. However, caution might be warranted when stock price appreciation far outpaces operational performance for specific market segments.

In the two charts below, we compare two common valuation measures of U.S. large cap growth, U.S. small cap value, and international stocks. Whether we consider price-to-book value (left) or price-to-earnings ratios (right), it is evident that U.S. large cap growth stocks are priced richly whereas small cap value and international stocks are priced in line with their historical norms.





While international diversification and exposure to small cap and value companies have acted as headwinds in recent years, we believe these market segments offer the potential to enhance returns in the years ahead, given more attractive relative valuations.

2. Expand the Opportunity Set

Throughout this article, we have discussed the drivers of expected returns over intermediate time horizons. But the future does not always evolve exactly as we expect, which can lead to certain types of investments or market segments performing better or worse than initially anticipated in the short-term.

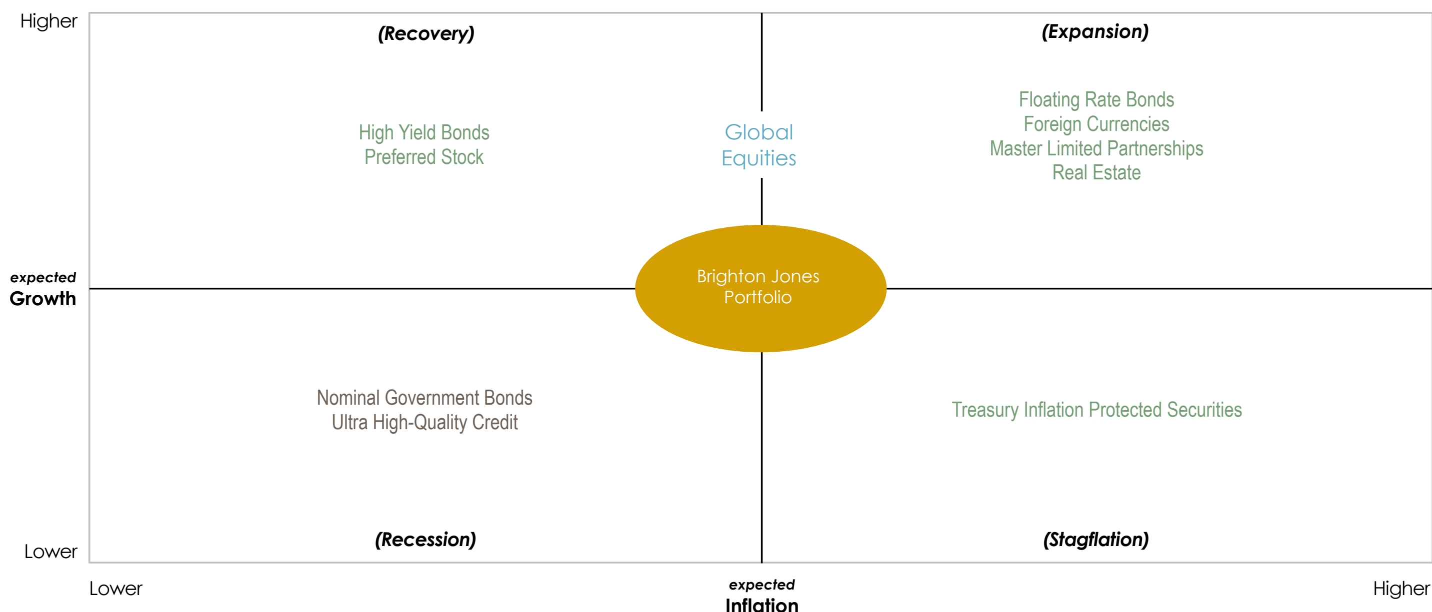
Because we have to survive the short-term in order to make it to the intermediate and long-term, we aim to diversify portfolios across a range of asset types that offer the potential to hedge unexpected outcomes that can adversely affect the performance of core asset classes. Let's explore how this works.

Prices of financial securities incorporate expectations about a wide range of variables, with economic growth and inflation being the two most influential. Economic growth is important because it affects corporate earnings, while inflation is important because it influences interest rate policy. Because economic growth and inflation influence the key drivers of investment returns—corporate earnings and interest rates—whether a particular market segment performs better or worse than expected in the future will be closely linked to whether these two variables are higher or lower than expected.

While we cannot predict when economic surprises will materialize, we can reasonably predict how different asset classes will respond to such surprises if they do. In yet another quadrant chart below, we illustrate how an expanded opportunity set of asset classes—beyond nominal government bonds and global equities—can help us achieve more consistent performance across a wider range of economic outcomes.

In recent conversations with clients, many have asked about the possibility of rising interest rates, a spike in inflation, a depreciating dollar, and so on. In structuring portfolios, we aim to include investment types that offer the potential to hedge these types of risks should they materialize.

Best Economic Outcome for each Asset Class



Consider a few examples (an exhaustive list is beyond the scope of this article):

(1) Periods of stronger than expected growth and inflation may result in interest rate hikes, which could be harmful to the performance of nominal government bonds. To hedge this risk, we allocate to floating rate bonds, which benefit not only from rising interest rates, but also from stronger corporate profitability.

(2) Periods of weaker than expected growth and stronger than expected inflation might lead to higher interest rates and declining corporate earnings. To hedge an outcome that might be unfavorable for nominal government bonds, corporate bonds, and equities, we allocate to treasury inflation-protected securities.

(3) Periods of stronger than expected growth and weaker than expected inflation tend to be beneficial for high yield bonds and preferred stocks. This is because stronger than expected growth is likely to benefit corporate earnings, resulting in lower default risk. At the same time, the Federal Reserve will be less likely to raise interest rates with lower-than-expected inflation.

3. Look to Private Markets

Over the past four years we have expanded our expertise in and access to private investments. In 2018, we acquired a majority stake in Blueprint Capital, giving our clients access to private credit opportunities (real estate backed lending). Later in 2018, we launched Brighton Jones Investment Partners, a team of in-house experts focused on private investing, which leverages the expertise of our own clients across various industries to perform due diligence and invest in privately held companies. Lastly, in 2019 we launched Brighton Jones Real Estate Advisory Group to help our clients manage and maximize the returns of privately held real estate investments.

By expanding our expertise in and access to opportunities in private credit, private equity, and private real estate, we expect to further expand our opportunity set beyond public markets and enhance investment returns for clients.

In 2021, clients who have expressed interest in private investments were approached with opportunities to invest in Frazier Health Care Partners Fund X, Security Properties Multifamily Fund VI, Brighton Jones Investment Partners Fund II, Blueprint Capital REIT, and various real estate tax strategies involving 1031 exchanges and Qualified Opportunity Zones.

If you would like to be opted into our distribution list for private investment opportunities, please reach out to your planning team.

Conclusion

At any particular point in time, the investment environment—defined by prevailing valuations, interest rates, and inflation—is a given. We cannot change it, and therefore have no other alternative than to accept it and invest within it.

The truth is, investing is never easy. When equity valuations are low and prospective returns are attractive, news headlines are likely to be terrifying, and it will be difficult to buy into market segments that have suffered meaningful declines. When equity valuations are high and prospective returns are less attractive, expectations for the future will be bright, and it will be difficult to take profit from investments that have delivered high returns. These actions are distinctly contrarian, which means you likely will not find solace in others agreeing with your view or following in your footsteps.

In today's investment environment, we believe broad fixed income and equity market indexes are priced to deliver below-average returns. In our view, the best course of action is to favor a Moderate Conservative stance toward risk. In the context of our investment framework, this means giving our equity investments a 15+ year time horizon and allocating no less than 30 percent to a range of high-quality and higher yielding fixed income market segments.

Indeed, many investors will find it difficult to allocate capital to conservative market segments in the midst of a bull market. It is important to remember that if an allocation to cash and high-quality fixed income prevents you from having to sell equities during a bear market, the actual return you earn on those investments will not be in the low single-digits—it could be many multiples of that. Preventing one ill-timed stock sale can potentially do more for your lifetime returns than other investment decisions you make.

While our outlook for broad fixed income and equity market indexes calls for muted expectations overall, we see opportunities to improve returns and consistency in three areas (1) rebalance overweight positions in domestic large cap growth stocks to foreign markets, small cap companies, and value stocks; (2) diversify among a wider range of fixed income securities, such as inflation-protected bonds, floating rate bonds, and private credit; and (3) explore whether investing in private equity opportunities fits your risk and liquidity profile.

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Do you have questions specific to your situation?
We are here to help. Contact our team at hello@brightonjones.com.

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