SEGALL BRYANT & HAMILL

4th QUARTER 2015

SBH NEWSLETTER

Thoughts on the Current Environment

Ralph M. Segall, CFA, CIC
Chairman, Investment Policy Committee; Principal

In three separate meetings this summer, the same question came up in discussion with three very different investment committees. Twice, it was in a professional capacity, and the third time was as a volunteer member of the committee. The question was simply this: is a spending rate of 5% still prudent? While a basic question, this is no trivial matter. What an endowment committee calls a "Spending Rate", a pension fund calls an "Actuarial Assumption", and a husband and wife call a "Sustainable Draw Rate". It is the return a portfolio can be expected to earn over a long period of time. Not to be achieved every quarter, not even every year, but over the long term, a rate that can be relied upon. Changing it has profound consequences for a portfolio - and for those for whom the investment capital is being accumulated. Overestimate that return relative to what is actually earned, and the portfolio will exhaust itself in time. (Ask the trustees of almost any public pension fund in this country whether this is a real concern or not.) Underestimate it, and saving for retirement takes a much bigger bite out of a family's current budget than may be necessary. Needed purchases may be deferred or cancelled without cause. Companies could offer larger pay increases and still not exceed their overall compensation budget if the rate of assumed earnings on a corporate pension fund was (correctly) thought to be higher.

"...I'm home. All the time it was...We finally really did it...You maniacs! You blew it all up..."

Planet of the Apes, 1968

In our work with private wealth clients, we talk about 5% being a Sustainable Draw Rate, our term for the concept. Our basis for this opinion is rooted in fundamentals. The long term return of the U.S. stock market has been around 9%, and the inflation rate that has been associated with that period has averaged roughly 3%. Subtracting inflation and another 1% for fees and expenses leaves a 5% real return. Most clients, however, cannot tolerate the volatility associated with a portfolio that is 100% allocated to stocks. Folding in bonds, alternatives, and cash into the mix brings down the volatility, to be sure, but it also reduces the expected return as none of those asset classes have averaged nominal returns of 9%. The long-term return on bonds has been 5.0% and on cash, 3.5%. To produce a portfolio which earns 5% and which is less than 100% allocated to equities cannot be achieved with earning merely the average index return. Given that we are active managers, we seek to surmount this hurdle.

As we and many others have detailed extensively over time, the Federal Reserve and other global monetary authorities fought the economic downturn generated by the bursting of the Real Estate bubble in 2009 with unprecedented strategies. Interest rates were driven to zero and held there. When that did not prove sufficient to spur global economic growth, the authorities began to purchase securities outright. The plan was to essentially reverse engineer a recovery. Instead of market prices rising to reflect increases in the underlying fundamental value of a security, it was thought that raising the price of the security could stimulate the "real" economy by making the holders of the securities feel wealthier - to the point where they would spend more. That, in turn, would lead to an increase in the underlying fundamental value.

Or, at least, that was how the play was drawn up on the blackboard. In fact, security prices are up (that part of the plan worked), but the economy has either moved ahead sluggishly (in the U.S.), advanced in fits and starts (in Europe), or faltered seriously (in China). It is in this context that many who are responsible for watching over other peoples' money are asking the serious question: do current asset price levels allow for required returns to be earned? Another way of asking this is to put it in terms of interest rates. At current interest rate levels, can any real return (forget about reasonable return!) be earned? To be clear, this is not simply a problem for holders of financial assets. Rates of return in the real part of the economy have been eroded, too. Persistently low interest rates, while not leading to economic growth sufficiently strong to achieve a liftoff pace, did spur a boom in investment in the first decade of the century. The global economy has all the productive capacity it needs in steel and other industrial commodities or oil (!). Managements to whom we speak all mention the difficult competitive environment they face and how tough revenue gains are to eke out.

It's a lean landscape investors face. Earning rates on short-term investments (think: money market funds) are essentially zero; yields on investment grade bonds are around 3% (with considerable maturity risk), and yields on less-than-investment grade bonds are not a whole lot better. The stock market by most valuation standards can, at best, be labeled fairly valued. If the consensus forecasted earnings growth does not materialize, however, those valuations would move from "fair" to "rich". And therein lies the dilemma. If the economy is strong enough to support expected earnings growth, interest rates will likely rise, which could by itself put downward pressure on equity prices. If interest rates, on the other hand, stay steady, it will imply the economy is not strong enough to generate much in the way of profit growth.

What is the way out of the box? We propose a two-part response. First, take a longer-term perspective. It may well be the case that a 5% real return goal will not be realistically attainable in the next 1-to-3 years. Ecclesiastes tells us that there is a time to reap and a time to sow. There may also be a time to lay fallow. Beyond that period, when both economies and markets have had time to return to "normal", a 5% target ought to be attainable. Second, within this transition period, make sure that the focus remains on protecting capital. We have seen over market cycles in the 21-year history of our firm that our investment strategies tend to have better downside protection in periods of market weakness. We believe that is so because our fundamentally-oriented research process starts with identifying companies that we believe have and can sustain high Returns on Invested Captial (ROIC). For a variety of reasons too lengthy to address in this essay, such companies possess characteristics that increase their chances of achieving their (typically above-average) growth targets. They are good companies to own almost always, but especially in the environment contemplated above.

When is "Liquidity" not really Liquidity?

John M. Lafferty, Jr., Principal, Senior Portfolio Manager

On the morning of Monday, August 24th, most market observers sensed that trading would not be pretty when the U.S. stock exchanges opened. News overnight regarding weakness in the Chinese economy had battered shares on Asian exchanges and domestic equity futures prices suggested that stocks would be down big at the open. Indeed, the drops in the first 15-30 minutes of trading were breathtaking – leaving investors with nowhere to hide. The mega-cap Dow Jones Industrial Average was down almost 1,100 points, a drop of 7%. The S&P500, a measure of large cap stocks, the tech-heavy NASDAQ and the MSCI EAFE, which tracks developed international stocks, were all down at least 5%. The Russell 2000, measuring small cap stocks, was the "best" performer in the first half-hour of trading – declining just under 5%. Eventually, losses were pared, but these indices all finished the day down 3% or more. Just as the age-old market axiom warns – in times of crisis (however ephemeral), all correlations got to 1.0.

Why were there such pronounced declines? Most commentary pointed to China exposure. Companies with little or no exposure to China were selling off, however, and the flurry of panic selling sent shares across market capitalizations and market sectors down sharply. Yet these declines – while massive – were not what proved most interesting. Rather, the behavior of a number of Exchange Traded Funds (ETFs) called into question some of the more fundamental assumptions investors make related to liquidity and the manner in which these wildly popular securities trade - in both normal and frenzied markets.

ETFs, which have risen to prominence in the last 15-20 years, convey similar benefits to mutual funds – broad-based exposure to a market, index, or sector through a single vehicle. In addition to being generally cheaper and more tax-efficient than mutual funds, ETFs have surged in popularity for their presumed liquidity – i.e. their ability to be bought/sold readily as shares trade continuously on exchanges just like stocks. Structurally, ETFs are designed to ensure that the funds will trade very closely to the underlying Net Asset Values (NAVs), and specific caution was taken to prevent arbitrage between an ETF and its underlying holdings. Unfortunately, as many advisors and their clients learned, what should not have happened to ETFs did happen, and the divergence between prices and NAVs should serve as a cautionary tale for all market participants.

The poster child for the precipitous declines among ETFs during the panic selling on August 24th was the Guggenheim Equal Weight S&P 500 Fund (Ticker: RSP). RSP has AUM of ~$10Bn and trades with significant volume (~1.5MM shares/day). Achieving its performance goal of tracking the equal-weighted return of the S&P 500 closely should therefore have been straightforward.

Curiously, quite the opposite happened, as for most of the first hour of trading that day, RSP traded at or around $50/share, while its NAV was approximately $71 – a whopping 30% discount. In the aftermath of this "flash crash," stories abounded regarding unfortunate investors – individuals and their advisors – having standing market orders executed at these temporarily massive discounts. Why did this happen? Shouldn't the prices of these vehicles have hugged their NAVs more closely? These questions bring us back to the topic of liquidity.

Often characterized as "readily liquid", ETFs are praised for their trading efficiency. Writing extensively on the topic, Howard Marks, a co-founder of Oaktree Capital Management and a well-recognized investor, defines liquidity as the ability to sell a security "promptly and without the imposition of a material discount". As the experience of RSP (and several other large ETFs) demonstrates, despite being presumed liquid, this and other funds did not trade anywhere near the prices implied by their underlying holdings. Marks suggests that liquidity is situational – because, just as correlations converge during market crises, in times of panic, "liquidity often goes to zero". In theory, ETFs are more than sufficiently liquid, but in practice, as we saw in late August, this liquidity did not come without cost – in the form of meaningful discounts to NAV.

The intent here is not to condemn ETFs; as SBH-clients know, we may in certain (albeit rare) circumstances use ETFs as a cost-effective way to gain exposure to previously hard to reach areas of the markets – typically, commodities and foreign currencies. Many explanations exist as to what specifically drove the price/NAV disconnect on August 24th. Among them, the most plausible has to do with market makers – those tasked with providing liquidity – simply walking away from the chaos. At bedrock, market making professionals are in the risk-avoidance business – and when the actions of panic-stricken investors drive bid-ask spreads to irrational levels, market makers, who are under no obligation to keep trading, stepped away from trading. When this happens, investors can pay a hefty price. Ultimately, the poor trading behavior of some ETFs with presumably easy-to-trade underlying assets (US large caps, for example) raises a much larger question: what might happen to ETFs where the underlying assets are not as easy to trade as large cap US stocks?

Howard Marks; Oaktree Capital Management Memo to Clients Re: Liquidity; March 2015

David Nadig; FactSet Insight, "Understanding ETF 'Flash Crashes'"; August 26, 2015

Assets in fixed income ETFs have swelled to ~$340Bn, a six-fold increase since 2008. How will these funds react should the Federal Reserve begin raising interest rates, and what if there's a flash crash in fixed income similar to what transpired in equities on 8/24? The adverse impact could be particularly severe in vehicles where those presumably less liquid holdings are concentrated, specifically ETFs comprised of bank loans, or (especially) high-yield (i.e. "junk") bonds. In the case of the latter, as investors have searched for yield in a prolonged low interest rate environment, assets in junk bond ETFs have soared from $10Bn to ~$40Bn since 2010. One well-known characteristic of junk bonds is that rising interest rates are likely to impact junk bond pricing more acutely than investment-grade credits. If investors choose to move out of these funds in a meaningful way, the ETF managers will find themselves forced to sell not what they should (the lower quality and more volatile holdings they have), but what they can (the more liquid, higher quality holdings in their portfolio).

August 24, 2015 was a test for ETFs and their behavior in early trading suggests that – despite their history and scale – they are still unproven in times of market panic. The behavior of equity ETFs, even passive ones, in a moment of stress should give everyone pause. It is in this context that the virtues of individual security investing can be underscored. As SBH clients have come to observe, significant market moves – up or down – don't cause us to trade more actively. We view the investment universe as comprised of markets of stocks, bonds, and alternatives – not stock/bond/alternative markets. We are confident that our research process will lead us to high-quality investments which we intend to hold for long periods of time. When portfolio liquidity is required and the need to draw on portfolios arises, we can look to individual securities as a source of funds. As the frenzy on August 24th highlights – having the flexibility to sell shares of individual stocks as opposed to selling "the market" or a particular sector to meet cash needs is a version of liquidity that comes in handy in both calm and chaotic markets.

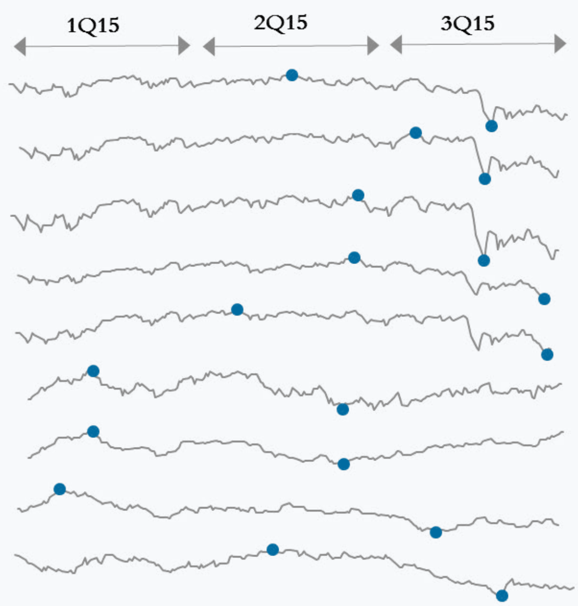
A. Lau and M. Flaherty; Reuters, "ETF companies boost bank credit lines amid liquidity concern"; May 13, 2015

Michael Connor; Reuters, "Liquidity risks overhang high-yield ETFs"; July 31, 2015

We are pleased to announce that we acquired the Quantitative Investment Team, led by Scott E. Decatur, Ph.D., from Philadelphia International Advisors (PIA) on June 30th. Dr. Decatur and his team currently manage International Small Cap and Emerging Markets strategies, which are offered in both separate account and mutual fund vehicles. The team will be located in suburban Philadelphia, in a newly established SBH office. This acquisition represents our first offering in non-domestic markets.

MARKET BAROMETERS
AS OF SEPTEMBER 30, 2015

	Dec 31, 2014	Sep 30, 2015	Low	High
Dow Jones Industrial Index	17,823.07	16,284.70	15,666.44	18,312.39
S&P 500 Index	2,039.00	1,908.70	1,862.30	2,114.20
Russell 3000 Stock Index	1,224.11	1,140.82	1,115.82	1,273.39
Russell 2000 Stock Index	1,204.70	1,100.69	1,083.91	1,295.80
Russell Midcap Index	747.89	711.22	698.23	803.63
Barclays Cap Aggregate Index	1,906.01	1,927.48	1,892.08	1,946.50
Barclays Cap Muni Bond Index	1,100.36	1,119.83	1,095.48	1,120.12
Gold (Price/Oz) London AM Fix	$1,199.25	$1,122.50	$1,080.05	$1,298.00
Goldman Commodity Index	3,232.80	2,603.62	2,448.55	3,335.08



Source: Bloomberg

SEGALL BRYANT & HAMILL
540 West Madison Street
Suite 1900
Chicago, IL 60661

Phone (312) 474-1222
Toll Free (800) 836-4265
Fax (312) 474-0521

www.sbhic.com