



In This Issue:

Ladies and Gentlemen ...
Bets Please

Functional Investment
Committees

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Bets Please

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WITH THE ONGOING RALLY IN RISK ASSETS and the prospect of continued monetary accommodation from the Federal Reserve, portfolio positioning and risk management are increasingly influenced by one's investment philosophy and time horizon. In this article, I present the most logical current arguments for and against the merits of a wide range of economies, trends, asset classes and investment themes. In parentheses, I present my own percentage odds as to which views are more likely to prevail.

Story continued inside.



U.S. Economy

FAVORABLE – It's likely to surprise to the upside due to the Fed (which continues to support the housing recovery with accommodative forward guidance); lower gasoline prices; and gains in employment and wealth. These factors fuel consumption and, thereby, capital spending, just as reductions in the deficit and government spending levels finally become less of a drag. **[33%]**

UNFAVORABLE – We are in an economic expansion, being well past the recovery stage, and must start to focus attention on stagflation and, ultimately, recession risks. Housing-price appreciation has already peaked in anticipation of inevitably higher interest rates. Consumer and business spending will continue to be restrained by higher taxes and anti-growth initiatives from Washington, while longer-term fiscal challenges remain unaddressed. **[67%]**

Euro-Zone

FAVORABLE – The reduction of risk brought about by improvements in fiscal deficits, current accounts and sovereign borrowing costs is more important than absolute growth levels, as a virtuous cycle of private sector and investor confidence takes hold. Peripheral countries receive backdoor subsidies from core countries via banking support following stress tests. **[35%]**

UNFAVORABLE – Government debt and unemployment rates will continue to increase as growth is capped at very low levels by higher taxes, ongoing banking system deleveraging and bad loan problems. Crisis risk will reemerge when investors discover Germany will insist on a Cyprus-style bank bail-in, haircutting bank debt holders, who are mostly based in the peripheral economies. **[65%]**

China

FAVORABLE – While China's trend growth rate inevitably will decline from previous investment-fueled levels, the contemplated financial market reforms are precisely the correct policy to improve capital allocation and reduce real estate speculation. **[50%]**

UNFAVORABLE – China has yet even to begin the massive transformation from an investment-led to consumption-based economy. Political risk and militarism increase as economic growth disappoints throughout this difficult transition. **[50%]**

Japan

FAVORABLE – “Abenomics” (the economic policies advocated by Shinzō Abe, Japan's Prime Minister) is much more than aggressive monetary stimulus; it encompasses a broad-based structural reform of Japan's economy. It would be difficult to underestimate the upside to growth if even some of the reforms are implemented, after years of deflation and economic stagnation. **[25%]**

UNFAVORABLE – Abenomics indeed may create inflation, but the talk of structural reform is simply campaign rhetoric. Japan's upcoming consumption tax increase and high levels of government debt remain of concern when there is no pick up in real growth rates. **[75%]**

Federal Reserve

FAVORABLE – The Fed's unorthodox practices have become conventional as a result of its success in providing liquidity in a crisis and subsequently reducing long-term rates, thereby supporting the housing recovery, capital market prices and economic growth. While policy tools will shift from quantitative easing to forward guidance,

the Fed's actions will continue to support growth and employment while maintaining long-term average inflation at 2%. **[10%]**

UNFAVORABLE – The Fed has trapped itself from both a policy and intellectual perspective. It is too risky for them to admit that they caused the past bubbles (and failed to see them develop); don't understand why quantitative easing has not enhanced economic growth; and can't quantify the ultimate risks of what they are doing. A crisis will result if the Fed loses control of the bond market, if short rates are anchored for too long, and long-rates spike before employment targets are reached. **[90%]**

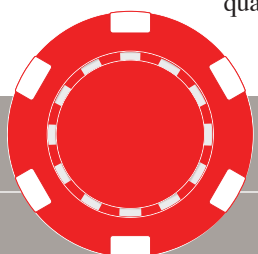
Dollar

FAVORABLE – It is poised to rally as it is fundamentally undervalued given an economy that is well into the expansion phase and will require monetary tightening long before Europe or Japan. **[50%]**

UNFAVORABLE – A combination of a continuation of sub-par economic growth and economic populism from the White House with a new ultra-dovish Fed Chair could trigger a long-term downward slide in the dollar as global investors seek reserve currency diversification. **[50%]**

Domestic Equities

PROS – Equities are well positioned despite the market rally because the continued economic recovery should support profit margins; forecast price-to-earnings ratios are reasonable; they are a striking value relative to fixed income markets; artificially low interest rates and wide open credit markets support shareholder friendly corporate actions and relative valuations; cash on the sidelines, with money only recently beginning to flow from bond funds to equity



funds; and option pricing still shows evidence of excess fear in the market. **[20%]**

CONS – They are overbought and overvalued due to outsized market gains relative to anemic past and plausible future earnings and GDP growth; and a combination of higher interest rates and lower earnings margins could surprise complacent investors as a capital expenditure pick up will depress margins despite a pick-up in economic growth. **[80%]**

Developed Market Equities

PROS – While European equities have outperformed US stocks over the past year, they remain attractively valued on a normalized basis, as earnings levels remain far below pre-crisis highs. “Abenomics” makes it quite likely that inflation takes hold and Japanese profit margins will return to pre-2008 levels, encouraging local investors to start a major rotation out of bonds and into equities. The apparent stabilization of growth in China should support exporters to China such as Australia where sentiment is already bearish. **[65%]**

CONS – While European stocks are more attractive than U.S. stocks on a normalized earnings basis, that view makes the heroic assumption that normalcy is achievable over any forecast period. Blue chip defensive stocks are actually more attractively valued in the U.S. than overseas, where the latter requires U.S. investors to assume currency risks when buying into an overvalued Euro. After their amazing gains, Japanese equities are not particularly cheap and are vulnerable to investor disappointment should the reform movement sputter just as higher taxes bite into growth. Australian economy and exchange rate remain vulnerable to China slow-down. **[35%]**

Emerging Market Equities

PROS – They offer an absolute valuation appeal combined with striking relative valuation versus U.S. equities, given the future earnings growth differential. Structural concerns are overdone, as countries in the aggregate are well positioned from a fiscal perspective. **[70%]**

CONS – The apparent valuation appeal shrinks when adjusted for sector differences and state-owned share exposure. Near-term profits will disappoint as countries deleverage from recent Fed-enabled credit binge just when higher interest rates are required to fight inflation. Political interference and corporate governance concerns mean that a discount-to-developed-market multiples may be appropriate. **[30%]**

Municipal Bonds

PROS – Munis offer attractive after-tax returns, as a good relative value versus Treasuries offers protection against rising Treasury rates, particularly in the longer-dated maturities. They are an excellent hedge against the strong likelihood of even higher marginal income rates given the appeal of populist candidates and the need to fund expanded and unreformed entitlement initiatives. Headline credit scares in Detroit and Puerto Rico only increase returns from active management. **[75%]**

CONS – This summer’s price collapse showed that municipal bonds, as a narrowly-owned, somewhat illiquid asset class, are vulnerable to higher benchmark rates. The risk of lower rated bonds is greater than previously believed, as creditor protection laws are eroded by the political process. The same political forces calling for higher tax rates might seek removal of the tax

exemption for municipal interest, with outstanding bonds not necessarily grandfathered. **[25%]**

High Yield Bonds

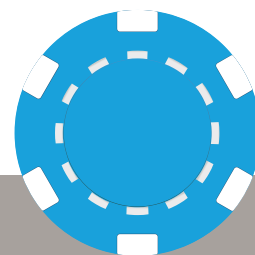
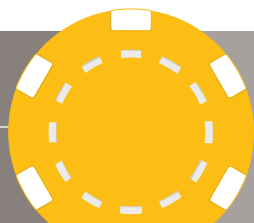
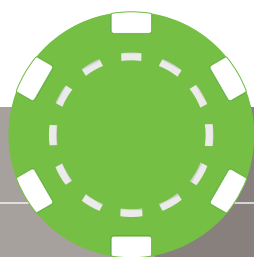
PROS – They are a perfect asset class for the current environment as credit spreads are reasonable, short-term rates are anchored, near-term default rates will be low, and maturities have been extended. Economic growth will be strong enough to support profits, but not so strong as to trigger inflation fears. **[15%]**

CONS – They offer an unfavorable asymmetric return profile as call provisions limit returns to coupon levels. There is exposure to downside risks of rising interest rates and intermediate-term default rates stemming from loose underwriting standards. **[85%]**

Emerging-Market Local - Currency Debt

PROS – Such debt offers an attractive real yield in a world where liquid investments are difficult to find. Foreign currencies are an increasingly important alternative to distorted developed-country bond markets. Lower than average yields are offset by improved credit status. **[60%]**

CONS – Investors are likely to be disappointed by this volatile asset class as the risk/reward ratio is unattractive. If the Fed remains accommodative, emerging markets’ real interest rates may decline as countries elect to tolerate inflation and target weaker currencies. At the same time, as we saw this summer, the sector is vulnerable to capital flight arising from Fed tapering and dollar strength. **[40%]**



Cash

PROS – While near-term real returns will be negative, there is no attractive, liquid, low-risk alternative to cash, given insufficient reward for either duration or credit risk in bonds. Excess cash plays a role as a risk-mitigant in portfolios lacking hedged exposures. **[70%]**

CONS – There is a guaranteed negative real return for several more years, particularly given the Fed's desire to keep short-term rates at zero while actively seeking a 3% inflation rate. **[30%]**

Gold

PROS – With the Fed targeting increasingly negative real interest rates for an extended period of time and valuations relative to equities and crude oil no longer unattractive, gold has strong fundamental appeal. Most of the short-term speculative money has departed, just as emerging market sovereign purchases are increasing. Gold serves as a hedge against “unknown uncertainties.” **[51%]**

CONS – There is no compelling reason to own it, given Euro-Zone stability, slowing inflation rates and an improving US fiscal outlook. Gold plunged when the dollar was weak and interest rates were zero, so how could it rally when tapering ensues and interest rates ultimately increase? Developed countries have booked gains from selling at high prices and renewed sales would cap the upside. **[49%]**

Hedge Funds

PROS – In a world lacking attractive long-only investment opportunities, hedge funds stand out as one of the few areas capable of generating attractive risk-adjusted returns. **[75%]**

CONS – Hedge fund performance was absolutely abysmal in the market crash and subsequent returns have fallen well short of long-only benchmarks every year. The recent tax increases make hedge funds even less appealing on a net after-tax basis. **[25%]**

Leveraged Buyouts

PROS – Capital markets are well positioned for leveraged buyouts, given wide-open credit markets, low nominal and real borrowing costs, supportive Fed policy, high profit margins and considerable runway for further economic expansion. **[40%]**

CONS – Activity levels may be negatively correlated with subsequent returns, as the combination of peak margins and low borrowing costs is more likely to produce overpriced deals than highly profitable ones. **[60%]**

Commercial Real Estate

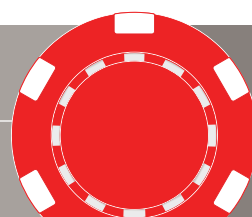
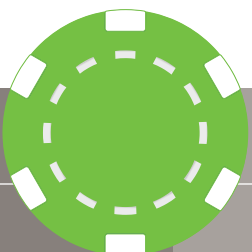
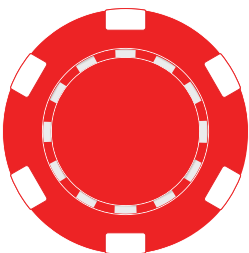
PROS – As investors have reduced their return expectations in line with the lower inflation and interest rate environment, office buildings outside of gateway cities offer attractive returns given that yields versus borrowing costs are attractive, per capita space needs have bottomed out, development projects are non-existent, and investor interest in these markets has only recently picked up. **[25%]**

CONS – Investors are likely to be disappointed as cash flow declines (due to lease expirations) and renewals occur at lower rental rates (with resulting cash requirements to fund tenant improvements. The combination of disappointing cash flow and ultimately higher borrowing costs will destroy returns, particularly for net-lease properties with added out-year risk when the primary tenants' leases expire. **[75%]**



Conclusion:

These cross currents and diametrically opposite perspectives make this a confusing time for investors. For those investors who also view valuation as important to their purchase and sale decisions, it is difficult to avoid becoming more bearish about both return potential and downside risks.





Functional Investment COMMITTEES

WHEN A FAMILY OR INSTITUTION FORMALIZES THE MANAGEMENT OF ITS INVESTMENTS, IT OFTEN CREATES AN INVESTMENT COMMITTEE TO OVERSEE THE INVESTMENT PROCESS AND PORTFOLIO BY WORKING WITH THE CHIEF INVESTMENT OFFICER (CIO).

Investment committees typically have a positive impact by bringing discipline and formality to the investment process. If emotion (in the form of excessive fear or greed) is the biggest danger to long-term investment success, then the formality and discipline of an investment committee can help dampen emotional decisions that can result in long-term portfolio damage.

Unfortunately, investment-committee process often inhibits timely decision making and implementation, which can detract from its value. One or more of the following factors (some of them very closely related) typically cause this result:

- An investment committee often has members who have significantly more expertise than the CIO in a specific area of investments. While this added expertise can be beneficial, it often leads to the committee limiting authority that is delegated to the CIO so it can remain closely involved.
- Investment committees typically meet about four times per year. Unfortunately, investment opportunities (and threats) rarely align themselves to a quarterly schedule. Because limited delegation implies more need for committee process, decisions can be delayed and opportunities missed. Even if provisions are made for ad hoc meetings, hesitation to take actions outside of scheduled meetings can still lead to missed opportunities.
- Most committees strive to work by consensus; there is a fear in taking bold action until everyone on the committee is at least comfortable. Successful investment actions are often the result of the kind of out-of-consensus thinking at which committees just aren't adept (or even capable).
- Investment committees are often very large. In families and organizations with multiple committees, the investment committee is often the most popular. In family firms and foundations, investment committees are sometimes viewed as training grounds for less experienced family members. The fact that a committee is large does not,

by itself, create an insurmountable problem; however, when a committee delegates insufficiently and explicitly or implicitly requires consensus on all decisions, the size of the committee exacerbates problems.

With these issues in mind, our experience is that the best investment committees:

- Have a charter that clearly identifies responsibilities and processes, which are regularly reviewed and updated.
- Operate at a policy level (e.g., setting asset allocation targets and ranges, defining authority for manager hiring and firing, etc.) and delegate as much management authority to the CIO as she or he is qualified to handle.
- Assure that the CIO has the resources (both internal and external) necessary to do the job.
- Receive complete reports from the CIO covering actions taken and the reasons for them. The committee holds the CIO accountable for these actions. It focuses questions on the reasons behind actions and future plans being considered.
- Make members available to the CIO for consultation in their areas of expertise. Committee members understand their role is to consult not to direct.
- Have chairpersons who keep their committees on task, make sure their members understand their roles, and ensure relationships with their CIOs remain healthy.

I am reminded of the wisdom of a friend and life-long successful investment manager who said that the best investment committees have many qualified voices, but only one member who has a vote. His investment committee had lots of discussion and gave significant input, but the individual with authority could always act timely and decisively.

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