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On Watch

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Making it Real After the (Liquidity) Thrill is Gone

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In This Issue:

Making it Real After the (Liquidity) Thrill is Gone

Counsel About Councils

Following is a summary of my annual strategy piece, the spring 2011 edition of Sentinel Horizons.

The macro views sharpened in the process of producing *Horizons* provide a top-down perspective that reinforces or challenges our bottom-up valuation work. Both are necessary in implementing our philosophy that valuation sensitivity in investment decisions, both within and across asset classes, is critical to reducing risk and increasing returns over the long term.

When learning to drive a car, you may remember the tendency to focus only on what is immediately in front, particularly in stressful situations. Over time, we learn the value of looking farther down the road and checking the mirrors, while still alert for potholes just ahead. Investors today, shellshocked with the market turmoil of the last few years, appear to assume that the current favorable conditions will continue. They would benefit from checking what is happening in other markets, tracking the route already traveled and lifting their gaze to check the signs. Today's popular investments are not nearly as attractive as they appear and conditions will deteriorate as interest rates increase.

Story continued inside ...

Story continued from front ...

Bullish Investors

Most investors today are quite bullish on equities given the continued economic recovery, positive earnings surprises and favorable liquidity support from the Federal Reserve. Most importantly, despite the market's near doubling from March 2009 lows, price/earnings ratios still seem reasonable and stocks look much more attractive than bonds. Investors continue to find the high yield bond market attractive despite its strong performance since corporate profits are high, default rates are low and valuations seem attractive. Worried about inflation as the Fed continues to print money, investors are seeking non-US investments such as foreign stocks and commodities that benefit from the ongoing global recovery, accelerating inflation and a weaker dollar. They find advanced economies attractive because the Euro Zone contagion appears contained. They also find emerging economy stocks attractive because they believe that their high inflation and interest rates are poised to fall.

Interest-Rate Tightening

While understandable, this extrapolation of current favorable conditions going forward is dangerous because it gives investors a false sense of security, particularly since many investments lose their apparent valuation appeal when viewed in a historical context. A check of other countries reveals that while we speak of an ongoing recovery, global growth rates have already peaked, especially in Asia, where interest rates (outside Japan) remain too low relative to inflation rates. While this unusual state of affairs has helped the recovery, it is already beginning to end. The central banks of China and other emerging countries have been insufficiently proactive in fighting inflation and will further increase interest rates to slow their economies. Having waited too long and afraid to tighten too much, a period of higher interest rates and inflation will result and persist for longer than expected, with a dampening effect on growth.

Viewed in this global context, one can appreciate just how unusual and unsustainable US monetary policy remains. Fed Chairman Bernanke is dovish on inflation to the point of irresponsibility, even by the inherently low standards of the Fed's dual mandate to support growth as much as to control inflation. Accordingly, investors are highly dependent on "The Bernanke Put," with its implicit promise of at least six month's notice prior to any actual rate increase. Although Bernanke will wait until early 2012 before raising interest rates, I believe he subsequently will be forced to tighten faster than he would like, as a) core inflation rises and b) recognition grows that the Fed's target unemployment rate should be much closer to 7% than Bernanke's 5%, given the high levels of structural unemployment. As Fed communication changes in preparation for rate rises to come, the effect on markets could be dramatic given investor expectations of seemingly endless accommodation.

Currency Considerations and Global Equities

The currency markets may be most impacted, partly because sentiment towards the dollar is so negative (with the currency close to three-year lows) and partly because the fixed income market has (surprisingly) already priced in an early 2012 rate increase and is, therefore, ahead of Bernanke in that respect. The dollar remains a structurally weak currency weighed down in the long run by the Fed's dual mandate. That weakness is exacerbated in the short run by both Bernanke's ultra-dovish views and Obama's lack of fiscal leadership. However, the dollar has fundamental appeal at this time, being undervalued by more than 20%. Given its increasing use by leveraged investors as a "funding currency," the dollar could spike should either short-run factor change. Should neither change, Treasury bonds could plummet, as current government bond yields offer little protection against concerns over either rising inflation rates or government debt levels.

These currency considerations color my global equity views. On one hand, international equities have more attractive valuations than their US counterparts. On the other, the dollar should rebound and turmoil should once again return to the Euro zone, making US equities more attractive. Having said that, our internal equity research shows domestic equities to be modestly overvalued, despite seemingly low P/E multiples and a remarkably tempting comparison of earnings yields versus bond yields. The reason is that, since corporate profit margins are at record highs, future earnings growth seems capped at close to nominal GDP growth rates. The implication is that P/E ratios need to be low to compensate for these subpar growth prospects. Within the market, large caps are more attractive, but not as much as one might think since large cap margins are already at peak levels.

As to Europe, the good news is that central bank liquidity support has purchased the time needed for bank recapitalizations and for the less competitive parts of Europe to implement structural reforms. Unfortunately, liquidity does not equal solvency. While Ireland, Greece and Portugal will avoid formal

debt restructurings until after 2013, the value of their debt will decline sharply in the interim. This development, when coupled with ratings downgrades and disappointing real estate loan-loss news from Spain, will trigger another round of Euro zone turmoil. While its debt problem appears manageable, Spain and the less competitive parts of Europe will struggle with a continued high Euro. In that sense, they are highly sensitive to the strength of the US economy since they would benefit from the resulting strengthening dollar.

Japan continues to be the cheapest developed market, but its intermediate term fiscal problem could weigh on its bond market. Russia, with its energy holdings, remains an attractive hedge on Middle East political-event risk. Brazil and (especially) Australia remain unattractive due to their extreme levels of currency overvaluation. Despite rising rates and unattractive valuations, I am upgrading China to neutral as its undervalued currency has been dragged down by the weak dollar.

High Yield Debt

I disagree with the bullish consensus on high yield debt. It is true that corporations are liquid, the Fed is on hold, credit spreads are reasonable, and near-term default rates are unusually low. However, the problem lies in the assumption that the out-year credit spread will remain at current levels. This seems optimistic given that the next credit downturn will occur when recently issued low quality debt matures. That will occur at a time when fiscal and monetary conditions will be much less supportive.

Although tempted to make higher yielding municipal bonds our single best idea since valuations look exceptionally attractive, I am concerned that the ratings agencies are behind the curve in terms of fully reflecting retiree benefit obligations in their analysis. Upcoming downgrades will prevent overall sector spreads from tightening, capping the upside of what should be a great bond-picking market. Active managers in higher yield segments should be accessed through separate account or partnership structures as opposed to mutual funds due to the latter's risk of forced sales to fund redemptions.

Alternative Investments

Alternative investments, public and private, become partial substitutes for sub-par prospects in traditional long-only asset classes and for access to attractive niche areas. Since stocks are not cheap, directional hedge funds offer an attractive risk/reward, particularly given the low cost of downside protection. Long/short equity funds with little net market exposure should do well and are needed diversifiers given the lack of fixed income opportunities. While the leveraged buyout segment proffers attractive pro-forma returns, some degree of patience is warranted as deal pricing has escalated. Niche mezzanine strategies can take advantage of regional bank lending reticence and a surplus of equity capital for lower middle market deals.

Emerging Market Currencies

Emerging market local-currency bonds are unattractive, mostly due to low yields. In addition, as shown in the graph, emerging market currencies are no longer undervalued from a long-term purchasing parity perspective (relative to the dollar) following the recovery of the last two years.

■ JP Morgan Emerging Market Currency Index

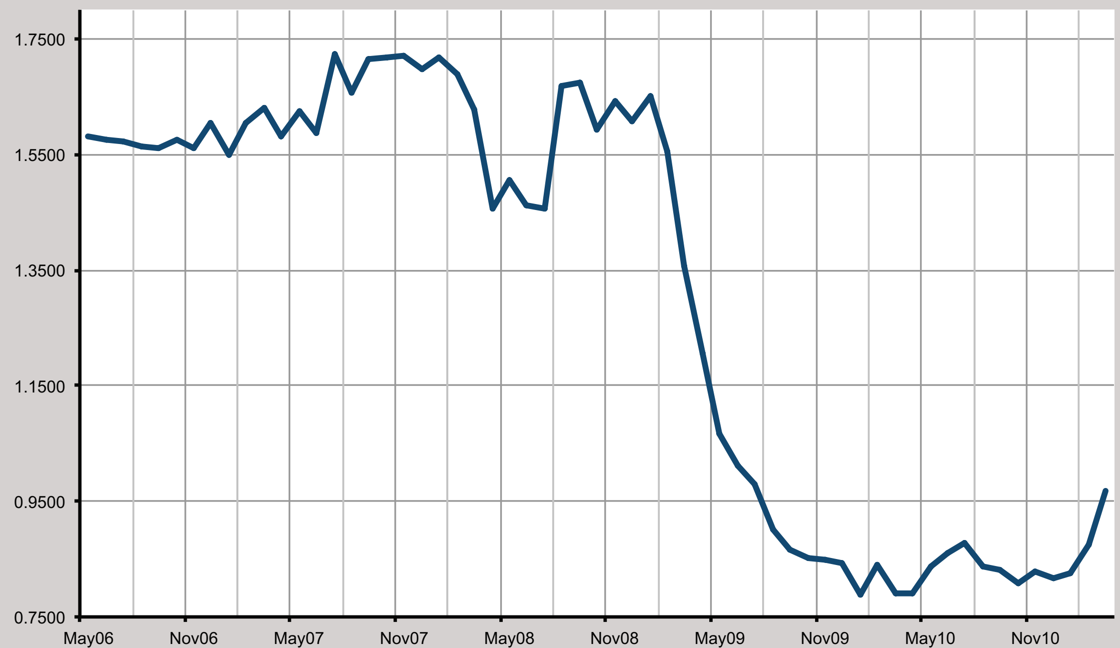
Source: Bloomberg Finance L.P.

High Yield Corporates vs Municipals

Investment grade municipal bonds yield more than corporate non-investment grade debt (junk bonds) even before adjusting for taxes.

■ High Yield Corporate Rate as a Percentage of High Yield Municipal (15 Year BB)

Source: Bloomberg Finance L.P.



The private real estate market has confounded opportunistic investors to the point where it may be better to be a seller in the apartment and the leading gateway city markets. We would rather target distressed opportunities involving maturing bank loans, including smaller deals where capital can be injected to create a low cost-basis-equity position, as well as various housing related plays, where we are less negative than consensus. I feel that attractive fundamental housing values offset the weight of the foreclosure pipeline and the change in credit standards from pre-crash levels. As one of the few domestic asset classes seemingly priced at a discount, distressed housing-related investments may be an attractive multi-year play on the employment recovery.

What to Do?

Our primary tool for tactically positioning client portfolios is the relative attraction of various asset classes on a valuation basis. Although performance and headline valuation metrics remain positive for most asset classes, it is appropriate to ease off the accelerator by reducing long-only exposure in front of a change in Fed orientation. International investments, especially in overvalued commodity-currency countries, are vulnerable to a spike in an undervalued dollar.

Starved for fixed income opportunities, municipal bond exposure can be supplemented with low-net long/short hedge funds as an alternative portfolio anchor. Private mezzanine debt may be added to enhance yields.

More directional hedge fund strategies help fill the portfolio's "equity gap," including those benefitting from an expected pick-up in volatility. Funds in the activist space may be used as partial substitutes for leveraged buyout investments, where pricing has escalated. Illiquid real estate investments should target distressed opportunities in smaller deals outside of the popular gateway markets. Atypically, consider residential real estate plays, as we are less negative than consensus.

Each year, the economic issues reflected in *Horizons* either reinforce or dilute our bottom-up valuation-based calls. This year, our somewhat more pessimistic views expressed in *Horizons* tend to confirm conclusions from Sentinel's other valuation-based work.

For a full copy of Sentinel Horizons, please contact Anthony DeToto at adetoto@sentineltrust.com or 713.559.9578.

Counsel About Councils

A family patriarch recently asked us several questions about the use and operation of a family council. We thought we'd share some of our responses with you.

A family council is an organized approach to facilitate family communication, education and public relations. Whether the family owns an operating business or shares substantial investment assets, the council offers a mechanism for the family to reach consensus on its philosophies and provide coordinated input to those who manage the family's wealth. Smaller families might use periodic informal family meetings, while larger families, particularly those with members who do not work in the business/ wealth management, add a level of structure by progressing from meetings to a more formal council approach.

ANTHONY J. DETOTO
Senior Vice President

What are your suggestions for expectations for a family council?

Many business/investment leaders approach formation of a family council with at least a bit of trepidation. They worry about what participants might do with the information that is provided to them. They fear that the forum will be used by disgruntled members to voice grievances and build alliances. It may seem easier just to let sleeping dogs lie.

Our experience is just the opposite. Properly run, a family council permits and encourages members to participate in constructive discussion. Members learn to communicate and compromise when there are disagreements. They learn to work together on issues that are important to the family and to the business. You and the family should have high expectations for the council, but it will require work and an open mind to meet those expectations.

Leaders should expect lots of questions and maybe some tension on subjects that they probably already know about. Expect some good ideas and input, perhaps even from sources from which you least expect it. Members should expect to be allowed to express their views, but should not expect to get everything they want. Over time, both leaders and members should expect an improved level of mutual understanding, accommodation of differing viewpoints, and enhanced family harmony.

What should be the boundaries between being an owner of wealth and micro-managing the operations?

For most families, boundaries can be set only after education and discussion. Initial educational topics often include developing awareness of the differing roles, rights and responsibilities of owners, directors and officers. Members become aware that shareholders do not (and should not) manage or micromanage the business, but must rely on officers for that role. They must be confident that the officers are subject to appropriate oversight, which emphasizes the importance of a functioning board of directors that contains objective and independent members.

Because owners naturally desire to have input and to be informed, the family council structure provides the mechanism for two-way communication. Meetings can be used to provide information about company financials and new product lines or services. They also provide a forum to air family concerns and ideas and to design ways to resolve conflict.

What are best practices around financial reporting, as well as defining the metrics that will be reported to the owners via the family council — as opposed to the board — as well as what will not be reported.

At the outset, it is important to understand that family members will have varying levels of business, accounting and financial backgrounds necessary to understand information that is provided in the family council. They may not understand what is important and material to them as owners. Education may be required to bring them all up to speed.

We recommend erring on the side of providing more, rather than less, information. Actual and perceived transparency is critical to building trust. Leaders should strive toward making financial disclosures as detailed as a public company makes to its shareholders. They should help owners understand what is important in these disclosures.

One objective of a family council is to build enthusiasm for the company. Discussing new product plans, new investment undertakings, charitable activities and the like can go much further in developing and sustaining committed owners than bland historical financial statements.

Most important is that all members hear the same information at the same time so that rumors are dispelled, hidden agendas tossed aside and everyone's fears allayed.

There certainly will be overlap between information presented to the board and the council. Many business leaders share portions of board presentations at council meetings. However, keep in mind the differences between a board's responsibilities and interests (e.g., management oversight, strategic direction, etc.) and those of family ownership (e.g., philosophical direction, long-term financial stability, return on investment, etc.).

For additional information, please contact Anthony DeToto at adetoto@sentineltrust.com or 713.559.9578

Sentinel Trust Company provides custom integrated planning, investment, fiduciary and administrative solutions to affluent families and their closely held businesses and entities.

Founded in 1997 as the successor to two 40-year old, investment-focused family offices, today Sentinel offers the stability of an institutional firm, the entrepreneurial spirit of a young firm, the personal feel of a family office and the in-house technical skills of independent planning and investment management firms.

For further information, please contact Anthony DeToto, Senior Vice President, at adetoto@sentineltrust.com or 713.559.9578.

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