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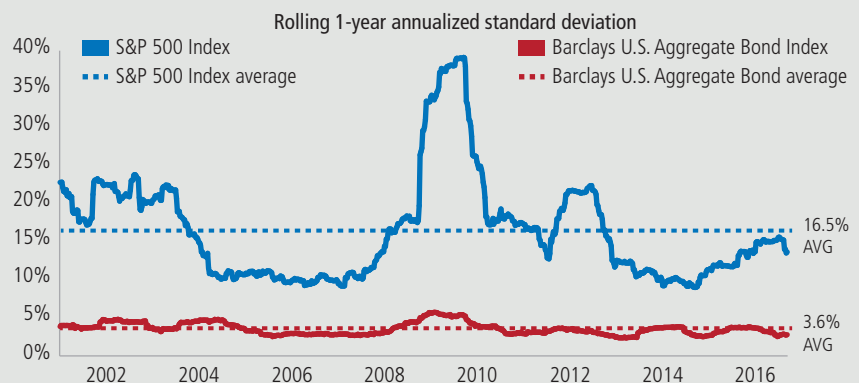
STOCKS ARE NOT THE NEW BONDS

2016 has been notable for droughts in some places and floods in others. There has been a disconnect, if you will, in normal weather patterns. Lately, we have witnessed a growing disconnect in the financial markets too. Asset class after asset class continues to rise in value despite stagnant global economic growth and flagging corporate profits. Why are investors chasing the market higher? Extraordinarily accommodative central bank policies are the most likely explanation. With a large fraction of the world's pool of government bond yields in negative territory, flows that normally would have gone into high-quality fixed income securities are instead finding a home in dividend-paying stocks. This "chase for yield" has pushed up traditional high-dividend payers like real estate investment trusts (REITs), utilities and telecom stocks to historically rich price/earnings multiples. This is the most concrete evidence we have seen in years that investors are substituting stocks for bonds in investment portfolios.

Bonds: Accept no substitute

There are two powerful reasons why stocks are not a substitute for bonds. The first is the relative volatility of the two asset classes. Stocks are historically about three times as volatile as bonds. Investors therefore demand higher returns in exchange for holding these riskier assets. Second, dividend payments to stockholders are not a contractual obligation; there is no legal compunction for corporations to continue to pay dividends. Dividend payments can be — and often are — cut at the first hint of trouble.

Exhibit 1: Stocks much more volatile than bonds



Source: Factset & IBES 1/1/02 – 9/9/16.

Stock investors need to be particularly mindful of potential economic inflection points. History has shown that markets often become the most euphoric at the most perilous point in the economic cycle. The current US economic expansion is now in its eighth year, while the average business cycle typically lasts five years. The stock market has historically peaked 6–8 months before a recession begins, though forecasting recessions is always challenging. When recessions do hit, corporate profits have fallen by an average of 26% and stock markets have typically fallen by roughly the same amount. Failing to avoid late-cycle euphoria can have severe costs for investors, especially for investors who have been driven into equities for the wrong reasons.

Don't be late

Instead of being an equity market latecomer, yield-starved investors might want to consider adding "credit," or corporate bonds, to their investment portfolios. Pools of investment-grade

corporate bonds are currently not cheap by historic standards, but they are not at extremely rich price levels either. Investors seeking yield can find attractive opportunities in corporate credit, which offers yields similar to or higher than equity dividends, but generally with far less volatility.

Global central banks have been providing novel forms of support for world bond markets with the aim of stimulating economic growth and inflation rates. But in my opinion, sound investment strategy does not include guessing where central bank policy is heading next. The guiding principles of preserving capital while generating growth are vigilance on the fundamentals, caution regarding gains, and the avoidance of fads. Don't follow raw market emotion, especially when easy money causes the temperature of the markets to rise just as fundamentals fall.

Past performance is no guarantee of future results.

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