CLEARPOINT

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THE TIMES THEY ARE A-CHANGIN'

BY TOM SEAY, MANAGING DIRECTOR, RESEARCH

It is not often that I quote Bob Dylan when discussing financial markets, but 2018 exposed many evolving changes over the past few years that are having a material effect on the economy and the markets. I'm going to explore a few areas that have witnessed some serious changes over the years. During my career, General Electric has gone from being one of Corporate America's leading citizens to an organization lacking a clear vision of its future. To be listed on the New York Stock Exchange was once emblematic of a company's success. Today, the regulatory burdens of being public and the financial incentives available to senior management make going private an attractive alternative. Once stocks were owned because one believed in the value of the company and its future; today's investors may be driven by computers using algorithmic trading programs with little regard for company fundamentals. Despite these alterations, however, I continue to believe fundamentals will drive long-term success.

GENERAL ELECTRIC

Formed in 1892 through the merger of Thomas Edison's Edison General Electric and the Thomson-Houston Electric Company, General Electric (GE) would grow to dominate everything to do with electricity[1]. It built the plants to create electricity, the wirelines that carried the power, and the appliances that used this power to cook toast, clean clothes, and cool homes. With operations in 130 countries and over 300,000 employees, GE remains a force to this day[1].

EMBRACING UNCERTAINTIES

The fourth quarter of 2018 saw the return of equity market volatility, with December being one of the worst months for the S&P 500 Index in many decades. The gyrations in the markets reflect the uncertainties that lie ahead of us. Certainly, the headlines of continued trade disputes, guesses about the Federal Reserve's future rate hikes, and the appearance of a global economic slowdown have all contributed to the nervousness that seems to have pervaded the markets in recent weeks.

Let us not forget that uncertainty is all around us, all the time, even when the markets are going up. Therefore, embracing uncertainty is an integral part of being an investor. Amidst these unknowns, an investor can have confidence in a sound investment strategy that can navigate through various market cycles. While it may feel like a drag to be diversified when the equity markets run up, a risk-appropriate portfolio mitigates the impact of severe downshifts in equity markets. This month's ClearPoint stresses the importance of fundamentals to long-term success, despite the constant changes around us... all the

But today's GE is not the financial powerhouse of its past. When the Dow Jones Industrial Average was created on May 26, 1896, GE was one of twelve companies on the original list. On June 26, 2018, GE was removed from the Dow[2] and "… was replaced by Walgreens Boots Alliance Inc., a drugstore chain with a market capitalization half as big as GE's"[3]. GE's stock price peaked on September 9, 2009, at $57.81 and closed 2018 at $7.57.

The credit markets have also opined on General Electric. Since 1956, GE had been rated "AAA" by Standard & Poor's (S&P); however, in 2009, GE lost its "AAA" credit rating[4], which was only the beginning of GE's slide down the rating's ladder. On October 1, 2018, S&P lowered GE's credit rating to "BBB+", just three notches above junk status[5]. By month's end, Moody's would follow with its downgrade to "Baa1"[6]. GE is a prime example of the fall of a mighty corporation and a reminder that no institution is immune to changes. (For a good read on GE's fall, I would guide you to the Wall Street Journal's article *GE Powered the American Century – Then It Burned Out*, December 14, 2018.)

THE DECLINE IN CREDIT RATINGS

GE is not alone when it comes to credit rating downgrades. In 1992, S&P rated 98 United States companies "AAA"[4] and today there are only two – Johnson & Johnson and Microsoft. (Let's not forget that on August 5, 2011, S&P announced its decision to cut the rating on U.S. Treasury debt from "AAA" to "AA+"[7].)

An analysis of the Bloomberg Barclay's Global Family of Indices shows a dramatic shift in the quality of investment grade U.S. publicly traded credit.

	January 2000[(1)]	November 2017[(2)]
AAA	7%	9%
AA	19%	10%
A	44%	36%
BBB	30%	45%

Source: [(1)] Lehman Brothers Global Family of Indices, January 2000
[(2)] Bloomberg Barclay's Global Family of Indices

Although the size of the U.S. investment grade corporate debt remains substantially larger than the U.S. corporate high yield market ($5.0 trillion vs. $1.2 trillion), the concern is if a large "BBB" rated credit (e.g. GE) would be downgraded to "junk" status. The major U.S. dollar indices include about $42 billion of GE's debt, about 3.5% of the U.S. dollar high yield bond index[8]. Downgrading $42 billion of GE debt to high yield would represent about 25% of the 2018 new issuance in the high yield market[8], a rather difficult pill to swallow! Credit rating upgrades and downgrades are a constant in the bond market, but Corporate America has become comfortable carrying a heavier debt load and investors have learned how to invest in highly levered companies.

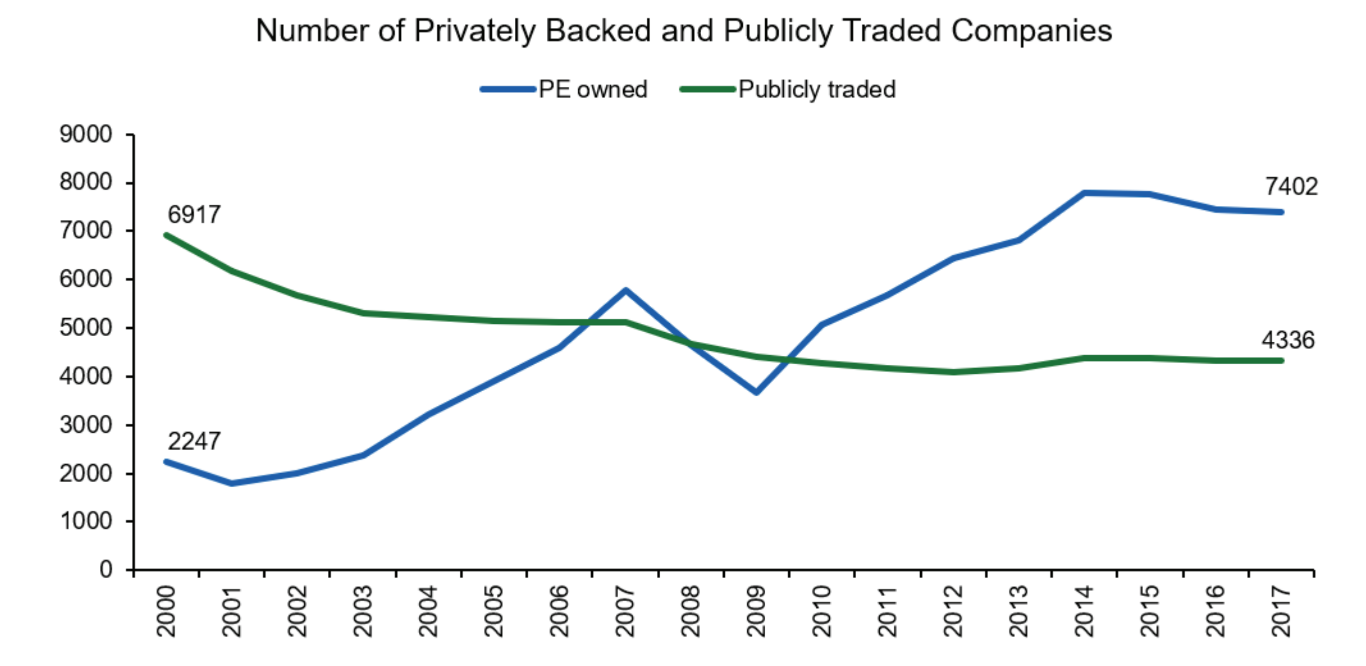
LET'S GO PRIVATE

Warren Buffett states that the best indicator of stock valuations is the total market capitalization of all U.S. stocks relative to the country's GDP. The most

more reason to stick to the plan and remain invested through the turbulence.

widely accepted source for total market capitalization is the Wilshire 5000 Total Market Index. The index was named for the nearly 5,000 stocks it contained when launched in 1970. Interestingly, as of September 30, 2018, there were only 3,582 securities in the index[9].

According to Cambridge Associates, "Over the past 20 years, the number of publicly listed U.S. companies has been nearly cut in half, from a peak of 8,090 in 1996 to 4,331 at the end of 2016, with delistings outpacing new listings in all but one year over this period"[10]. The decline in public listings is due to companies going out-of-business, mergers and acquisitions, or the desire to go private. As the following chart shows, the growth of U.S. private-equity owned companies now surpasses U.S. listed companies.



Source: World Bank, Pitchbook

Another major driver of the growth of private over public listings is the decline in initial public offerings (IPOs). IPOs peaked at 815 in 1996[10], prior to the tremendous growth of passive investing. Per Cambridge Associates, "Since 2007, overall inflows into index funds and ETFs (passive strategies) have surpassed $1.3 trillion, compared to $1.7 trillion in outflows from actively managed funds." The problem for IPOs is that passive strategies do not participate in IPOs. With passive strategies not participating in IPOs, combined with the hassle and cost of being a public company, the number of IPOs since 2015 has not surpassed 200 in any calendar year[11], affecting the make-up of the publicly investable universe and increasing the interest in private equity investments.

THE RISE OF PASSIVE INVESTING

Passive investing has not only affected the IPO market, but it has dramatically changed the structure of the financial markets: "As of December 2017, passive funds accounted for 37 percent of combined U.S. MF (mutual fund) and ETF assets under management (AUM), up from three percent in 1995, and 14 percent in 2005. This shift for MFs and ETFs has occurred across asset classes: Passive funds made up 45 percent of the AUM in equity funds and 26 percent for bond funds at the end of 2017, whereas both shares were less than five percent in 1995"[12]. As the chart on the following page shows, the growth in passive equity AUM has come at the expense of active management.

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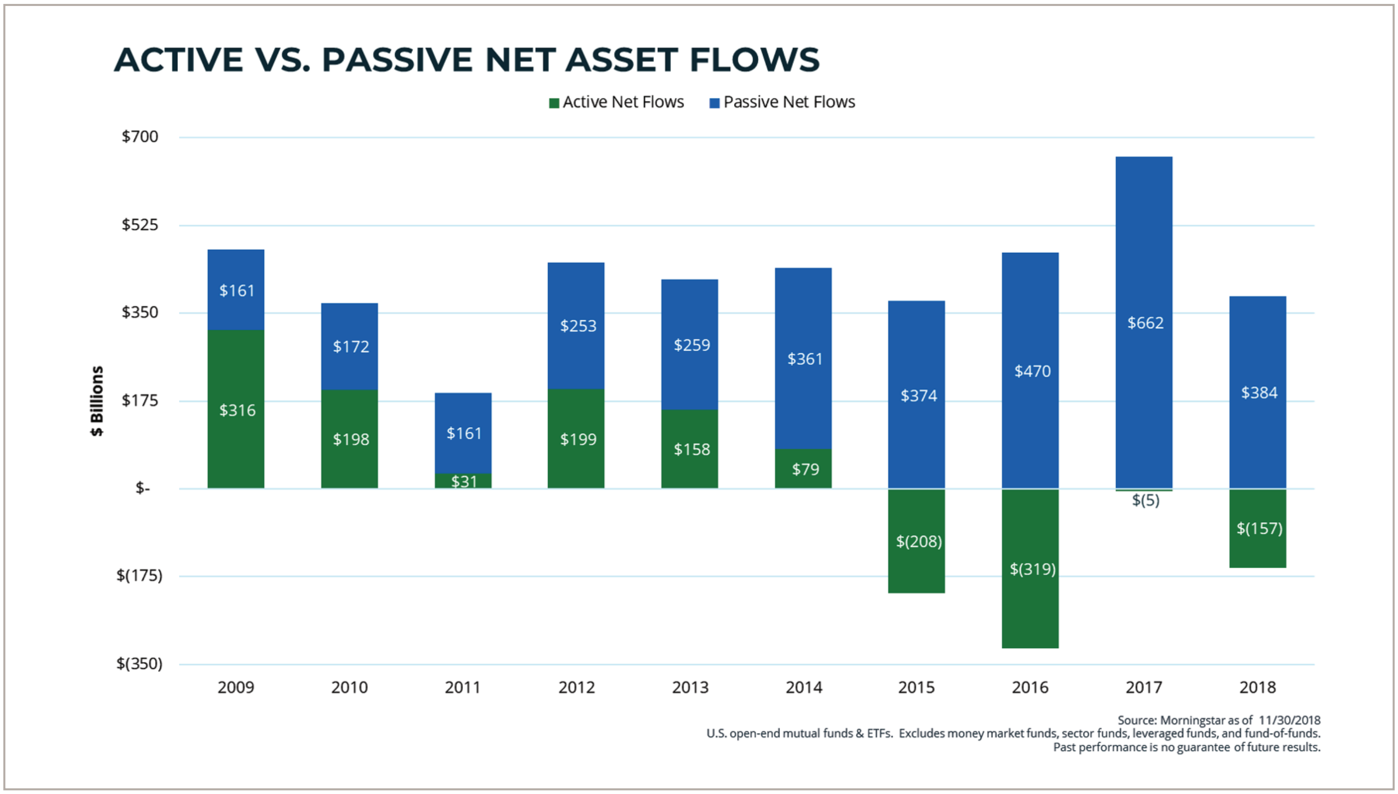

By default, passive investing is essentially a momentum- or trend-following strategy. Passive funds buy when fund flows are positive and sell when fund flows are negative. No fundamental analysis or company research is necessary, the funds just buy and sell as needed. But as Epoch Investment Partners states, "... passive *investing* does not equate to passive *investors*"[13]. The following chart shows the implied average holding period for the ten sector SPDR ETFs offered by State Street Global Advisors. What is clear from this is analysis is that these ETF investors, on average, have a short-term trading horizon.

	12/31/2016 Market Cap in Billions	Average 2016 Daily Turnover	Implied Average Holding Period (# of trading days)
Financial Select Sector SPDR	$22.47	6.79%	15
Energy Select Sector SPDR	$17.59	8.64%	12
Technology Select Sector SPDR	$14.14	3.68%	27
Health Care Select Sector SPDR	$13.51	6.01%	17
Consumer Discretionary Select Sector SPDR	$10.82	4.88%	20
Industrial Select Sector SPDR	$10.17	9.53%	10
Consumer Staples Select Sector SPDR	$8.31	7.58%	13
Utilities Select Sector ETF	$6.90	10.23%	10
Materials Select Sector ETF	$3.65	10.80%	9
Real Estate Select Sector ETF	$2.31	2.33%	43

Source: Epoch Investment Partners, Inc., *The Impact of Passive Investing on Market Efficiency*, May 2017

This short-term trading mentality equates to significant representation of U.S. stock market trading volume. Although U.S. ETFs account for roughly 15% of the of U.S. equity markets assets, trading in ETFs usually accounts for about a quarter of the daily volume in U.S. stock markets, and that can leap to nearly 40 percent on some days[14]. When one combines the equity trading volumes from the various trend following strategies (e.g. quant, passive index funds and ETFs, futures and option-related strategies), J.P. Morgan estimates that 90% of current equity trading volume comes from trading decisions that are often driven by algorithmic or programmatic reasons rather than fundamental ones.[15]

CONCLUSION

At year-end of 2017 there were almost as many U.S. equity mutual funds and ETFs (4,234) as there are U.S. listed companies (4,336)[16]. The types of investment strategies behind all these investment products can have significantly different reasons to buy or sell a stock and the time horizon to determine success. The challenge is to discern the short-term noise driving the markets from the fundamentals that will deliver success over the long-term.

The final days of 2018 were some of the most startling days in the Dow Jones Industrial Average pricing that I have witnessed. Ebenezer Scrooge gave us a down 653 point Christmas Eve present only to be followed on Boxing Day with a 1086 point rally. This type of trading was typical for what we experienced throughout the year's final quarter. It is difficult to pinpoint a specific culprit for such volatility – trade war, government shut down, Fed policy – because the economic data and company fundamentals have been favorable and should be supportive for financial assets.

Yes, Bob Dylan might be right and *The Times They Are A-Changin'*, but financial markets are constantly innovating. Apple might be my son's GE and, although GE's credit rating has declined to "BBB+", Apple's is a solid "AA+". We are cognizant of the impact of programed trading that merely follows the trend and can be the cause of market volatility. We are aware that Corporate America is changing; it is willing to go private and carry a greater debt load. But, we are not casual investors and we do not grieve for the good old days. Instead, our passion for the markets and curiosity to discover, we believe, will lead us to investments that help our clients meet their goals.

Sources:

(1) General Electric website.

(2) Money-Zine.com, October 24, 2018.

(3) Wall Street Journal, *GE Powered the American Century – Then it Burned Out*, December 14, 2018.

(4) FT.com, May 24, 2016.

(5) Reuters, October 2, 2018.

(6) Moody's, October 31, 2018.

(7) Standard & Poor's, August 5, 2011.

(8) Shenkman Capital Management, Inc., *Investment Note*, November 2018.

(9) Wilshire.com, *Wilshire 5000 Total Market Index Fact Sheet*, September 30, 2018.

(10) Cambridge Associates, *CA Answers: Is Private Equity Replacing Public Equity?* November 2017.

(11) statista.com, The Statistics Portal, *Number of IPOs in the United States from 1999 to 2017*.

(12) Federal Reserve Bank of Boston, *The Shift from Active to Passive Investing: Potential Risks to Financial Stability?* August 27, 2018.

(13) Epoch Investment Partners, Inc., *The Impact of Passive Investing on Market Efficiency,* May 2017.

(14) Bloomberg, *How ETFs Became the Market*, September 13, 2018.

(15) Polen Capital, *Outperformance in the Next Bear Market?* December 2018.

(16) Qz.com, *There are now almost as many equity funds as there are stocks for them to invest in*, May 9, 2018.

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MARKET BENCHMARK RETURNS

December 31, 2018		1M	3M	12M	YTD
US Large Cap	S&P 500	-9.0%	-13.5%	-4.4%	-4.4%
US Small Cap	Russell 2000	-11.9%	-20.2%	-11.0%	-11.0%
Developed Intl	MSCI EAFE	-4.9%	-12.5%	-13.8%	-13.8%
Emerging Intl	MSCI Em Mkt	-2.7%	-7.5%	-14.6%	-14.6%
Real Estate	NAREIT	-7.7%	-6.1%	-4.4%	-4.4%
Core Fixed	BarCap Agg	1.8%	1.6%	0.0%	0.0%
Short Fixed	BarCap 1-3Yr	0.8%	1.2%	1.6%	1.6%
Long Fixed	BarCap LT G/C	3.7%	0.8%	-4.7%	-4.7%
Corp Debt	BarCap Corp	1.5%	0.0%	-2.1%	-2.1%

Source: Bloomberg

The performance data shown represent past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.