COLUMBIA THREADNEEDLE INVESTMENTS

An asset allocation expert answers top financial advisor questions

May 7, 2018

Jeff Knight recently spoke to a group of financial advisors about the biggest market risks, the possibility of a recession and the risk of agreeing with everyone else.

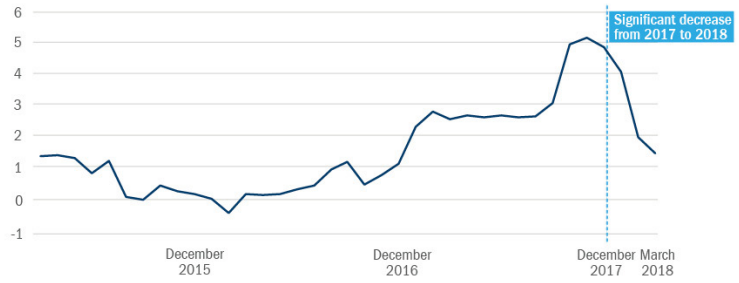
Advisor: What's the biggest challenge with portfolio construction in 2018?

Jeff: One of the major questions investors need to answer is how much risk they want coming from equity. It's a central question this year because there's been a very pronounced shift in equities' efficiency and risk-adjusted attractiveness from last year.

A way to measure this change is by looking at the Sharpe ratio — a measure that adjusts returns based on the amount of risk taken to achieve them. In 2017, the average one-year rolling Sharpe ratio for the S&P 500 Index was close to 3. Returns were near 20% and risk (measured by standard deviation) was about 6%. You can interpret this to mean that for every unit of risk taken, equities had three units of return. But looking at the same measure this year, the Sharpe ratio is no longer 3 — it's barely positive, and with the way markets are trading, it could be negative on any given day.[1]

Equity investors are getting less return per unit of risk

S&P 500 Index rolling one-year Sharpe ratio, March 2015—March 2018



Source: Morningstar Direct, Columbia Threadneedle Investments as of 03/31/18

Jeffery L. Knight
Global Head of Investment Solutions and Co-Head oof Global Asset Allocation

Advisor: Do you expect a recession?

Jeff: We don't think we'll see a 2018 recession in the U.S. or in any major player in the global economy, and our outlook is based on a couple of observations. First, we track Purchasing Managers Index, which is a composite of monthly survey responses that tends to correlate very strongly with global economic activity. The most recent snapshot tells us that across 30 countries, every one of them was in expansion mode. So, it's unlikely that a recession would just spontaneously occur. Second, we have an internal model we refer to as the investment clock that maps the prevailing economic conditions into one of four quadrants: expansion, slowdown, contraction and recovery. Our investment clock model has shown expansion in the U.S. and worldwide for several months in a row. It would take a lot of economic deterioration to move us to a different quadrant, and even more deterioration to move us straight to contraction.

Advisor: Most financial market experts agree with you that a recession isn't likely this year. What's the risk of agreeing with the consensus?

Jeff: Whenever there's such a strong consensus, it means that the consequence of anything happening other than the consensus opinion is harsher. What would it look like if the consensus is wrong? For example, if the Fed were to hike interest rates very aggressively very early or if a trade war broke out on a large scale, it could increase the risk of a recession. The point is that we agree with the consensus views but recognize that a departure from these views could introduce downside risk. That's why we position portfolios to mitigate the downside risk. Even if nothing bad happens, having diversifying assets in a portfolio that help manage downside risk helps to alleviate concerns about the what-ifs.

Advisor: What do you see as the biggest risk to markets?

Jeff: The major risk we see is if the Fed were to make a policy mistake and raise interest rates too much. Particularly if its actions were to invert the yield curve, which is an unusual situation in which short-term rates are higher than long-term rates. We think there will be two more rate hikes this year and believe that's about all the U.S. economy can tolerate. If we see a third hike, we would be concerned that it would elevate the risk of a yield curve inversion.

Advisor: How do your political views play into your portfolio recommendations?

Jeff: The short answer is they shouldn't, and they don't. This is an environment of extreme and polarizing political commentary. In my opinion, political passion makes it easy to allow a rooting interest to skew analysis, so that news flow gets interpreted to suit one's political tastes. This has been an expensive way to make portfolio decisions in the last several years because prognostications of doom and gloom have often not matched the facts nor financial market outcomes. For example, if you had gotten out of the market after Brexit or President Trump's victory, you would have missed periods of quite strong returns. Investment decisions should be focused on actual policy, and on facts that change the intrinsic value of the security under consideration. All that other stuff — the rooting interests — can be saved for Twitter.

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Bottom line

Last year was exceptional, and 2018 won't deliver the same exceptional results. But there is global synchronized growth, we don't expect a recession in the near-term and the value proposition of equities still looks pretty good compared with other asset classes such as bonds. In this environment, we continue to support a diversified strategy that features a material allocation to global equities.

1 Source Columbia Threadneedle Investments as of March 31, 2018.

The S&P 500 Index tracks the performance of 500 widely held, large capitalization U.S. stocks.

It is not possible to invest directly in an index.

Sharpe Ratio divides a return in excess of the 90-day Treasury bill by the standard deviation to measure risk-adjusted performance.

Standard Deviation is a statistical measure of the degree to which an individual value in a probability distribution tends to vary from the mean of the distribution.

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CTBPBVN6 (5/18) 2108341