CONWAY• JARVIS LLC
Investment Outlook

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Conservative Investors Caught in the Middle

The Total Return Strategy

The Middle. Some call it between a rock and a hard place. It's where a growing number of *conservative* investors find themselves today: In need of a return on their capital, but repulsed by the paltry returns offered in the bond market and unwilling to increase stock allocations amid predictions of global economic ruin. For them, neither asset class presents a compelling risk/reward proposition. No question, it's difficult to advance the case for stocks when storm clouds are on the horizon. But ask yourself when that isn't the case? There is always something to worry about and experts will tell you to bury your money in treasury bonds or a mason jar in the back yard. That's a luxury for those that have an over-funded retirement plan but definitely not a successful strategy for investors who need a return on their capital to fund their life plans. Where can they go to find a decent rate of return?

We think history provides a lesson. This isn't the first time the stock market has been mired in a lengthy, slow-growth recovery arising from dire economic conditions and self-inflicted fiscal policy wounds. The 70's marked the emergence of a strategy that plied the middle ground for conservative investors willing to accept a tolerable measure of stock market risk in exchange for cash flow from dividends paid by high-quality, "blue chip" companies. These conservative investors had a target rate of return in mind that was lower than the indexes might offer. The theory was that they were giving up relative out-performance in exchange for predictable dividend flow and lower volatility.

The theory proved true in the second half of that decade and the "total return" strategy rose to prominence. At the time, dividends contributed a historically large proportion of return to investors since stock returns were falling far short of their historical benchmarks. Stock yields looked even more attractive to investors who saw their bond funds tank in the face of rising interest rates triggered by the Fed's fight against inflation. It was a tough time for investors who wanted to get out of harm's way. In the end, those who accepted a modicum of risk through the total return strategy fared better than most until interest rates peaked and the bull market of 1982 began to reward growth investors once again.

We see a number of similarities between the current recovery and that of the 70's. Investors suffered from eroding confidence in their leaders, a major bear market, and geo-political events unseen in their lifetimes. Sound familiar? In the aftermath of the 2008 meltdown, we saw this recovery extending further in time and at a slower pace than most experts were predicting. Today, that view is far more popular and the total return approach has become a widely touted strategy. Despite that, there are still opportunities out there in the value/income category. It should be noted that these stocks are likely to correlate with a market falling on geo-political events or fears of systemic risk emerging again. Investors should take comfort in the fact that the companies they own will still be in business when the dust clears and, unlike some European governments, the dividend checks they issue won't bounce.

The Transition Ahead

The total return strategy is a *temporary* compromise for those investors who would normally commit capital to bonds as part of a balanced account. Their stated portfolio objective is a target rate of return for a portfolio of stocks and bonds. At the present time they're feeling compelled to substitute value/income stocks for bonds in order to meet those target rates of return. There will be a time when short to intermediate term bonds once again present a reasonable value proposition.

A number of things have to happen first. Most immediate of those is the creation of a blueprint for sustainable operating budgets for the Euro-Union and a successful restructuring of outstanding debt of those "Club Med" countries currently on the brink of default. The weeks ahead will hopefully serve as proof that the plan just enacted will serve to effectively quarantine not just Greece but Spain, Portugal, and any other sovereigns that threaten the spread of contagion to the rest of the Euro-Union. In the US, a *change of trajectory* in the budget is required to return to a path of sustainability and avoid a repeat here of the Euro-experience. We don't expect to see immediate solvency or surpluses, just a step in the right direction to provide certainty and confidence to a business community that has driven the recovery up to this point without an assist from policy-makers.

If policy-makers "get it right", a resurgence of demand in a world awash in liquidity is sure to bring with it an increase of inflation. Central banks will meet the challenge with higher interest rates that will act as a headwind to stocks and burst the bond market bubble. This will be the time for value/income investors to begin to return some of their bond dollars to the bond market. They'll have to be content with the lower yields offered by short-term bonds in order to avoid the "Yield Trap" that we wrote about in 2011. Many who fled from stocks into long-maturity bonds in the latter half of the 70's saw prices crumble at the turn of the decade and locked in losses as they then fled into money market funds. Short-term bond yields will eventually rise to levels that conservative investors need to meet their targeted portfolio returns. As rates peak, bond-buyers can then begin to extend maturities. That's how it played out in the period 1974-1982 and, geo-political surprises notwithstanding, we expect this monetary cycle to repeat. For us, it's not a question of *if* but *when* this transition begins.

For us, that could be as little as two or as much as five years from now. It's dependent on fiscal policy-makers doing the right thing to inject the confidence needed for businesses, lenders, and investors to put the world's liquidity to work. As the biggest customers of the Emerging Markets, Europe and the US have to get their budgetary acts together to avoid further delay and possible impairment of the recovery of the global economy that we currently enjoy.

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