Perspectives

Quarterly Investment Analysis from Van Hulzen Asset Management

July 2009

2010 and Beyond:
Flying into Economic Headwinds

By Craig Van Hulzen

You can fly from San Francisco to Boston in a little over five and a half hours. But the return flight can take nearly an hour longer. The difference is in the winds. Flights eastward benefit from favorable tailwinds that push the plane forward, while return flights battle headwinds that slow progress.

I have been thinking about headwinds and tailwinds as clients asked me about economic projections for the 2010s. I believe that good investment returns will be possible in the coming years. But achieving these returns will require navigating powerful headwinds and challenging equally powerful assumptions many investors adapted during the high-flying 1980s and 1990s.

An essential aspect of future returns will involve focusing on income rather than relying on stock prices. But I'm getting ahead of myself. First, let's take a look back at the factors that made the high-flying '80s and '90s so unique.

Riding the Tailwinds

During the 1980's and 1990's U. S. equity markets flourished, providing annual returns exceeding 13%. These historic returns, which came to be accepted as "normal" but were actually unsustainable, resulted from a confluence of pro-market trends that may not align again for generations.

The '80's began with unusually high interest rates (the Prime rate was at 20%) and tax rates (the top bracket at 70%).

Demographics also played an important role as members of the large Boomer generation earned more money, raised their families, improved their standards of living and re-wrote the books on U.S. consumption. Boomers' consumption produced high revenue growth for many companies and helped to fuel earnings growth in stocks.

Corporations borrowed more capital to expand and meet the larger demand. The economy grew at rates that were well above the historic average, and the words "productivity gains" were heard almost daily in newscasts and Wall Street reports.

In time, tax rates dropped dramatically, interest rates moved from double digit levels to historically low levels, credit availability moved from normal levels to historically high levels and consumption became a much larger portion of the total economic output of the economy.

These tailwinds were fun while they lasted. During these two exciting decades a combination of easier credit, increased spending, reduced taxation, and the easing of credit costs combined to create a massive stimulating force.

The Winds Turn

As we entered the 2000's these pro-market tailwinds began to subside. Most of the expansionary benefits from tax reductions and declining interest rates were now fully priced in the system, and consumption began to level off.

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Since credit remained cheap and easy to obtain, the most popular investment became real estate. The meteoric rise in real estate values was a natural result of overlapping factors. Investors wanting to borrow capital could do so at a very low cost. Adding to the temptation was the fact that banking standards were perversely low.

Most of the forces that fueled growth and earnings in the 1980s and 1990s had subsided, but easy credit created a bubble in real estate prices that ultimately led to a much harder decline in asset prices.

As we look to the coming years, it seems clear that the tailwinds that once helped us have been replaced by headwinds that now impede economic growth. Some reports predict we may be battling these headwinds throughout the 2010s.

For example, look at the changes in per capita consumption. Americans who once consumed with abandon are finally saving. And while saving is a very good idea, this sudden shift from consumption to saving will slow economic growth.

Meanwhile, both the availability of credit and the desire to borrow are gradually returning to normal, pre-Boomer levels. Credit lines are being withdrawn, loan originators are requiring more earned income and actual proof of the ability to pay them back, and consumers are requesting fewer loans for all kinds of purchases. The continued reduction in credit and increased rate of savings could spell a long-term slowdown for an economy long dependent on consumption.

Right now, interest rates and taxes are at historic lows. This means they can only rise. Any potential economic recovery will be stalled by rising interest rates and concerns over inflation. And the massive federal deficits and government stimulus spending will require much higher taxes in the coming years.

Prospects for the 2010s

It's no wonder people are longing for the 1980s and 1990s, a period that gave us President Ronald Reagan, the Apple Macintosh computer, DVDs, and Fed Chairman Alan Greenspan's famous phrase, "irrational exuberance."

Returns during the 1980s and 1990s were roughly 4% higher than returns throughout the preceding eight decades of the 20th century. The 2010s could post returns that are 4% lower than normal, which means they would average a 5-6% annual return. Such predictions make sense when we look at the headwinds we face:

- Rising tax rates
- Retiring population / high unemployment
- Rising interest rates (in later years as growth recovers)
- A GDP expected to average 2.0-2.5% for the next 10 years.

Like the high-flying '80s and '90s, the low-growth 2010s will not last forever. In time the U.S. economy will begin to grow once again, providing better investment opportunities. And there are demographic trends on the horizon that make the 2020's look promising.

But we don't need to bury our heads in the sand and wait for better times. A balanced perspective and reasoned strategy can help achieve good returns, even during today's tough economic environment. To do this we will need to resurrect a foundational principle that many investors have forgotten.

Focus on Income, not Price Appreciation

The swinging 1980s and 1990s caused some people to forget a basic lesson of economic history: income is more important for long-term portfolio success than price appreciation.

This may come as a shock to many people, but it's borne out in returns over the past century. Throughout the 20th century, income has been the key contributor to total return and real price appreciation has been secondary.

Historically, price appreciation has returned roughly the level of inflation plus the GDP growth of the economy. Today, dividend income from stocks traded on the Dow Jones Industrial Average is well below historic averages. The dividend yield of a typical equity portfolio is approximately 3%, versus a historic average of 4%.

Looking forward, it will be imperative to maximize income in portfolios, no matter what strategy is being used. Strategies that rely solely on stock selection and price appreciation will be hard pressed to deliver the returns most investors are trying to achieve. Additionally, growth strategies (which are also called "long-only") involve higher-than-normal risks that should not be ignored.

Assessing Volatility and Risk

Today's economic scenario features an unwinding of leverage (credit), high levels of government involvement, aggressive regulation and rising taxes. This scenario is custom made for higher volatility and slower growth. Stock prices will rapidly rise and fall as investors react to new economic data.

Other factors may add to the markets' increasing volatility, including changes in investment policy among China, India, Russia, Brazil and countries throughout the Middle East. Depending on the decisions these nations make, America could experience a weakening of its reserve currency status.

And no one should discount unknown forces, such as terrorism, which can upset world markets. (Economist Nassim Nicholas Taleb's book, *The Black Swan*, explores the profound impact of large-impact, hard-to-predict, and rare economic events.)

With higher than normal risks to investor capital and lower than normal expected growth, a portfolio must focus on generating income and controlling risk. Any strategic action that can provide both income and reduce exposure to price changes (like covered call or a buy-write strategy) is worth consideration.

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An example of the "buy-write" strategy (which derives its name from buying a stock and writing a contract to sell it to another investor in the future) is the S&P Buy-Write Index. This index is the same as the S&P 500 stock index with one exception. It owns the index of stocks but then offers to sell that asset each month for a preset (higher) price. The key difference then is the income received each month. The investor still receives the income from the stocks (currently approximately 3%) but also receives another 3-4% annually from the buy-write strategy.

Essentially the difference between the regular SPX index and the buy-write BXM index is the income received for holding the asset. The regular index is approx 3% and the BXM index typically generates around 6-7% income.

In 2008, the BXM index collected so much income that it beat the SPX stock-only index by 11%. The buy-write strategy actually produces more income when stock prices are volatile, which are precisely the times when such a strategy is sorely needed.

The downside to this strategy is that it reduces upside growth during the contract period. The upside is determined by the investor (manager) and receives a commensurate amount of income. But in a market scenario where upside appears to be limited, this income-producing strategy can be powerful.

A portfolio strategy that focuses on generating income, with a secondary objective of upside potential when prices do rise, can produce more stability and less volatility. Such a portfolio can more reliably produce desired results and will likely outperform a traditional strategy during a slow growth environment.

Monitoring Current Trends

These are some of the brush strokes in the big picture. As we indicated in our January 2009 "Perspectives," investments that profit from current trends are also an important part of a long-term strategy. That's why we are focusing on investments that can profit from likely scenarios such as:

- Rising interest rates;
- Weakening U.S. dollar;
- Rising inflation concerns;
- Flattening of U.S. economic growth;
- Continuing scarcities of basic commodities, leading to rising prices of food, energy, etc.

While also generating income from traditional investments by collecting dividends, option premiums, and interest income.

An old sailor's maxim goes like this:

A pessimist complains about the wind.
An optimist expects it to change.
The realist adjusts his sails.

Our clients and partners have benefited from the adjustments to our investment strategies during the first half of 2009. For example, our interest rate investment rose by over 20% in the first half of the year and our China investment rose by over 30%.

We believe that a strategy that profits from the implications of current trends and maximizes income can significantly outperform traditional strategies in the coming years.

Sincerely,

Craig Van Hulzen