Financial Alternatives
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Investing Newsletter **January 2021**

Quarterly Market Review Newsletter

Stock market returns around the world were strong in 2021. Bond market returns were mixed with inflation-protected bonds earning strong returns while more traditional high-quality bonds experienced slightly negative returns.

In addition to this newsletter, be sure to read our Quarterly Market Review newsletter - available on our website - which contains both long and short-term investment return data from markets around the world. This quarter's Market Review also contains an interesting article entitled, "All-Time-High Anxiety" which discusses how stocks fared historically after reaching all-time highs.

Returns Going Forward, and More

In this newsletter, we briefly discuss Vanguard's 10-year return forecasts for stocks and bonds as well as how stock market returns on a year-to-year basis rarely land anywhere close to the long-term market averages.

We will also show how markets have historically performed one, three, and five years after hitting all-time highs. While this is covered in the article mentioned above, it is such an important topic that it bears repeating.

Later, we touch on why we believe a first trust deed investment fund can be an excellent fixed income alternative in this low interest rate environment. Finally, we share thoughts on why we think it is prudent and wise to plan for the possibility that investment returns will be lower in the coming years.

Vanguard's 10-Year Return Forecast

At the beginning of a new year, we frequently get asked how we think the stock market will do in the coming year. The only honest answer anyone from the investment community can give to this question is that they don't know. **Nobody can predict short term stock market returns.**

We have also never found anybody who can successfully time the market - which would require getting two decisions right: First, one would need to know precisely when to exit the market (and perhaps pay a huge capital gains tax bill); and second, know precisely when to re-enter, typically during a time of extreme pessimism. That stated, making longer term

Executive Summary

- Vanguard's 10-year forecast for U.S. equity returns is 2.3% to 4.3% per year; for global equities it's higher at 5.2% to 7.2% per year; and for U.S. and global bonds it ranges from 1.3% to 2.4%.
- Equity returns could turn out to be lower than the historical averages in the coming years.
- Market corrections are a good time to rebalance your portfolio and add back to stock holdings.
- Equity returns on a year-to-year basis rarely land close to long term average returns. This is normal and to be expected.
- History shows that reaching a new market high doesn't mean the market will then retreat.
- Average market returns one, three, and five years after a new month-end market high are actually similar to the average returns over any one, three, or five-year period.
- Trust Deed fund investing can have a place in many high-net-worth client portfolios depending upon the circumstances.
- It is wise to have a plan in place for the possibility of reduced future investment returns.

Asset-class return outlooks

U.S. equities	U.S. aggregate bonds
2.3%–4.3%	**1.4%–2.4%**
16.7% median volatility	4.6% median volatility
Global equities ex-U.S. (unhedged)	**Global bonds ex-U.S. (hedged)**
5.2%–7.2%	**1.3%–2.3%**
18.4% median volatility	3.8% median volatility

These probabilistic return assumptions depend on current market conditions and, as such, may change over time.

IMPORTANT: The projections or other information generated by the Vanguard Capital Markets Model® regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Distribution of return outcomes from the VCMM are derived from 10,000 simulations for each modeled asset class. Simulations are as of September 30, 2021. Results from the model may vary with each use and over time. For more information, see page 6.

Source: Vanguard Investment Strategy Group.

forecasts based on historical valuations can sometimes give us an idea of whether we should expect higher or lower than average historical returns in the coming years.

As you can see from the 'Asset-class return outlooks' on page 1, Vanguard's 10-year forecast for U.S. equity (stock) returns is 2.3% to 4.3% per year. This is well below the long term average return for large U.S. stocks, as represented by the S&P 500 Index, which had an average 10.3% return per year from 1926 through 2020 (source: S&P and Dimensional Fund Advisors). Vanguard says their forecasted returns are lower than historical averages because U.S. equities are trading at higher-than-average historical valuation levels. Their 10-year forecast for global equites is higher at 5.2% to 7.2% due to these markets being less richly valued.

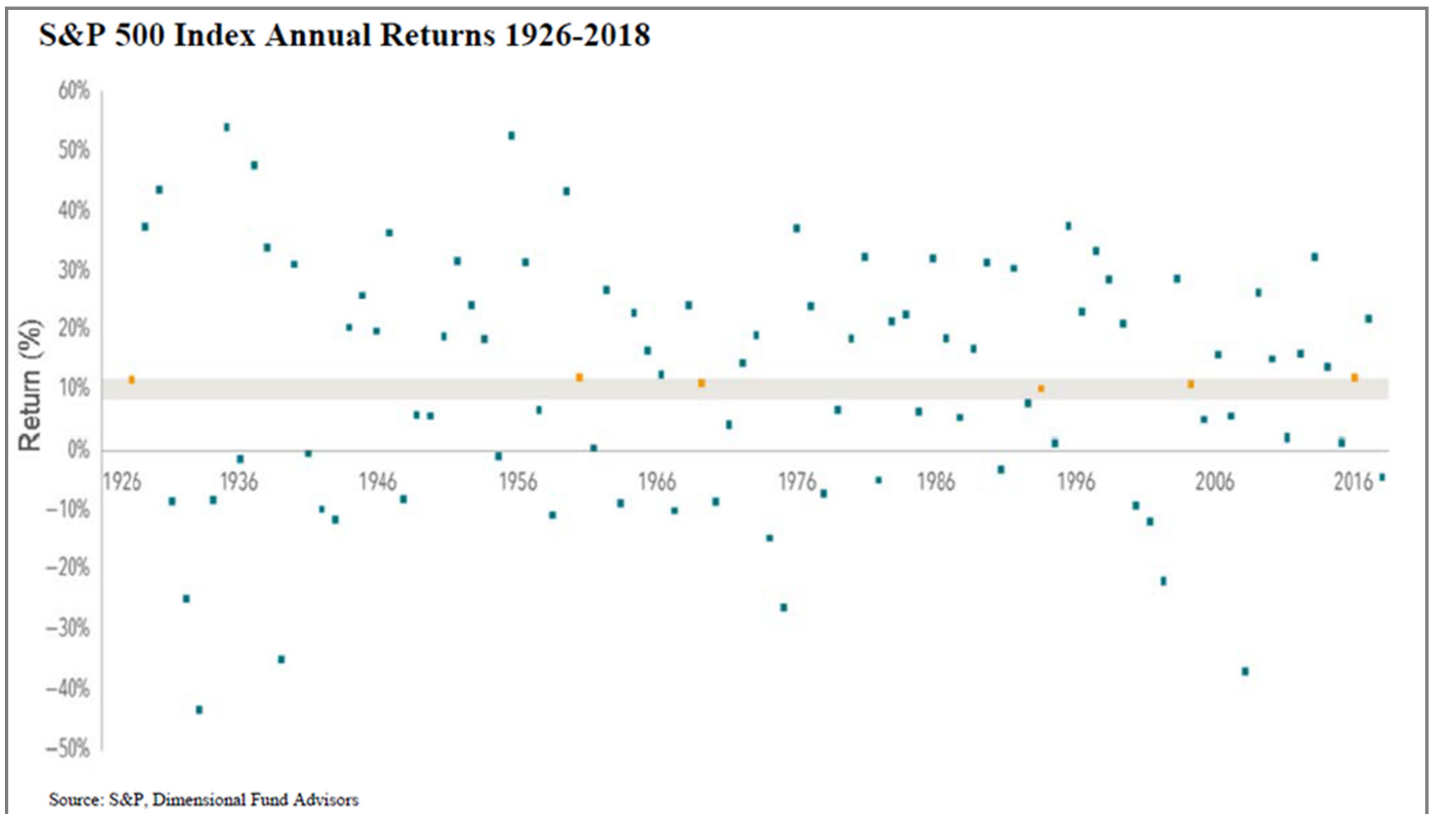
You can also see Vanguard's forecasted bond returns for both U.S. and global bonds ranges from 1.3% to 2.4%. With reported inflation markedly higher, garnering real returns from high quality bonds may continue to be a challenge near term; and this is why focusing on equity returns is important.

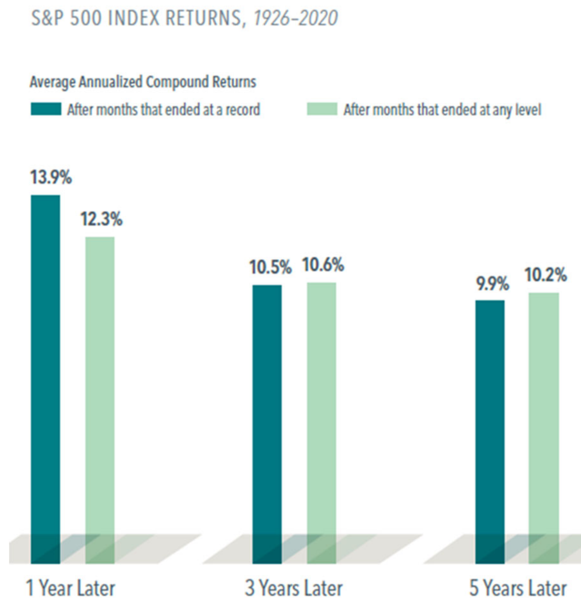
Stock market returns could very well turn out to be lower than the long term averages in the coming years, and investors need to be aware of this possibility and have a plan in place for how they will deal with this, should it come to pass. On the other hand, Vanguard's forecasted returns could also turn out to be overly conservative. For example Goldman Sachs predicts 8% to 9% U.S. equity market returns in 2022 (S&P 500) based on a decelerating economy that still benefits from economic growth of 3.5% (source: John Tousley, Managing Director & Global Head of Market Strategy 1/13/2022).

We do not feel it is prudent to make a big bet on anybody's forecast. Instead, we think it is best to invest in a well-designed diversified portfolio of stocks and fixed income investments that fits your goals and circumstances. In addition, depending upon your risk tolerance it may make sense to increase your portfolio's stock allocation the next time we experience a major market correction. Successful investors may actually look forward to corrections so they can add back to their target stock allocations at cheaper prices - we refer to this as rebalancing your portfolio.

How Often Are Yearly Market Returns Close to Long Term Average Returns?

How uneven have stock returns been on a year-to-year basis? When you look back at S&P 500 Index returns from 1926 through 2018, the average return has been roughly 10% as we indicated earlier. Some investors may expect that yearly returns will frequently land around the average - perhaps in a range of 8% to 12%. As you can see in the chart below, the reality has been quite different! Out of those 93 years, annual returns landed in the 8-12% range only six times - or less than 7% of the time (as indicated with the orange dots in the





Source: Dimensional Fund Advisors

chart on page 2).

This unpredictability is why it is so important to have a long-term orientation when investing in U.S. and global stock markets; historically, the longer the holding period, the more likely you would have had a positive outcome.

The point here is that equity returns will likely be all over the map on a year-to-year basis and you need to be ready for that. Because of this variability, it is normal for average expected returns to only begin to be realized over long periods of time. Seasoned investors understand that stock market returns have never come evenly - and by nature, they likely never will.

Why a Stock Peak Isn't a Cliff

Many investors may think a record market high is a signal that stocks are overvalued or have reached a ceiling. However, they may be surprised to find that the average returns one, three, and five years after a new month-end market high are similar to the average returns over any one, three, or five-year period.

In looking at all monthly closing levels between 1926 and 2020 for the S&P 500 Index, 30% of the monthly observations were new highs.

After those highs, the average annualized compound returns ranged from nearly 14% one year later to just under 10% five years later as shown in the bar chart above. Those results were close to average returns over any given period of the same length. When viewed in terms of whether the S&P 500 has simply risen or fallen after notching a record, it was higher 82% of the time after one year, and 78% of the time after five years.

History suggests that reaching a new high doesn't necessarily mean the market will then retreat. Stocks are priced to deliver a positive expected return for investors, so reaching record highs with some regularity is exactly the outcome one would expect.

Why Consider Trust Deed Investment Funds?

Since 2007, we've used Trust Deed Investment funds in our client portfolios to take the place of a portion of their fixed income allocation. A private trust deed is basically collateral for a loan made against a real estate investor's property - in other words, it is a private mortgage. Trust deeds and mortgages are not the same, but conceptually they are more similar than different.

Trust Deed fund yields can vary significantly depending on the underlying loans. These days, we would expect more conservative funds to offer yields of about 5-6%, and more aggressive ones to offer yields of 8% or more. Trust Deed funds that lend on a lower percentage of property value (lower loan to value ratio) inherently have more safety of principal than funds that lend at higher loan to value ratios.

We believe funds that prioritize safety of principal can serve as a better complement to the fixed income portion of an investor's portfolio. Conversely, higher yielding Trust Deed funds may be considered more speculative investments – they offer higher regular cash payments, but there is also a higher risk of principal losses. For example, a non-performing loan may result in a property being sold at a loss - which is ultimately borne by investors.

If you compare expected returns from a Trust Deed fund with the returns from the Vanguard forecasts discussed earlier, these funds can appear to be an attractive option for high-net-worth client portfolios. Of course, returns alone don't tell the whole story, and many other factors should be considered before investing in a fund such as these. For example, typically Trust Deed investments have limited liquidity, and cannot be redeemed for period of time or on a routine basis like a conventional mutual fund. In addition, we would not expect to see much, if any, capital appreciation in a moderate to conservatively managed Trust Deed Investment fund.

Plan for and Expect Lower Future Returns?

Since market returns will vary dramatically year to year and even decade to decade, it is prudent to have a backup plan of action that is workable and feasible should investment returns be lower than expected (or should your expenses end up being higher than expected). The key here is to have the plan worked out and in place before you need it. This will help you remain calm when markets are falling and keep you from selling stock positions in a panic when you should actually consider buying them at cheaper prices.

A prudent plan may include the following:

- Make a commitment ahead of time to consider adding back to your portfolio's stock allocation the next time we get into a serious market correction - in other words, rebalance your portfolio.
- If it makes sense to do so given your needs and circumstances, consider a wider range of investments, such as Trust Deed investments, and,
- Create a flexible spending plan that will help you confidently reduce your expenses should the need to do so ever arise.

Summary

Stock market returns were quite strong and broad-based in 2021. For additional detail on this, be sure to read our Quarterly Market Review newsletter.

Some are predicting that equity and bond returns over the coming years could turn out to be lower than past long term averages. To achieve better long-term outcomes, we believe it's better to avoid big bets on any one forecast, and instead maintain a well diversified portfolio and a plan to rebalance during market corrections.

It's normal for equity returns to deviate significantly from average returns on a year-to-year basis. It's also important to remember, as shown, that just because the market is hitting all-time highs does not mean reasonable returns can't be made in the near term.

Once again, if your lifestyle is highly dependent on the performance of your investment portfolio, it is prudent to have a plan of action that is workable and feasible should investment returns be lower - or expenses be higher - than expected.

If you would like to discuss your investments or any other aspect of your financial life in greater detail, please give us a call. We are wishing you all the best in 2022.

Past performance is no guarantee of future results. All content in this newsletter is intended as general information, not specific advice. Performance data listed is for illustrative purposes only. Portfolios are personalized and often consider many variables, including investment objectives, age, time horizon, risk tolerance, and tax variables. Information contained herein has been obtained from sources believed reliable, but not guaranteed.

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