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Fiducient Advisors, Nonprofit Investment Stewards Podcast
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Future Outlook on Equity Markets (2021 Year-End Updates) with David Bianco

[00:00:00] Welcome to Non-profit Investment Stewards with Bob DiMeo and Devon Francis from Fiducient Advisors. Bob and Devon are passionate about helping nonprofit organizations prosper. Whether you oversee endowment, foundation or retirement plan investments, this podcast exists to help stewards improve performance, reduce costs and discover strategies that enable your charitable organization to prosper and advance its mission.

[00:00:26] Now onto the show. Hello, and welcome back to the Nonprofit Investment Stewards podcast. I'm Bob DiMeo. Great as always to be joined by Devon Francis. As our show title, the Nonprofit Investment Stewards, implies, we routinely touch on topics important to investment committees and other nonprofit leaders. If you're an investor and perhaps curious about what to expect from your endowment or foundation portfolio, today's episode is absolutely for you.

[00:00:56] We're very fortunate to be joined by one of Wall Street's best known [00:01:00] strategists who's about to share super timely insights on stocks, current valuations, inflation, and more, and how all that could possibly impact your portfolio. I'm very eager to jump into that, but before introducing our guests, Devon, how are you doing?

[00:01:16] Hi, I'm excellent, Bob. Thanks for asking. We are so excited to be joined by David Bianco today. David is the chief investment officer of the Americas at DWS Group. He is a chartered financial analyst. He received his BS from the Wharton School, and as Bob mentioned, he is a very sought-after wall street strategist who publishes his own research.

[00:01:38] Appears in many publications, as well as numerous media outlets, including CNBC. So, David, thank you so much for taking time to join us today. And it's great to have you on the show. Thank you, Devon. Thank you, Bob. Great to be here. David, so good to have you on this show. And maybe before we jump to specifics, perhaps you can start with your role and [00:02:00] how you attempt to help investors navigate these markets and economies and such.

[00:02:05] Sure Bob. I am the Americas CIO at DWS. We're a global investment manager across active, passive, and alternative investments, about a trillion dollars in assets under management worldwide. My role is to help shape and communicate our macro views to both our portfolio managers and our clients who are employing our strategies.

[00:02:29] I also had the active equities group that's based in New York where we have a little bit more than $20 billion of equity mutual funds, active funds, and separately managed institutional accounts. And it's just a pleasure for me to work with the portfolio managers every day. And what I do is work with them to help connect the macro to the micro, pick securities, and guide these strategies where appropriate with certain macro inputs.

[00:02:57] Excellent. Thank you, David. So why don't we jump right [00:03:00] into it here? Listeners are probably tuning in around year-end of 2021 or the beginning of the new year. And perhaps we could talk a little bit about stocks and your thoughts on valuation levels, particularly for US stocks. Sure. I normally focus on the S and P 500. However, global equities and large cap to small cap equities are areas we invest in.

[00:03:21] And segments of the equity market constantly on my mind, they, we have many benchmarks across the equity market globally that we are tasked with beating. So, I think, I stay focused on many parts of the equity market, but the S and P 500 tends to be the great benchmark and the dominant, still the dominant part of global equities.

[00:03:46] The S and P 500 has been doing extremely well since the end of the pandemic. And we were at close to all-time highs. We had a bit of a pullback right after the Thanksgiving holiday on COVID variant concerns, but for the most [00:04:00] part, the S and P has marched upward steadily since April of 2020 with gains that are, oh, about 50% from where the market was in February of 2020 before the pandemic hit.

[00:04:15] And that follows a prior bull market and expansion of nearly 11 years. That's just been absolutely terrific. And the S and P 500 has pretty, nearly tripled from where it was during its 2007 highs. So, it's been an incredible equity market and the past two years have been a straight upward March led by growth stocks, led by mega caps.

[00:04:40] A lot of people ask the question, how is the equity market, the S and P 500 done so well for so long in these challenging times, particularly the shock of the pandemic? And many are quick to point out the policy response by the Fed and from the fiscal side as well. [00:05:00] And those two things are very important, particularly for the economy and to employment.

[00:05:06] But what I think is often not fully understood by investors is that the technology portion of the S and P 500 and the surge and the earnings power at tech stocks and everything tech related is what's really fueled this powerful rally led by tremendous earnings growth. Also, PE expansion. We do have PEs that are at record levels.

[00:05:30] We can talk about that, but I want you to understand that the S and P 500 has transitioned from being stocks that are used to described as a global index. It's moved away from being a US or domestic index a long time ago to a global set of companies, US companies, but doing business around the world.

[00:05:49] But now what I emphasize is that the S and P 500 is a digital index. 28% of the S and P's market cap is the tech sector. [00:06:00] 12% more from the communication sector, which is where companies like Facebook and Google and Netflix sit, then you've got internet retailing, you've got electric vehicles.

[00:06:13] You've got a lot of crucial digital infrastructure businesses, even within REITs, data centers, cell towers, I'm going to put forth that at least 45% of the S and P 500 is tech plus or digital type of businesses. And that's the reason why the S and P has done so well during the pandemic and surprised everybody to the upside in terms of its earnings and its returns.

[00:06:37] Since the pandemic broke out in early 2010. Truly remarkable returns, and appreciate your insight there. It prompts the question, I think, by a number of investors, how high is too high? We've had energy and other sectors really dominate in the past. And often, that doesn't end well. Is there a point where [00:07:00] valuations are just too stretched in your opinion?

[00:07:02] Well, we are paying attention to valuations. And I'll talk to you about how I think about that. It is true that the tech sector is larger than it's ever been before, tech alone 28% of the S and P 500. And investors have taken concern with times in the past, the late 1990s, the tech sector was by far the largest in the S and P.

[00:07:23] Uh, if you go back even to the financial crisis, the financial sector was the largest in the S and P before things ended badly. In the early 1980s, the energy sector was the largest and very poor returns for a long period of time for energy after that. So many investors do ask the question, is this just another episode of one sector being too big?

[00:07:45] Our answer is no. And we start off with the earnings, as I was explaining before, the earnings have surged at technology, at communications. And although the valuations are high, we think they're justifiable. [00:08:00] And the way I start with that is first talking about how we think about the valuation and appropriate valuation of the S and P 500.

[00:08:11] Right now, the S and P is trading at about 22 times the earnings I expect for this year, 2021. We're expecting $213 of earnings this year, $228 over earnings for the S and P 500 in 2022. And we're using a fair target PE of 22. And that is a high PE versus history. A lot of people cringe when they hear PE is above 20. And the average PE for the S and P 500, which began in 1957, but the average PE since 1960 is 16.

[00:08:46] And the average PE since 1995 is 18, 18 and a half. So, we have the S and P 500 at a good 20 to 25% premium to its valuations since the mid-1990s. [00:09:00] How do we think about that? It all sits or stands on the shoulders of the bond market. The way I think about a fair PE is first to ask myself, what would be a fair, real return to earn on the S and P 500 over the long-term?

[00:09:20] A real after-inflation return that would be fair. Since 1960, that return has been about 6% in real terms and close to 10% in nominal terms, with inflation. So, one divided by 6% gets you that historical PE of 16. And then as time went on, we saw interest rates declining, particularly since the late 1990s and through the 2000s in the past, really 20, 25, 30 years of a steady decline in nominal and real interest rates have gotten us before the pandemic thinking that a 5% or maybe [00:10:00] slightly above 5% return would be fair for the S and P 500 in real terms.

[00:10:03] Obviously, one divided by 5% is 20. And if you want to go below 5%, you start getting above 20. Or right now we look at the long-term bond market, especially long-term treasury inflation protected securities. And we see the ten-year TIPS yields at negative 1%, when historically, they're usually about positive 2%.

[00:10:27] So, we're assuming that real yields climb to about 0%, and nominal treasuries ten-year yields climb to 2% over the next year or two. And we use that base risk-free real rate of 0% and we're adding a 4.5% equity risk premium to it. One divided by four and a half percent is 22. That's the math. And that's the way we think about the fair value of equities, which are real assets as well as real estate and other things.

[00:10:59] But when you [00:11:00] think about what type of earnings growth a company should be able to generate if it paid out all of its earnings as dividends, the earnings growth should still beat inflation. So that long-term g in that growing perpetuity formula should be inflation if the company pays out all of its earnings and thus the fair cap rate, if you will.

[00:11:22] And those who follow real estate will understand this concept, the fair cap rate for an equity or a stock, just as it is for real estate, is the fair, real cost of equity. And I'm taking one and dividing it by that, or a cap rate, if you will, a four and a half percent, which is what we're using for the S and P 500 and that 22 PE as our fair target. It's uncomfortable because it's so much higher than history, but that's what's fair.

[00:11:50] Given, well, given these interest rates that we observe and even higher, if you use today's interest rates, but we're of the view that they will, long-term rates will [00:12:00] climb. And that treasury yields stabilize at about zero in real terms and 2% in long-term nominal terms. I hope that helps. Yeah, that does help a lot.

[00:12:10] David, it's really interesting to hear you go through the math. And it does make current valuations seem more justifiable. You talked about the bond market. I think we're going to circle back to that, but before we leave equity markets, just wanted to get your thoughts. I know typically you play in the large cap, domestic equity space.

[00:12:28] But do you have any thoughts on market cap, large versus small stocks, investment style, value versus growth, or, can you share also some thoughts on international markets, developed and emerging markets? So, for several years, my preference has been for US equities, large and even mega cap equities, with a preference for growth stocks, and it's worked out extremely well.

[00:12:53] And we've almost never deviated from that preference. And then we've been sticking with it. [00:13:00] Even though there are many who are calling for a rotation to value because growth has done so well for so long, we still see better sales growth, and better margin improvement potential at the growth stocks, I tend to be a fan of businesses that have very valuable and tangible assets.

[00:13:24] Innovation businesses. And when we look at companies, we often think to ourselves, what's the growth potential? Just replicate the business. And then what will the incremental profitability be upon that growth? We prefer businesses that have strong sales growth potential, and high economies of scale, ones that have low incremental costs, high fixed costs.

[00:13:53] That way as the business grows, the incremental profits scale up very quickly. We see that a lot of intangible growth type of businesses, whether it's [00:14:00] technology, communications, but also we see this at healthcare and select consumer businesses as well. So, David, go back to following up on some of the comments that you made about fixed income.

[00:14:14] So we've been in a declining interest rate environment for much of recent history. You anticipate that rates will rise up to about 2%. Can you share some of your thoughts on fixed income from an investor's perspective, do you think it makes sense to have an allocation? What types of instruments do you prefer in the space?

[00:14:34] Let me start with when I, one of the foundational principles that I use when it comes to thinking about interest rates. And the first is a conceptual question of what should be the fair return for taking absolutely no risk at all? And I'm of the view that in a world where inflation risk is moderate, and we need to monitor that risk, given the pandemic and the [00:15:00] fiscal policies that have come ever since.

[00:15:02] But if inflation risk is moderate, to me, the fair return for taking no risk at all in a very affluent world where there's a large savings pool, the fair return for taking absolutely no risk at all in real terms in my view is 0%. So, this relates to the concept of what would be our star, the neutral Fed funds real interest rate.

[00:15:26] And to me, the fair or neutral return interest rate for no risk should be about zero. Right now, it's negative 100 basis points on long-term bonds, as we said, and the overnight rate is still 0% in the United States while inflation has been running, even above 5%, but we expect inflation to slow down and I do expect nominal interest rates to climb.

[00:15:52] And I think we should get to that fair or neutral, real return of about 0%. And that's, that's the foundation for where we [00:16:00] think interest rates will go. And then we add an equity risk premium, as I mentioned before, for thinking about a fair PE. But that I think is an important thing to contemplate that some would say interest rates are low because there's a lot of debt in the world.

[00:16:15] I disagree. I think there's interest rates are low because there's a lot of wealth in the world. And the opportunity costs of forgoing consumption for the choice of savings is a lesser sacrifice than it's been in the past. So, there's no return being provided for that simple trade off. And that's why risk-free interest rates, treasury bonds, particularly in real terms, have been zero and below zero when the Fed's trying to stimulate the economy.

[00:16:48] So, David, that's an interesting take. I think I hear you saying, because of the wealth, money doesn't have to necessarily be put to work as much as in other scenarios or environments. And [00:17:00] if that's the case, or even if it's not, talk a little bit more about inflation, is this transitory or not?

[00:17:05] And just how you think investors might prepare on the inflation front going forward. Because there's so much wealth out there, it's hard to get an attractive return or even historical returns without taking risk. And it's important to aim for your return targets, protect against inflation, but you know, be

careful in how you take that risk and get the best return you can for it. Inflation is something we all need to guard against.

[00:17:34] When some investors might be managing against certain liabilities, they can do that well with fixed income. Fixed income, also particularly treasuries, long-term treasuries, provides a risk edge. If you own a lot of risk assets, you should own treasuries, long-term nominal treasuries, because they provide a risk hedge.

[00:17:54] Now, inflation-linked or inflation protected treasuries [00:18:00] provide inflation protection. And that is one of the simplest and quite effective ways to get inflation protection, but you can also get inflation protection with real assets. And, uh, because of, uh, what we believe is if one wants to get a positive return, they're going to need to take risk.

[00:18:15] And because we want to protect against the more elevated inflation risks that we've seen over the past year or so versus history, at least the past 20, 30 years, this is a time where we're favoring real assets in our portfolios. So, let's shift gears a little bit and talk about ESG or SRI.

[00:18:35] So environmental, social, governance, or the SRI, either sustainable and responsible investing or socially responsible investing, a lot of acronyms, a lot of different terms. Um, but you know, what are your thoughts on that space? We've got a lot of thoughts in that space and DWS has committed itself to being a leader in that space.

[00:18:56] We have dedicated ESG strategies, where [00:19:00] there are minimum standards and certain issuers, companies, or just rolled out of our equity or our fixed income portfolios, but most of our strategies, because this is what we do unless our clients direct us otherwise, most of our strategies are robustly ESG considerate, and we are examining these environmental, these social, these governance issues.

[00:19:23] And we're trying to make sure they're appropriately reflected in the valuations of the securities. And if not, we will pick better investments. And we're at a time when a lot of these ESG factors are just beginning to get more appreciated by the broader investment community. And we're in the process. I believe we're in the process of the market moving to better price these risks and these opportunities.

[00:19:44] So in many cases, we found that even in these ESG considerate strategies, and in our dedicated strategies, which have done very well over the past couple of years, that [00:20:00] underweighting these poorly-rated ESG companies has helped our performance.

[00:20:04] But we don't know if that's always going to be the case. We believe it's important to evaluate these ESG factors and then decide whether or not they're priced into the securities or not. We want to make decisions in the best economic interest of our clients. But then for clients that have directed us to do so for philosophical or value-based reasons, we will follow their directions and exclude companies based on certain ESG criteria.

[00:20:31] ESG is here to stay. It's kind of one of these things where I would argue it's always been around. It's just been formalized more. If you ask investors, do you care about management? Do you care about management care about governance? Do you concern yourself with stakeholders and just the sustainability of the profits?

[00:20:51] I hear investors talk about the importance of normalized profits and understanding the risks around those profits and the valuation. The importance of [00:21:00] governance. And so, I think it's been around for a long time. It's just, we've got more tools, more data and more focused on these considerations than in the past.

[00:21:08] Absolutely. You're spot on when you say ESG is here to stay. For investors that would like to incorporate a sustainable and responsible investing approach, do you think that it requires sacrificing returns? What are your thoughts on that? I don't think it requires sacrificing returns. Well, first, I think it's important that if the strategy is ESG considerate, the investment manager needs to make every effort to make sure they're not sacrificing returns, but there are some strategies where clients have asked for a minimum-standards and for certain companies to be ruled out. In those situations, there might be some sacrificing of return.

[00:21:54] But in the recent periods, a couple of years, it hasn't been the case. [00:22:00] There's been added performance by underweighting those securities. So, it's something that needs to be continued to be managed actively, proactively. And there's no simple answers. Some of these companies that do have the ESG concerns are addressing them.

[00:22:16] And many in the investment community are engaging with management teams to share views on these matters and hear from the management teams about their plans. And then the market is always trying to price these things as best as possible. So, in a world where markets are not always efficient at all times, all securities, but over time, it generally moves to be more efficiently priced.

[00:22:37] We want to make sure that if there's an ESG risk premium built into a security that is sufficient and attractive for certain portfolios, those are appropriate investments. David, let's take a look now at your outlook. Maybe we'll make this a two- or three-part question actually. Love to hear your outlook for the markets over the [00:23:00] coming one to three years.

[00:23:01] And also have you share perhaps what your greatest concern is? And then what the greatest opportunity might be for longer-term investors like a, like a nonprofit leader over overseeing an endowment or a foundation portfolio? So, it's been a great equity market, particularly in the United States, the S and P 500 since early 2020.

[00:23:25] After the lows, when the pandemic first broke out, it's a new cycle. It's a new bull market. I'm not sure how long this one's going to last. And at this stage, I'm not confident that it's going to be a very long cycle, like 10 or plus years, such as the prior cycle was. It might be a more short-lived cycle.

[00:23:46] I don't think we have a recession in 2022 or 2023, but at this stage, I don't think we should be comfortable with the idea that it will be much longer than five years. In many ways, the economy is running a little hot. [00:24:00] We've got inflation pressures a lot earlier than normal. And, um, this, this might not be as much of, or long-lasting of a Goldilocks economy as the prior expansion was.

[00:24:14] That said, I do think the S and P delivers another good year of returns in 2022, mid-single digit, normal type of S and P returns fueled by earnings growth of about 7% and a stable PE of about 22. As I said, which assumes that interest rates don't shoot up and assumes that the Fed doesn't need to aggressively hype in late 2022.

[00:24:36] Where I seen into 2023 by the market. So, in short, we're thinking it's another good year of equity returns, and that could continue for another few years, provided inflation comes down and provided inflation comes down without the Fed needing to be too aggressive in its measures to fight it.

[00:24:58] So we think it's a good equity market. [00:25:00] Inflation is a risk. One of the ways to protect against inflation is real assets. One of the ways to protect against the possibility of the Fed having too aggressively high rates to fight inflation is to own banks. One of the few sets of businesses that do better.

[00:25:19] As interest rates go up and make more earnings, our banks, higher interest rates are good for banks. Fed hikes are good for bank profitability as long as those fed hikes, don't trigger a recession and a credit cost cycle. So, we're preferring real assets, equities. Within equities, where you're still

tilting a lot toward the best businesses, digital businesses and these banks for the view that rates will climb.

[00:25:46] And while we're looking for companies that have pricing power, I think it's important that people think about that in a much more sophisticated way, because we prefer companies that are raising their productivity instead of their [00:26:00] prices. When you hide prices, you disappoint your customers and you really just encourage competitors or alternatives.

[00:26:07] So a lot of these companies that are hiking prices right now may find that that harms their longer-term profitability. Also in many cases, they're only hiking their prices because their costs are going up and you'll find their replacement cost of their assets will go up as well over time. So, we think there's more economic or real pricing power at businesses that have very low tangible cost base because they have high intangible costs and assets.

[00:26:34] So again, we prefer these tech businesses, these communication businesses, banks, healthcare, that's where we're overweight. And for investors that may not have that type of risk budget, we do think that one of the lower hanging fruits may not be the best returning part of the equity market, but we think it should be attractive returns.

[00:26:55] Utilities, REITs, infrastructure, in my view, there's a lot of good [00:27:00] inflation protection to be found. Utility companies, infrastructure companies, a lot of these are plays on clean energy as well. I like to think of energy as being something that in the past was transported as a solid, then it became transported as a liquid or gas.

[00:27:16] But it's going to be transported as a current, through the wires, through the electric grid. And the utility companies have that very valuable distribution system. And they're going to be involved in the cleaner generation as well of energy. So, I think utilities are a great bond substitute with inflation protection and at lower risk than many other equities out there.

[00:27:38] So I think for somebody trying to manage against certain long-term liabilities, utilities, REITs, they belong in the portfolio. Well, so we have really covered a lot. Given that our listeners include not only nonprofit leaders, but also investment committee members and other types of folks, what other recommendations or key points would you like to share with them?

[00:27:59] I run an active [00:28:00] equities group at DWS. I'm a big believer in active management. You heard from me that I'm still a fan of large cap, mega cap growth stocks out of the S and P 500. But we do need to look for some alternatives. We do need to be diversified against what's become the dominant part of the equity market in the United States for good reasons, but it is the dominant part.

[00:28:21] So we are trying to find securities outside of the biggest tech and communications companies and we're finding them. We also think there's good opportunities in healthcare and we are looking abroad and we are looking more at small caps. But what I would say to you is, do not give up on active management because alpha is not inflation, and it's a risk-adjusted return.

[00:28:41] And if you can generate 50 or a hundred basis points of alpha in this negative, real interest rate world, that is a tremendous boost to the real return of your portfolio. So. The [00:29:00] importance of active management to try to add economic value at a time of low returns for taking no risk, unless you're willing to take some risk, active can be very important and active management and diversification across the asset classes is crucial to making sure you're not overly exposed to these companies that are great companies, but have become the dominant parts of the US equity markets.

[00:29:25] Wonderful insights, David. Thank you so very much, but before we let you go, you're obviously covering a lot on the professional front and very busy, very engaged. Just curious about David Bianco, the person outside of your professional activities. What do you really enjoy doing? Thanks for that question.

[00:29:43] I enjoy being with my family. I've got two boys here. I live in Long Island and my wife and my two boys, as a family, we play some golf. We go skiing. Those are just some really special moments when we get to do those things as a family. And I live and breathe markets. I love economic history.

[00:29:59] I love the [00:30:00] markets. It's what I do. I wake up in the morning and I focus on what's going on around the world in markets. And it's just never ending, intellectual stimulus. And it's an honor, it's a privilege to work in this business. You're always a student and that's what I enjoy very much about what we do.

[00:30:20] Well said. David, it's really clear that you're passionate and very knowledgeable about the work that you do. We are so appreciative of not only your time, but also your expertise and the wonderful insights that you've shared with us. If listeners would like to learn more or perhaps access resources, how might they do that?

[00:30:37] I would invite any listener to visit the DWS website, www.dws.com. And look for me, David Bianco. I publish weekly publications, thought leadership publications under the Americas CIO view, uh, title. And you can [00:31:00] see everything from our equity market targets, our sector allocations, our S and P earnings estimates, our valuation models.

[00:31:06] We put a lot out there. And for those who appreciate this type of analysis I think we're very transparent and willing to provide our best insights to our close clients. Well, David, thank you so very much. You've covered so many topics that I know will be of interest to our listeners. And thanks also to our listeners who include investment committee members, board members, CFOs, and other nonprofit leaders overseeing investment portfolios.

[00:31:34] Devon and I want to make you aware of a useful tool at Fiducient that we call an observations and considerations analysis. It provides a high level, but really, really useful look at your portfolio’s allocation, diversification, costs, and more. If you oversee an endowment or foundation, and you'd like these complimentary insights, ping me or Devon on LinkedIn or at the show email address.

[00:31:55] So thanks once again, David, we really appreciate your time. Thank you for having me. [00:32:00] And thanks to all you good stewards for investing your time to help your nonprofits prosper. We'll connect with you soon on the next episode. Thank you for listening to the Nonprofit Investment Stewards podcast. Click the subscribe button below to be notified of new episodes and visit Fiducientadvisors.com for more information. The information covered and posted represents the views and opinions of the guest and does not necessarily represent the views or opinions of Fiducient Advisors.

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