Fiducient Advisors, Nonprofit Investment Stewards Podcast
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First Quarterly Quick Take of 2023: Important Investment Updates with Brad Long

[00:00:00] Welcome to Nonprofit 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, and it's always good to be joined by co-host Devon Francis. Earlier this year, Devon mentioned an exciting update we'd be adding to the show, and we're launching that with this episode. Some of you have no idea what we're talking about, but for others it's totally obvious.

[00:00:49] Devon, how are you and would you please unveil the news? I'm great, Bob. Thank you. Uh, the unveiling that Bob mentioned is that we've added video to the podcast. So, for those of you who enjoy listening only, of course, you'll continue to do that as you always have. But some of you do enjoy video format and maybe you are curious as to what we look like.

[00:01:09] So here it is, you can see it in all its glory. So, in the future, we may also be able to include graphics that relate to what we and our guests are discussing. So video is another option. And we hope that you enjoy both the audio and the video format. So, another quarter has passed, and that means it's time for our quarterly quicktakes with our Deputy CIO Brad Long.

[00:01:32] So Brad, welcome and uh, welcome to the new format. How are you? Thank you. Yeah, I, I wish I would've known too far in advance. I could have gotten rid of the beard that I've grown over the last six months, but thanks for having me. Brad, great to have you on the show. And it looks very dapper. So, we had you on the show just 90 days ago, and we were coming off of a terrible year for stocks and bonds.

[00:01:53] Inflation had soared. There was a war in Europe and a whole lot more, and it felt like surely 2023 we're gonna be able to turn the page to a more normal environment. But as you all know, that has not been the case at all. So, to set the stage for those of you overseeing endowment and foundation

portfolios, or quite frankly, if you're simply an investor in general, Brad will begin by addressing top stories on the markets and the economy.

[00:02:19] But he won't regurgitate the headlines. I think you'll appreciate his take and his insights. We'll then move to some practical implications for your portfolio. And then finally, we have our grab bag at the end where we'll pose timely questions to Brad. Uh, of course he's going to tackle this banking crisis.

[00:02:35] We don't know by the time you're listening to this or viewing it if that entire mess is resolved or not. But candidly, it doesn't matter because Brad will touch on a few core investing principles that might help you navigate the banking debacle, or at least help you avoid the next crisis de jure. So with that, let's get to it.

[00:02:53] So Brad, you and your team came into 2023 with three broad expectations. Fiducient shared those with all of our clients, and we used them to help position our portfolios coming into the year. So, can you reiterate what are those expectations and how are they playing out as the first quarter of 2023 comes to a close?

[00:03:14] Yeah, it's funny, we're sitting here, it's only March and it feels like, at least compared to November or December, we're in a very different world. But the expectations that we set coming into the year, you know, I guess I'll jump to part of the punchline is they're the same. The three primary things we thought would be influencing prices and portfolios in 2023 were the following.

[00:03:32] So the first was continued market volatility. And that's not to take kind of the bear market of 2022 and just staple it over 2023. It's this idea of, as we exit this period of zero bound interest rates, with higher interest rates, there are implications that come from that across the equity market, across fixed income markets, and the interaction between the two, which is extremely important.

[00:03:53] And so we do think that we'll be reverting back towards a higher volatility market where asset allocation matters

[00:04:00] more, and that certainly has played out thus far in 2023. The second is, uh, theme is moderating inflation. Moderating is a key word. We don't think we'll solve inflation in 2023, but really, the Fed really needs a credible path towards lower inflation, not necessarily hitting that precise 2% rate of inflation.

[00:04:18] And we definitely think we're on the path there. And if we want, we can kind of double click on that with some recent data, uh, that we have some pretty unique insights on. And then the finals at Bear Market bottom. We don't have precise timing. We don't know exactly when markets will bottom, but we

have a belief that 2023 is a more constructive year to be adding risk capital than 2022 with the preconditions of the Fed will stop hiking, that inflation will be moderating, that earnings expectations will have fallen, and those are good conditions to be adding risk capital for the foreseeable future.

[00:04:49] And so thus far, those three things, while it's been a very bumpy road, are still very much intact. Great. Thanks Brad. That's helpful to uh, have you set the table like that. One thing

[00:05:00] that I wanted to follow up on is you mentioned that we do expect continued volatility and certainly we've seen that so far.

[00:05:06] One area of the market that's been particularly volatile over the last couple weeks has been fixed income yields. Can you talk a little bit about what's driving that market? It's been, it's been a very interesting market on the fixed income side, uh, and 2022 was certainly an interesting market. Certainly, in my career and definitely since the late seventies or early eighties, expectations for future rates have been more volatile than they've ever been.

[00:05:33] If we just rewind even just a few weeks ago to early March, expectations for the Fed and kind of their terminal rate, or the highest rate that they'll hike to, was a modest kind of half a percent higher from where we are today, which is the 4.75 range in the federal, federal funds rate. Then Jerome Powell came out and said, Hey, really good January inflation economic, or I'm sorry, January and February economic data,

[00:06:00] we might have some more wood to chop here.

[00:06:01] And all of a sudden, expectations blew out and said, wow, we're gonna need maybe a point. So, 1% or more of increase in interest rates and then you just zoom right to the end of that week and SVB came around and expectations fell through the floor and effectively said, we're not going up from here.

[00:06:17] There's gonna be a rate cut. Now as the dust has settled a little bit there, we're back to a quarter point increase in kind of a moderating cycle going forward, and that has created a lot of pricing volatility in the fixed income market with yields on the 10 year, the 30 year, the two year, all moving quite a bit.

[00:06:35] Practically what that means for us. Again, kind of positioning with that idea of volatility in mind, that's been somewhat beneficial for the changes we've made year over year. But it also means that there's a little bit of risk there for investors trying to kind of chase the news or chase their tail on some of these moves and swings.

[00:06:53] You can really make a whole year or lose a whole year in trying to time rates. And we think today with the volatility that we've seen, we would [00:07:00] absolutely recommend staying away from that. Brad, given all of that, I'm really looking for your perspective for the types of clients and listeners. So think of the executive director at the nonprofit, the financial officer president, or investment committee member, or again, there's so much happening right now that this applies to pretty much any investor.

[00:07:19] But with all of that, how does it unfold in terms of practical portfolio implications, especially when you are thinking about a long-term investor? So, the themes that we laid out, right? The idea of higher expected volatility, which we've seen or continued volatility, if you will, moderating inflation and potentially your bear market bottom.

[00:07:41] You know, those are things that, you know, while there are gonna be, in our view, important in 2023, they really persist beyond that. So, so for those that are. You know, allocating or as a steward or fiduciary overseeing a long-term pool of capital, you know, we think the things that we are talking about there really continue to apply today.

[00:07:58] So, for [00:08:00] example year over year we increased our position in kind of intermediate or longer duration fixed income securities. Part of that was we had materially higher yields than we did at the start of 2022. That means translates to usually better return expectations going forward. But also those securities tend to be a better diversifier in periods of real volatility.

[00:08:22] 2022 is somewhat of an exception to that. It was an extraordinary year for fixed income and equity and fixed income fell at the same time. We believe with recharged rates and higher yields, fixed income can start to play its traditional role of diversifying a portfolio. And so, you know, as we think about rate volatility and we think about maybe even an inverted yield curve, the temptation is to say, oh, well, maybe I should just kind of put this all into cash.

[00:08:46] Whereas we think now, especially in this market, having that thoughtful diversification, having those positions that can really benefit if we go into a recession, if we do see a continuation of banking volatility. Those positions can really

[00:09:00] benefit portfolios and help us get through these more difficult times cuz these are the times we really wanna lean in on diversification, not reduce diversification.

[00:09:09] So, fixed income or bonds paying more and, and you know, maybe warranting more allocation than they had for a decade, if you will. Uh, what about alternatives, Brad? There's been some recent news actually about, uh,

some large institutions I think of state funds and the like, of, of lowering allocations to private equity and such.

[00:09:29] But there are a number of nonprofits that are just building allocations. Do you think this setting right now with more volatility actually lends itself, whether it be private equity or marketable alternative hedge funds, what are the thoughts from a practical portfolio implications perspective on alternatives?

[00:09:47] Yeah, it's, it's a great point. So you can kind of split those into two major food groups, let's call it private assets and marketable alternatives are really hedge fund portfolios. The idea, let's just take hedge funds for a moment, the idea of higher

[00:10:00] volatility and more differentiation amongst winners and losers.

[00:10:05] That is an environment historically in which hedge funds have really thrived and added a lot of benefit. They're also not solely reliant on their success based on the direction of the market. So, if markets are up, they can still add value to portfolios. Or markets are down, they can still add value to portfolios.

[00:10:20] So the independence of market direction, this is a good environment for that. We actually wrote a paper at the beginning of 2022 offering that as, Hey, reconsider these things that have kind of been left for dead for the last 10 years. They could be a surrogate at that time, very low yields. On the private equity side or private assets.

[00:10:39] I'd say many investors are somewhat looking reactionary at their books and saying, wow, there's markdowns. I'm reading about venture capital trading off. I'm not sure what's happening kind of behind the curtain on some of these, but we have to remember that we, when we invested in private assets, one, you invest a certain amount of money and then that is deployed over a number of years.

[00:10:58] It's not invested the very single day that you commit to that position. So, buying positions as they've come down and as private equity, right? It doesn't defy gravity. So, if public markets are down, private markets are probably also down to some similar degree. And so, investing into those periods of volatility often can be a more profitable forward-looking return.

[00:11:19] And then we're not putting that all that money to work at one time, so over a number of years. So, if we're reacting to just what we see today in private markets, we're probably chasing our tail a little bit on when that money actually gets put in the ground. And so, I think for allocators, we really need to remember that timing difference.

[00:11:38] Yeah, it makes great sense. Brad, I, I wrote a piece just recently and in it I mentioned you know, you could argue that right here, right now, broad, thoughtful diversification is as important as it's ever been. And I think your allocation approach, uh, really supports that. So let's jump to the grab bag.

[00:11:57] I'd like to start with the banking crisis and specifically Silicon Valley Bank, SVB. When we look around, there's plenty that went wrong and lots of people deserving of blame, but I wanna take a different angle here. Touching on one of the root causes that not only fostered bank failures, but it also impacts how portfolios might perform for the foreseeable future.

[00:12:19] And what I'd like to do is quote Derek Thompson of the Atlantic. Uh, he shared this on his podcast, Plain English. Frankly, it's one of my very favorite podcasts. And he says this, I want to talk about the phenomenon of ZIRP, Z-I-R-P, zero interest rate policy from the Federal Reserve. It goes on to say, one of the themes I think that have emerged from the last year, 15 months, has been that lots of things that we thought were the wave of the future were in fact, what I would call LIRPs. Low Interest Rate Phenomenon.

[00:12:54] He says, we are living in the ashes of a LIRP economy. So, Brad, I've also written on this a bit and effectively how free money has led to, I'll call them revenue land grabs by tech startups like Uber subsidizing rides or streaming services being subsidized. It goes on and on. because we were in a no interest rate environment, investors didn't care so much about profits.

[00:13:17] It just didn't matter if profits were years off because we couldn't earn anything on sitting in bonds or in cash anyway, so, so Brad, here we are. And the question is, are we sitting in the ashes of a low interest rate phenomenon? And if so, what does that mean for investors going forward? I wish I, uh, I was a as good of an order to come up with something as sitting in the ashes of ZIRP or LIRP, but we were, the answer straightforward is yes.

[00:13:47] You know, in a far less eloquent way, I was really talking about this or we were talking about this as the low interest rate or zero bound interest rates hangover, right? There is a policy effect of extraordinarily [00:14:00] accommodative, monetary and fiscal policy, really since the GFC. I mean, we did see interest rates rise a little bit, but ultimately trough kind of at a policy level at zero.

[00:14:09] But at a practical level, you know, really, uh, in that Covid time period where extraordinary monetary and fiscal measures were, were put in place. There were outsized winners and beneficiaries of very accommodative markets and policies, low inflation, low volatility. And that was benefiting

certain sectors, whether, you know, Bob, you mentioned the prioritization of revenue growth over earnings growth.

[00:14:33] Whether that be what mattered on the fixed income side from a credit research perspective, if you had bad credit, you could simply refinance at a lower rate and, you know, kick the proverbial can. Um, non-zero bound interest rates, higher interest rates. Flips that script on all of that. And that's why we were talking about this as a primary theme on 2023 and going forward is that credit work matters in fixed income.

[00:15:00] The equity risk premium, actually creating earnings at the bottom of an income statement, matter in the equity markets. The interaction between those markets matter more, right? It's not just extending risk because 10 years, it's really been, the path to success is concentration. You know, just own the S&P.

[00:15:18] Don't own international. Or just own tech. Don't own the S&P. Or just own five technology names or the FANGMs. Right? As we think about the unwind of that policy, it creates a, a material shift and it redistribution of potential winners and losers and the asset allocation inference from that is extremely important.

[00:15:36] So yes, we are living the, the live of kind of that policy hangover, that policy fallout. And we think it does have a material impact. And those that are operating with the last 10 years playbook and then just simply reapplying it to the future are probably gonna be fairly disappointed in what's to come, rather what was.

[00:15:58] So let's stick with the situation going on in the banking world and, and we'll be SVB specific. So, CFOs and others thought it was a good idea to invest millions above FDIC limits in SVB. It would be fun to ask you what their duty and responsibility was, but we'll take a different approach for now.

[00:16:17] Um, we'll just simply get your thoughts on the decision to bail out depositors and make them whole and what that means going forward. So should every depositor in every bank assume that they are fully covered at all times? Yeah, it's, it's a great question and one that's probably gonna draw some political bantering, right?

[00:16:37] So SVB, given its size and many other regional community banks, they're not considered systemically important banks. And that's a legal designation for some of the largest banks in the world. But what the FDIC and the Fed and treasury did in effectively bailing out, as we mentioned, depositors is they really brought in what's called the systemic risk exemption. And they said, you know what?

[00:16:59] We, we hear you. It doesn't fall under this kind of loose definition of 250 billion in assets, but we do think that it's important. Now, there's really a couple ways to think about the bailout, if you will. One would be the role of the FDIC and what they're actually trying to do.

[00:17:17] The FDIC doesn't wanna take companies into receivership and keep them. They wanna receive companies in periods of stress and sell them back into the market. They don't wanna be a long-term home. They wanna be a temporary home, and so receivership allows them to do that. But by bailing out depositors, SVB had a very unique franchise.

[00:17:34] They had many depositors that were well above 250,000. The majority of their assets were not FDIC insured. Looking at that and trying to find a bid in the market, they could say the franchise value of this business, our ability to sell it to someone else and get it off the government's balance sheet, is going to be highly dependent on bailing out these depositors above 250,000 or more.

[00:17:56] So that's kind of one component of it. The second is gets into this idea of [00:18:00] moral hazard. And this is somewhat of a personal view, but I think you could have some kind of conversation around this. Where should moral hazard really lie? You kno0w, getting, having insurance or having assets above the $250,000, should that be with the individual or the company that's responsible for that?

[00:18:18] When in actuality the fed and regulators and, uh, many others, rating agencies looking at these businesses, didn't even know that. type of risk exists, and it's their professional day job to do that. Whereas kind of, you know, Johnny or Susie's small business, or you know, Billy or Susie, uh, depositor, can they really judge that risk independently by looking at the financial statements?

[00:18:42] That's unlikely. So moral hazard was brought in with equity owners being wiped out, fixed income, uh, debt holders. Having material haircuts across their book of business, management being replaced, but the moral hazard wasn't placed upon the depositors. And that feels like it's a good middle ground [00:19:00] for actors that are in a position to actually be able to do something with that information.

[00:19:04] But without making kind of an example of these smaller businesses or individuals that had FDIC, or had assets above the FDIC insurance. So it's a, it's a tenable line, but it's a hard one to try to cross, and it feels like they came to a pretty elegant solution.

[00:19:21] That's helpful. So, most of our listeners are dealing with portfolios that are held with custodial banks. So, can you talk a little bit about some of the

considerations or what investors should know about deposits on the custodial side? And do you have any, you know, practical insights that you can share from that perspective?

[00:19:42] You know, I think the thing about banking crises, and hopefully we have fewer of them than more, is there, they tend to be a crisis of confidence. And because the banking industry is the essential plumbing to everything in our world, whether it's your personal checking account or where your assets are custodied, it creates this call in to question everything type mentality.

[00:20:05] Banking and custody are different, and that's an important distinction to make. When you think about having your banks held at in deposit at a bank and the use of that capital, whether through loans or investment, and then custodying your assets, even if it's at a bank of, of a similar name.

[00:20:23] Those are effectively two separate ledgers. In short, your money is your money regardless of the volatility or concern around the institution. Now, the FDIC'S equivalent on the custody side SPIC. That is an institution that exists to help protect custody in, uh, in individuals in the instance of custody failure.

[00:20:43] But custody failure tends to happen around things like books and records failure or margin balances that are un lent. Securities not really around kind of banking industry volatility in general. So, the co-mingling of that idea of I'm worried about the banking industry, I'm worried about deposits and can my assets be custody at a bank?

[00:21:05] There, there may be some ties that overlie those two, but I don't think we should just simply lay them on top of one another and say they're the same issue. So, in short, the vast majority, and we are not custodian experts and that is not our role. But if you're thinking about kind of this recent concern, we wouldn't say it necessarily bleeds into custody and many custody institutions are very safe and kind of assets are held uh, separately and legally separate from those assets, uh, on the banking side.

[00:21:31] So we wouldn't necessarily put those on top of one or another. Brad, let's go with a macro concept here, uh, which really should have and does have, I believe, implications for all investors. Over the years, we have written about and referenced Hyman Minsky, the late Economist who produced the Financial Instability Theory.

[00:21:50] Essentially, he says that, it's really interesting, stability ultimately produces instability. And as you know, it works like this. When things are going so well for so long, people become a little loose in terms of safeguarding against risk and bank lending standards start to loosen up and so on. So, stability ultimately leads to instability.

[00:22:11] I'm just wondering if it's possible that with Silicon Valley Bank and now Credit Suisse and so on, are we possibly seeing a reverse Minsky moment? In other words, that instability, these bank failures, might compel more focus on risk. And by doing so, help us avoid the big catastrophe by adjusting bad behavior before it's too late?

[00:22:32] Uh, what's your, your take on that, Brad? Bob, I think it's a great point. And in short, I think the answer is pretty clearly yes. And that's an analogy that you can use even across the economic cycle. Right? Businesses will grow, uh, when consumers are spending, they'll start adding new products, adding new lines, growing more.

[00:22:50] But then as financial conditions contract, then you see you know, kind of a pullback to center and core practices. And that's very common. Now, the banking industry in particular, you might see something similar. So, we had the global financial crisis, which we went through in 2008. Now, rarely does the pendulum kind of swing to perfect.

[00:23:08] Usually it swings past, and then there's, you know, uh, an oscillation back to trying to finding the right middle ground. So, Dodd-Frank was enacted here in the United States. Basel III was enacted across the pond. That really reregulated banks and put a lot more capital in the system to make them stronger and more able to weather crises like this.

[00:23:27] Now, as you fast forward over time, some of that regulation has been pulled back. There was a change in regulation that happened, uh, in 2018 where the type of regulation that happens in the banking industry actually rose from businesses or banks that had 50 billion in assets up to 250 billion in assets.

[00:23:44] Interestingly enough, Silicon Valley Bank was just under that 250 threshold, and so they weren't regulated in the exact same way. Was the rollback in that regulation, was that inappropriate? Did it cause this crisis? Did it, you know, I think power factual is hard to say, but clearly there'll be a, uh, a new look at kind of capital and it's not so much capital requirements that are concerned here.

[00:24:08] It feels like recent regulation did a lot to under, uh, to, to improve that. It's more liquidity management and risk management and how that influences smaller, less, uh, globally systemic banks like regional banks and others. So, Bob, I think this is going to be an opportunity that will create more stability in the financial system, but obviously we're in the midst of it today.

[00:24:32] So obviously, there's a lot going on in the markets. We've covered a lot today. Before we wrap up, is there anything else that you'd like to add or perhaps underscore? You know, like I mentioned earlier, this idea of banking

crises tend to be a crisis of confidence and they touch everything. In periods of time like this, it's really easy to let emotions run and not think about kind of our core principles of investing.

[00:24:58] I can give you a number of recent examples where it feels like the market has a ready, fire, aim type approach where they're using imperfect and impartial information to make decisions. These are the times where we need to reroute back on what is it we're trying to accomplish? How are we trying to accomplish it?

[00:25:17] What is the portfolio that we have to help us achieve that goal? And kind of come back to fundamental principles. But also, don't simply just take kind of banking and start to call into question everything. There are things that still stand, principles which we've talked about of diversification. You know, using those principles to our benefit.

[00:25:34] You know, these are periods of time that many just tend to call into question what they're trying to accomplish and how they're trying to accomplish it. And now are the times where we really need to lean back on those first principles. Great. That's an important reminder. Well, thank you as always for joining us.

[00:25:51] You're always full of insights and information and we appreciate your time. Uh, as folks know, listeners and viewers can obtain a lot more, uh, information on our website, Fiducient.com, and we will also provide a link to the article that Bob referenced, um, where he ducks about Professor Minsky. We'll include that in the show notes.

[00:26:11] So Brad, thank you so much for joining us. Yeah, thank you for having me. Brad, great having you on the show and, and fun to do this video format here. We've got Beauty and Bran with, uh, Devon, always looking fantastic and with you and your handsome beard. This is, uh, a new format and a fun format.

[00:26:27] So always good to have you on this show. And with all this uncertainty and volatility that Brad is referencing, those of you oversee investments, have a lot on your plate. Last week I talked to Jenna Friedman, our director of marketing. The marketing team is incredibly busy. We're actually responding to 18 RFPs this month.

[00:26:45] And why do I mention this? It's because if you're a bit anxious or simply feel it's good governance for you to take a look and review the advisor that's working with you, feel free to reach out to me or to Devon at any time. So, to all you good stewards, thanks for investing time [00:27:00] to help your nonprofits prosper.

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