Fiducient Advisors, Nonprofit Investment Stewards Podcast
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Q3 Quarterly Quick Take: 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. It's always nice to be joined by co-host Devon Francis. Devon, how are things? Great. Enjoying the summer so far. Although between camps and other activities, it sometimes feels like the summer is busier than the actual school year.

[00:00:47] Bob, how are you doing lately? I'm doing really well. Summer's a good thing, and actually I just returned from Mackinac Island, Michigan, where I spent a few days at the Midwest Colleges Alliance President's [00:01:00] round table. That's a mouthful, but it was kind of a think tank experience where, uh, I don't know, 50 or so presidents of private colleges and universities gathered and we had an opportunity to chat about endowments and their impact on the institutions over time, and it was just super stimulating.

[00:01:15] So I'm doing great, Devon. Thanks. That's great. So it's midyear, which means it's time for another Quarterly Quick Takes with our colleague and partner, Brad Long, and I think folks will really enjoy the format of today's episode. So what we're going to do is have Brad take us through three distinct segments.

[00:01:32] So we'll begin with the then, what Brad and Fiduciary's research team were expecting from the markets and the economy as we headed into 2023. In the second segment, Brad will cover the now, what's happened thus far in the year, how that compares to our original expectations, and then finally, we'll conclude with the go forward.

[00:01:51] Here, we'll ask Brad to share insights that we hope will be very useful for you, leaders of nonprofit organizations who oversee investments, whether that be [00:02:00] endowments, retirement plans, or any other type of investment program. But before we get to that, Bob, I was hoping that you might be able to share some exciting news with our listeners.

[00:02:10] Oh, absolutely, Devon. Happy to and happy to update our listeners and frankly, very excited to congratulate our longtime colleague and partner, Brad Long. Brad joined the firm in 2012 after gaining meaningful experience at both Citi and Wells Fargo. And as listeners know, Brad was our Deputy Chief Investment Officer, and he also has chaired Fiducient's Investment Committee, uh, for some time.

[00:02:32] It's exciting to announce that as of July 1st, Brad is now Fiducient's Chief Investment Officer. Brad has done an exceptional job of working side by side with Matt Rice and others in leading our research efforts. Very pleased for Brad and a special thank you and best wishes to Matt who has contributed meaningfully to the firm over the years.

[00:02:52] This is a planned transition over quite some time, so we're excited for all, and congratulations, Brad. Thanks so much, Bob. [00:03:00] So with that, let's jump to our quarterly insights. Brad, we said we'd begin with the then. Please remind listeners just how unusually punishing 2022 was and more important, what we're expecting from the markets and the economy in 2023.

[00:03:16] So you want my first podcast as CIO is to come back in and remind people how hard things were? Is that really it? So the then, right? So, in 2022, obviously a pretty unique year, uh, one that was characterized by inflation, the Fed's action to try to quell, uh, high levels of inflation and rising interest rates.

[00:03:35] So bonds fell, stocks fell, many asset prices fell kind of across the board. And you know, in our regular process we're updating capital market assumptions. We're building and looking to the future, right? You can't drive a car in the rear-view mirror. And so, October and November of last year, we were talking about our 2023 outlook.

[00:03:52] And our outlook was really summarized with three broad themes that would be influencing prices in 2023. It was continued [00:04:00] volatility, which we can talk about in greater detail, moderating inflation and a bear market bottom. By and large, those have been moving in the direction that we'd expect.

[00:04:09] Now, not precisely how you would expect, but again, it's the markets and things are dynamic and live and so, there is false precision in trying to predict the future. But those themes we really think still hold today and are gonna be meaningful through the rest of 2023 and frankly beyond. So that takes us to segment number two, the now.

[00:04:29] It's midyear. And Brad, how would you describe market and economic behavior through the first half of the year and what has that meant for endowments, foundations, or really any type of investor for that matter? Yeah, so maybe using the guise of the themes we are expecting in 2023. So, with volatility, there's been quite a bit of volatility in the fixed income market.

[00:04:51] Markets are still trying to decide the true direction and long-term direction of inflation, how the Fed will be reacting to that. And so, interest rates have been moving [00:05:00] around quite a bit and expectations in particular have been moving around a bit. So the VIX is the volatility index for equities. The MOVE index is the equivalent on the fixed income side, and the MOVE index has been very volatile in the first half of the year.

[00:05:13] So that has certainly come to play. Now on the equity side, we'll talk about in a bit, but you know, volatility at the high level has been modest, but when you look just under the surface, there are actually quite a bit of churn there, and I think it has important inferences for investors. On the inflation end of the front half of the year.

[00:05:31] You know, remember a year ago, June, we were at 9% plus inflation on CPI. You know, our most recent data reading, which was May of this year in 2023, it's 4%, which is materially lower and a lot closer to the fed's target of 2%. But as we talked about in our outlook, we don't have to hit 2%. 2% is uh, you know, somewhat of an arbitrary, but somewhat of a magic number in which people are gearing towards.

[00:05:57] But the important inference is that are we on a [00:06:00] credible path towards lower inflation? And we believe we are. And that means that the Fed is nearer its end of its rate hiking cycle, whether it was done in May, or they hike one or two more times. We think we're closer to the end than we are to the beginning.

[00:06:13] So those are very important. Now, 2023, the surprises if you will. When we were writing our outlook in October of 2022, we did not predict a banking crisis and almost, in somewhat of a funny way. The majority of our conversation last quarter was around a banking crisis, and it feels like most people have forgotten that that happened.

[00:06:32] So that certainly still lives in prices today. It's an important part of, you know, how the economy can potentially grow with the formation of capital and lending through the banking system. So maybe it's not a headline anymore, but it still lives under the surface. And then the second thing, as we were sitting in October of 2022, was we were not really predicting a AI hype cycle.

[00:06:54] And that has largely been the biggest driver of US equity market [00:07:00] returns. It's put US large cap growth and kind of mega growth stocks back in the driver's seat, which is to some degree is surprising given their success over the last decade. And some of the AI hype is certainly warranted.

[00:07:13] There's potential for material transformation across industries. The question is the degree to which it's warranted, right? Because some of those securities have really moved in a meaningful way. And so, where we stand today and the portfolio positioning that we put in place, we're very comfortable with.

[00:07:29] But again, as, uh, as the future becomes the present, right? The context around how we got here might be a little different than what we were thinking just a few months ago. That's helpful, Brad. So, you mentioned about AI kind of driving some of the returns we've seen. So obviously that favors growth companies and we've seen that large caps have outperformed.

[00:07:52] What can you tell us about valuations as we look at the current landscape? Yeah. And one of the important things for those that invest [00:08:00] with us or, you know, are managing your own, you know, portfolio. We think timing, trying to time value and growth cycles is really a fool's errand, if you will, for precisely this reason.

[00:08:11] Right? When you, you know, look at the end of 2022, growth stocks were really being punished. They were long duration assets. As interest rates were rising, they were trading off and had some of the worst returns. You know, now we're just halfway through 2023 and they're the bell of the ball, right?

[00:08:27] So trying to time that, uh, is a very difficult thing to do. So, you know, as we think about the valuations of some of those securities, especially as we look at within kind of the AI sphere, if you will, a lot of those valuations are pretty high. You know, we can pick on Nvidia as being, you know, the best stock in the S and P 500 this year.

[00:08:47] It's up almost 186% through today's recording, which is June 29th. That's a really big move in a half a year now it trades at 40 times forward earnings and over 200 times trailing earnings. [00:09:00] We are not individual stock pickers. We're not here to say that is warranted or not. But those are pretty full valuations.

[00:09:07] And so in parts of the market, valuations can be very full. The S and P 500 today sits at about 18 times forward earnings. That's above historical averages, but not in a meaningful way. For context, at the end of 2021, before markets pulled back, you know, we were trading at 20, uh, 20 plus times, around 21 times, uh, forward earnings.

[00:09:28] And so valuations are full, but not everywhere. You know, if you look across the, uh, you know, the ocean over to either Asia, you know, whether we can talk about China if we want to, or European markets valuations are far more constructive. There also here in the US small caps still you know, remain attractive.

[00:09:46] But, you know, there's a lot of nuance under that hood. So, in certain segments, you know, valuation has moved up with price, because price has moved a lot faster than earnings, and others, uh, they may remain far more attractive, like fixed income. That's a very attractive market today. [00:10:00] Okay, great. So, we have the landscape of the now. Let's move on to segment three and talk about the go forward.

[00:10:06] So we really welcome your perspective on expectations for the remainder of this year and beyond. Yeah, so the remainder of this year, again, you know, trying to predict the future is always difficult, but our expectations remain similar around the themes that will be playing out. So, volatility across markets. That has an important inference around things like asset allocation and positioning.

[00:10:28] We positioned ahead of potential volatility. Uh, one of the primary ways we did that is we added to high quality fixed income both through nominal bonds like the Barclays aggregate and through things like TIPS. Those positionings we think help, uh, warrant against potential volatility. And we wanna talk about that in a moment.

[00:10:46] Uh, this idea of, uh, a recession or a looming recession, which the market's been talking about. You know, so those positionings still very much remain. And, you know, with the idea of a recession, I think that is, if we rewind the clock maybe to the then, [00:11:00] in October of 2022 and November of 2022, almost every call it strategist or the, the street was saying, yep, there is a recession coming.

[00:11:09] The only question is it gonna be February or March? And now we sit here in June and no such thing has occurred. And there's a great phrase that we, hear and talk about often is, you know, the analysis of averages leads to average analysis. Meaning, you know, if you look at the Covid economic contraction or the zero bound interest rate policies we had over, you know, more than a decade.

[00:11:31] That was anything but average. That was very extraordinary. And so many, I think using that average saying either by time or by, you know, looking at leading indicators saying a recession is coming, I think they were somewhat mistaken in using that average analysis. Nonetheless the probability of a recession is rising in our view.

[00:11:51] That could, we know we're not, we're not here to time recessions. We're long-term investors. That could manifest in the back half of this year. It could manifest [00:12:00] in 2024, or it could not manifest at all, but the likelihood is rising for a number of reasons. And so, as we think about portfolio positioning, things like high quality fixed income, things like thoughtful diversification across to geographies and, and types of investing alternative investing, which we can talk about in a moment.

[00:12:18] You know, those can all play a material role with the potential for a recession to the future. But I do wanna leave our listeners with this. Recessions are not to be feared. They're to be understood. Recessions happen every six years on average since 1950. They're a natural part of economic growth and contraction.

[00:12:35] And so we have to prepare for them and understand that they're a present part of markets and market cycles. But we should not be, in our view, we should not try to time, you know, that is, again, somewhat of a fool's errand in which, you know, you end up missing out on a lot of the potential gains and those that had that view coming into this year have missed a pretty extraordinary run in the S and P.

[00:12:57] So Brad, uh, that's interesting. I think we can, uh, [00:13:00] sort of expand on a functional pointer, if you will, for our clients and the three of us we serve not only in a client capacity, many nonprofit organizations, but we sit on nonprofit boards and committees where, you know, we are responsible for overseeing, uh, investments as well in our volunteer efforts.

[00:13:18] But I think about 10 plus years where not only was prudent diversification not rewarded, good stewards were actually penalized for diversifying. And I think you're inferring of course, that that's changed, but do you wanna underscore how you see that playing out over the next decade or so?

[00:13:36] Relative to the last decade? Yeah, I mean, the last decade you can somewhat tongue in cheek, but characterize, you know, Hey, don't own international, just own US. Or don't own US, just own tech. Or don't own tech. Just own FANGM right? A handful of securities. And so the mantra has been, the more concentrated I am, the more success I will have.

[00:13:57] That is also, we don't believe [00:14:00] coincidentally very much overlapped with effectively zero bound interest rates after the great financial crisis in 2008. And so, you know, this idea of kind of very narrow bands of success in a different interest rate environment, we think is a low probability. Now look, we have higher interest rates and there has been a very narrow band of success with just AI, you know, this year.

[00:14:22] That being said, again, take our gaze out more than a quarter, more than a year. You know, we're 10-year investors. We are long-term investors. The inferences of higher interest rates on what that means to fixed income and its contribution in portfolios, what that means to the dollars success relative to other currencies.

[00:14:42] The dollar has been extremely strong over the last decade. Will it have a repeat performance? Potentially. Not likely, right? So as we think about, just owning these narrow, narrow bands of assets that just kind of run up and to the right in success, we think that that's trying to have a repeat strategy of [00:15:00] what happened over the last 10 years and ignoring the rest is likely not the path forward.

[00:15:05] And regardless if you think about being a steward of assets, having diversification allows you to continue, you know, the programming and the important things that those assets exist for, and helps mitigate material risks and smooth the ride along the way. So, even if we're wrong, even if the band of success is very narrow over the next decade, it doesn't mean that diversification still can't play a meaningful role in helping smooth that ride for fiduciaries over time.

[00:15:33] Yeah, that's interesting. And I think diversification, and you talked a little bit about volatility and it's just interesting given the many challenges, the war in Ukraine, strained relations with China, higher borrowing costs, it's pretty remarkable that at least through this recording in late June, there was research just released by Deutsche Bank that shows that it's been more than three months since the S and P 500 declined at least 3%.

[00:15:58] And in fact, that's one of the longest [00:16:00] stretches since World War ii. Now we know there's unsettled activity, and you mentioned some of that earlier. And that's appearing on a day-to-day basis. But in the broad scheme of things, market volatility appears somewhat low, given the environment. Can you talk about that and, and maybe that even further supports the need for diversification going forward?

[00:16:20] Yeah, it, it's a great point. And one of those kind of average analysis ends, right? So I was picking on Nvidia earlier, right? But Nvidia being the best returning stock in the S and P 500, up a 186%. So through this recording now, we also mentioned the banking crisis that happened earlier in this quarter.

[00:16:38] And many of the bottom constituents of the S and P 500 are banks or others that are down 40, 50% or more. That is a tremendous spread. 186 down to negative 45 or negative 50, like those are big, big spreads and numbers. And what happens is the aggregate level of [00:17:00] volatilities or the aggregate move in the S and P 500, let's just pretend you have one stock, a big stock in the S and P 500 that is up a lot and everything else is down.

[00:17:11] This is the theoretical. The top level volatility will seem low and success will seem common, whereas under the surface, when you start to peel away, even just the first layer and looking at some of the constituents, you'll very quickly find a different story. And so, I think the VIX is a good kind of broad measure of volatility.

[00:17:30] But you know, the analysis really needs to go beyond the average and under, you know, kind of that next level. And you start to see more of that churn. And Bob, it does speak very much to diversification, right? If you were, if you were a value growth timer and you got on the value train last year, and by the way, that was a good train to be on, you are materially underperforming this year, right?

[00:17:52] So another reason we don't believe A, you should time that, and B, you should be diversified. Cuz over time things like value and growth, both add value. They [00:18:00] just add value at different times. So it does take kind of that next level analysis to really start to see the clearer picture. Great. So, in keeping with the theme of diversification, do you have any insights you'd like to share about alternative investments like hedge funds or private equity, private credit, that sort of thing?

[00:18:22] Yeah, I mean, private equity, you, uh, well, I guess you can hold those into kind of three different buckets. So private equity, we talked a bit about this maybe two podcasts ago. You know, the downward move in 2022. You could see that easily on a day-to-day basis in public markets, but you didn't see it as much in private markets.

[00:18:41] And that's just a mechanism of how they price over time. Now we can see, and we are seeing, some of that data come in and prices have come down. That's a better buying opportunity, all else equal, in private markets, and those are very long-term assets, you know, 10 years or more. And so [00:19:00] prices across those segments have been coming down.

[00:19:02] But much like actually the public market, which is pretty interesting, the largest segments of private markets, so the biggest funds and the largest underlying portfolio holding companies, those are still trading at fairly rich multiples. The further you go down that spectrum into kind of lower middle market funds, uh, or smaller portfolio holding companies, those are trading at sometimes half the valuations.

[00:19:27] And so, private markets is a big, broad space and you really have to be thoughtful about how you allocate there. And today, and this isn't a today item just because of valuation, but, y ou know, we are lower middle market investors in private equity. We think that's a great place to start and build a plan, uh, thoughtfully over time.

[00:19:45] And the valuations in that space are even more attractive today than they have been. So that's been a, you know, recent trend. You know, the macro trend of continued volatility and some of that churn I just talked about under the hood of the s and p 500. That's a good environment for things like hedge funds or we call them [00:20:00] market of alternatives.

[00:20:01] You know, the more dispersion of securities and more opportunity for those that are a bit more quick on the trigger, right? And hedge funds are paid to be quick and move allocations around based on some of that volatility. And so, that can create a good environment and they're also not dependent upon just the direction of the market.

[00:20:20] So if we do go into a recession, or if markets do pull back, you know, some of those hedged positions might be helpful. Private credit is a bit of a third leg, if you will. That is an area in which frankly, frankly, we see more risk than probably most of our peers. We don't have enough time to get all the way down that rabbit hole, but in short, private credit has become somewhat of the shadow banking system as banks have been restricting lending.

[00:20:46] And a lot of that risk has kind of been squeezed out of banks, but it doesn't disappear. Risk just shifts. And so, it shifted and it shifted to private credit. And you know, that's a big, broad statement, but if you're just talking in aggregate, it's a space that perhaps we have [00:21:00] less interest. Now, in the micro, there's certain instances it could make sense and for certain clients but it's an area we'd say, Hey, yellow light, some caution here.

[00:21:09] You know, tread lightly if you're moving in this direction. And if clients have more questions about that, we're always happy to follow up with greater detail. Brad, that's great. Uh, really appreciate the insights. Anything else you'd like to add or underscore at this point for these very interesting times with respect to the markets and the economy?

[00:21:28] Yeah, I mean, look, it always feels like it's unique. It's always different this time. We have US China relations or war in Europe, et cetera, et cetera. Yet markets are up. You know, things look good. The AI hype cycle is here. Um, we would say, these things, for long-term investors, this is not new.

[00:21:48] The uncertainty of the future, geopolitical risks, changing in valuation, certain segments running while others aren't. That's part of investing. It's part of the life cycle, and frankly, it's part of how we [00:22:00] position portfolios with resiliency going forward. So while an an average investor, kind of, or an investor at all, you know, we are included, right?

[00:22:07] We're emotional beings as well. You know, as you look at markets, it's, it's easy to kind of get caught into that hype cycle. We would say staying with the plan over the long term is by far and away the best process to win over the long term and kind of getting caught up in the short term.

[00:22:24] You know, that's the one where you really trip. So, resist the temptation, especially as we talk about all these churning things going on underneath to shorten your gaze and really try to invest short term the real money. It's over the long term. That's an important reminder. So thanks for that.

[00:22:42] And thank you as always for your time and your expertise. And as folks know, there's a lot more information on our website, please feel free to visit it at Fiducient.com. You can find more insights from Brad. White papers, blog posts. We also have recordings of previous webcasts and, and a lot of good [00:23:00] stuff out there, so feel free to check it out.

[00:23:02] Yeah, Brad, thanks so much for joining us. Greatly appreciate it. So I would simply say that, uh, given the uncertainty of the markets and of the economy, Brad talked about sticking with the plan, frankly, I would say for sure. But it begins with starting with a good plan and then sticking with the plan. And so, I think it may be as important a time as ever given all these uncertainties for endowment and foundations, uh, any sort of investor to be prudently and thoughtfully diversified. If you have questions or concerns regarding the investments you oversee.

[00:23:34] Feel free to reach out to me or to Devon. Our team would be happy to provide some analytics, including a stress test on how your portfolio might perform in various scenarios we could see going forward. So, to all you good stewards, thanks for investing time to help your nonprofits prosper. We'll connect with you soon on the next episode.

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