November Topic of Interest

Reaching for Returns in a Low Return Environment

Money market yields are zero, most Treasury bonds are yielding less than 2%, and the average annual return for the stock market during the past 10 years has been -0.4%. With institutional spending needs typically ranging from 4% to 8% there exists an obvious disconnect between investment returns and liabilities.

During such times, many investors knowingly or unknowingly move out the risk spectrum seeking higher returns. The current risk free rate of return is 0.11% (3 month T-Bill). Any investment with a higher yield or expected return than this incorporates a greater degree of risk. It is imperative that an investor understand what risks he or she is taking. If you don't fully understand the risks, don't invest. If your adviser cannot adequately explain the risks, it is time to find a new advisor.

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Chris Cahill, Principal

Accepting a modest increase in risk is not necessarily a poor decision. In fact, it is quite common. Most organizations don't have their entire portfolio invested in Treasury Bills. However, accepting increased risks must be weighed with your ability to tolerate the potential outcome. The key is to understand the potential outcome, and that means understanding the underlying risks. Here are some major risk categories that should be considered in your decision making process:

Risk	Questions
Volatility Risk	What are the potential changes in asset valuations, especially to the downside? How is changing strategies going to affect portfolio diversification?
Interest Rate Risk	What will a change in interest rates do to valuations? Also, will a change in rates affect how quickly your capital is returned?
Liquidity Risk	Are their lock-ups or penalties? What is the worst case in terms of maturity? If the investments can be liquidated what is the potential market risk?
Credit Risk	What is the level of certainty that your capital will be returned?
Transparency Risk	Are you able to identify the underlying investments on an ongoing basis?
Operational Risks	Are the assets held or accounted for by an independent custodian or administrator? Are there potential accounting concerns such as FAS 157, bond covenant violations, UBTI, etc..?

The above list of risks is by no means all-inclusive. However, knowing and understanding the answers to these questions will go a long way in preventing surprises down the road.

Most organizations have some limit to the amount of risk they can accept. In a low return environment this may mean re-evaluating spending policies and liabilities or adding assets to the corpus. This can be a difficult and unpleasant task, but it is a task of prudence. As a fiduciary, a significant loss of your organization's assets due to excessive risk is far more unpleasant.

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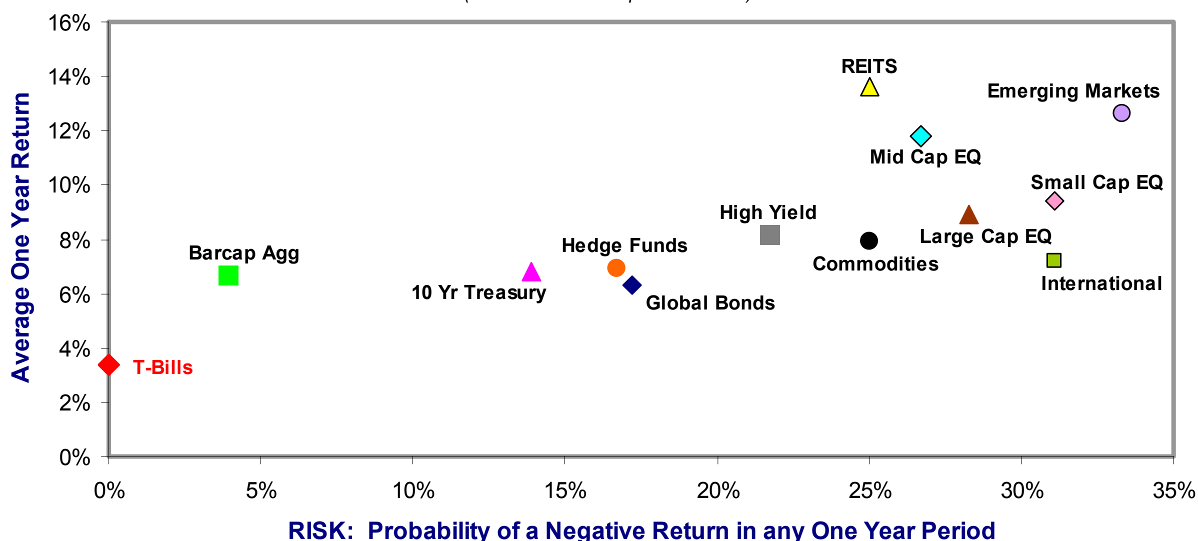

When seeking higher results, another common mistake is chasing returns. "Chasing returns" refers to investing in a strategy or asset class that has produced attractive returns in the recent past. It is a tendency of human nature to extrapolate recent events far into the future. This tendency can be dangerous when allocating assets. Investments tend to be cyclical. Investments that have performed well are many times at the top of their cycles and at high valuations. Valuation is arguably the single most important factor in successful investing. Investing at high valuations will seriously hamper the likelihood of a successful outcome. The key is to be forward looking rather than picking yesterday's winners.

Return Ranking by Asset Class, Style and Capitalization

Total Return

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	10 Years Cumulative
Best	Small Cap Value	Small Cap Value	Bonds	Small Cap Growth	Mid Cap Value	International Equity	International Equity	Large Cap Growth	Bonds	High Yield	Small Cap Value
	Mid Cap Value	Bonds	High Yield	Small Cap Value	Small Cap Value	Mid Cap Value	Small Cap Value	Mid Cap Growth	High Yield	Mid Cap Growth	Mid Cap Value
	Bonds	High Yield	Mid Cap Value	Mid Cap Growth	International Equity	Mid Cap Growth	Large Cap Value	International Equity	Small Cap Value	Large Cap Growth	High Yield
	Large Cap Value	Mid Cap Value	Small Cap Value	International Equity	Large Cap Value	Large Cap Value	Mid Cap Value	Small Cap Growth	Large Cap Value	Small Cap Growth	Bonds
	High Yield	Large Cap Value	Large Cap Value	Mid Cap Value	Mid Cap Growth	Large Cap Growth	Small Cap Growth	Bonds	Large Cap Growth	Mid Cap Value	Large Cap Value
	Mid Cap Growth	Small Cap Growth	International Equity	Large Cap Value	Small Cap Growth	Small Cap Value	High Yield	High Yield	Mid Cap Value	International Equity	International Equity
	International Equity	Mid Cap Growth	Mid Cap Growth	Large Cap Growth	High Yield	Small Cap Growth	Mid Cap Growth	Large Cap Value	Small Cap Growth	Small Cap Value	Mid Cap Growth
	Large Cap Growth	Large Cap Growth	Large Cap Growth	High Yield	Large Cap Growth	High Yield	Large Cap Growth	Mid Cap Value	International Equity	Large Cap Value	Small Cap Growth
Worst	Small Cap Growth	International Equity	Small Cap Growth	Bonds	Bonds	Bonds	Bonds	Small Cap Value	Mid Cap Growth	Bonds	Large Cap Growth

Sources:		
	Large Cap Value: Russell 1000 Value Index	**Large Cap Growth:** Russell 1000 Growth Index
	Mid Cap Value: Russell Mid Cap Value Index	**Mid Cap Growth:** Russell Mid Cap Growth Index
	Small Cap Value: Russell 2000 Value Index	**Small Cap Growth:** Russell 2000 Growth Index
	International Equity: MSCI EAFE Index	**Bonds:** Barclays Capital Aggregate Index
	High Yield Bonds: BarCap High Yield Index	

Finally, the least risky way to increase returns is to lower investment costs. Be diligent about what you are paying. Evaluate your fee structure versus industry norms. Contrary to popular belief and the marketing promises of vendors, paying above average fees doesn't typically result in achieving above average returns. Actually, it's usually the other way around. Nonetheless, controlling costs is the one variable that an investor can control in any type of market environment.