

Market and Portfolio Update: Year in Review

2019 was a strong finish to a stellar decade, with major equity markets delivering double-digit returns and high-quality bonds posting their best returns in 10 years. The markets seemingly disregarded much of the political uncertainty experienced during the year, including concerns around the Chinese economy, tariffs, U.S. protectionism and the potential for a “hard” Brexit. There is now more clarity around these matters, with the recently finalized “Phase One” trade deal with China and Boris Johnson’s December 12 election win; however, the markets will endure tensions surrounding these issues for many years to come. In a stark reversal, the Federal Reserve reduced rates three times in 2019, alleviating the fear of overtightening that had hung over the markets at the end of 2018. As rates declined, longer duration bonds benefited, and the U.S. Aggregate Bond Index outperformed the 1-3 Year Treasury Bond Index by 510 basis points.¹ All in all, 2019 was a good year for the Brown Brothers Harriman policy portfolios, and we are pleased with the returns that we generated as markets rose. As with all of the market and portfolio updates in *InvestorView*, this article is backward-looking and is a review of 2019, written as of December 31, 2019.

Investment Returns as of December 31, 2019

| Asset Class | 3 Months | YTD | 1 Year* | 3 Years* | 5 Years* | 10 Years* |
|---|----------|-------|---------|----------|----------|-----------|
| Fixed Income | | | | | | |
| 1-3 Year Treasury Bonds | 1.1% | 3.6% | 3.6% | 1.9% | 1.4% | 1.2% |
| U.S. Aggregate Bonds | 2.5% | 8.7% | 8.7% | 4.0% | 3.0% | 3.7% |
| Global Aggregate Bonds (USD – Unhedged) | 1.1% | 6.9% | 6.9% | 4.2% | 2.3% | 2.6% |
| U.S. Municipal Bonds | 2.3% | 7.5% | 7.5% | 4.7% | 3.5% | 4.3% |
| U.S. High-Yield Bonds | 3.9% | 14.4% | 14.4% | 6.3% | 6.1% | 7.5% |
| U.S. Leveraged Loans | 2.8% | 8.6% | 8.6% | 4.4% | 4.4% | 5.0% |
| U.S. Inflation-Linked Bonds | 2.2% | 8.8% | 8.8% | 3.4% | 2.7% | 3.5% |
| Equity | | | | | | |
| Global Equity (ACWI) | 9.2% | 27.3% | 27.3% | 13.0% | 9.0% | 3.5% |
| U.S. Large-Cap Equity | 10.9% | 31.5% | 31.5% | 15.2% | 11.7% | 13.5% |
| U.S. Small-Cap Equity | 7.3% | 25.5% | 25.5% | 8.6% | 8.2% | 11.8% |
| Non-U.S. Developed Equity (USD) | 7.1% | 22.7% | 22.7% | 10.1% | 6.2% | 6.0% |
| Emerging Markets Equity (USD) | 7.3% | 18.9% | 18.9% | 12.0% | 6.0% | 4.0% |
| Non-U.S. Developed Equity (Local) | 7.2% | 22.3% | 22.3% | 8.2% | 7.2% | 7.7% |
| Emerging Markets Equity (Local) | 7.5% | 18.5% | 18.5% | 11.9% | 7.9% | 6.5% |
| Long/Short Equity Hedge Funds | 5.9% | 13.9% | 13.9% | 6.2% | 4.6% | 4.7% |
| REITs | 6.9% | 25.9% | 25.9% | 8.1% | 7.1% | 11.9% |
| Commodities | | | | | | |
| Gold | 7.6% | 18.3% | 18.3% | 9.8% | 5.1% | 3.3% |
| Silver | 16.6% | 15.2% | 15.2% | 3.9% | 2.6% | 0.6% |
| Crude Oil | 4.4% | 34.5% | 34.5% | 4.4% | 2.8% | -2.6% |

*Annualized return figures.
Past returns do not guarantee future results.
An investment cannot be made directly in any index.

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¹Basis point: one hundredth of one percent.

Reflecting on the decade, it was a good time to be invested in equities, particularly U.S. large-caps. For example, an individual who invested \$100 in the S&P 500 Index on January 1, 2010 would have accumulated \$257 dollars by December 31, 2019, earning an impressive 13.5% annualized 10-year return. A big driver of these returns was the recently coined “FAANG” stocks, Facebook, Amazon, Apple, Netflix and Google (Alphabet), which today total around \$4 trillion, or 15%, of the S&P 500’s total market value. In fact, these five stocks alone generated a 10-year annualized return of 24.9%, or close to 30% of the S&P 500 Index’s return. The decade also saw an unprecedented downward trend in interest rates as central bankers around the world injected substantial amounts of liquidity into their economies. In the U.S., the 10-year Treasury began the decade at 3.85% and ended it at 1.92%. While U.S. Treasuries are still paying interest, approximately \$15 trillion, or 25%, of government bonds worldwide now trade at negative yields. Investors are essentially paying governments for the privilege of lending them money. The willingness of central banks to support their economies with unprecedented levels of monetary intervention for such a prolonged period is something no one predicted at the start of the decade. The question before us today, however, is do central banks have enough dry powder in their arsenal to continue accelerating growth?

We can’t predict what the markets will do in the future, especially over short periods, but we do know that many investors will be tempted to exit, or substantially reduce, equities considering their recent strong returns. We understand this reaction, but we firmly believe it is impossible to time the markets. It requires not one, but two perfectly timed decisions – first to exit the market and second to reinvest. And while we have shown similar data in prior *InvestorView* articles, it is worth repeating: an individual that invested \$1

in the S&P 500 Index in 1927 would have accumulated \$182 by the end of 2019, but investors that missed the 10 best performance days would have only accumulated \$60. Market timing simply does not work.

So, what should investors do after having been through the longest bull market in history?

- **Review your asset allocation to ensure it aligns well with your risk tolerance and objectives. Take opportunities to rebalance back to those targets.** Now is an optimal time to review your asset allocation to ensure that it aligns with your unique circumstances and objectives. A prolonged bull market can lull investors into a false sense of security. Therefore, it is important to make sure that you understand the risks inherent in your portfolio so that when equity markets decline, you can remain invested or even increase equity exposure. Once you have reaffirmed your asset allocation, take opportunities to rebalance, especially through low-cost methods, such as reallocating new inflows, dividends or interest income. While a tactical decision to sell equities is ill-advised, rebalancing is a prudent exercise in risk management that is especially important as markets reach new highs.
- **Stay invested with high-quality active managers.** In this environment, we at BBH are especially happy to be invested with our roster of high-quality active managers that have concentrated portfolios, are disciplined in their valuation approach and are willing to hold cash when attractive opportunities are not available. While cash is a drag on returns during up-markets, it provides a source of downside protection and option value when markets decline. Notably, during past market dislocations, such as the fourth quarter of 2018, our managers successfully redeployed cash into securities that,

all else equal, were more attractively priced than they were prior to the market pullback.

- **Don’t reach for yield.** Despite the temptation to increase yields by investing in lower-quality securities, like high-yield bonds, we believe that investors aren’t getting paid enough for the risk inherent in these securities. We prefer to own the stocks and bonds of high-quality companies with strong cash flows and balance sheets that can survive and thrive in a downturn. For individuals that need additional income, you should work with your relationship manager to develop a program that provides for regular distributions of capital from the portfolio, not just interest and dividends.

Equity Markets

As seen in the nearby chart, all global equity benchmarks finished higher than they started in 2019. While equity investors have earned double-digit returns, most of these gains occurred by April 30, as the markets rebounded after the sharp declines of the fourth quarter of 2018. Across global equity markets, U.S. large caps were the best performers once again. They outperformed all other equities, including small cap. The year saw the S&P 500 Index deliver a 31.5% return, representing the benchmark’s best calendar year gain since 2013. Moreover, the Index was up on 59.5% of all trading days, which is tied for the fifth highest percentage since 1928.

All sectors generated positive returns, but technology, with a 51% return, was responsible for roughly one third of the Index’s total return for the year. This is only the second time in the last 18 years that an S&P 500 sector has generated a return in excess of 50% (the first time was in 2009). Energy, although at the bottom of the list, still generated a respectable return of 11.8%. Gains were widespread, as about 90% of the stocks in the S&P 500 Index generated positive

returns. Company insiders also reinforced the positive view on stocks, as the ratio of insider buying to selling continued to increase during the year, which helped to propel the market higher.

Non-U.S. developed and emerging-market equity returns trailed U.S. equities once again, though they still generated sizable returns at 22% and 18%, respectively. Currency wasn't much of a factor during the year, and non-U.S. developed and emerging-market equity indices in local dollars were only marginally lower than in U.S. dollar terms. Given more reasonable valuations that currently exist outside of the U.S., the medium- to long-term outlook for non-U.S. and emerging market equities could well be favorable.

Fixed Income Markets

2019 was the best year for high-quality bond returns since 2002, with the U.S. Aggregate Bond Index's return of 8.7% at a level that is more commonly associated with equity returns. The year began with the fed funds rate at a target range of 2.25-2.50% and a relatively flat yield curve. However, by late August, the yield curve had inverted with the 10-year Treasury out yielding the two-year, scaring markets and prompting fears of a recession. Three successive fed rate cuts over the balance of the year brought the fed funds rate to a range of 1.50-1.75% and helped restore a more normal, upward-sloping shape to the yield curve. Today, however, both short- and long-term yields stand near historically low levels, limiting both current income and the future upside return for the asset class. Low interest rates remain somewhat perplexing. If Rip Van Winkle had fallen asleep in 2010 and woken up in 2020 to an economy growing at roughly 2.5%, unemployment near historical lows, wage growth of 3% and inflation of 2%, we expect he might be surprised to find the 10-year Treasury trading at a paltry yield of 1.9%.



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Despite these low levels, the U.S. is still a relatively attractive place to invest in fixed income, as it is still possible to find high-quality bonds trading at yields of between 2% and 4%. In contrast, the benchmark 10-year German bund trades at a yield of -0.25%. Practically speaking, this means that today, an investor would pay roughly \$102.50 for a bond that pays no coupon and matures in 10 years at a price of \$100. Accordingly, U.S. investment grade fixed income still plays a key role in BBH's portfolios. First and foremost, fixed income provides an important source of downside protection. During equity market selloffs, high-grade, longer-duration fixed income is one of the only asset classes that tends to rise in value, making it an invaluable source of downside protection for portfolios. Additionally, fixed income still provides an important source of yield, and it is still possible to generate positive, real, after-tax total returns above inflation, which allows it to preserve the real value of our clients' capital. While our desire is to have a greater proportion of our assets invested in longer-duration fixed income, our current positioning stands at close to

an equal balance of short-duration and longer-duration fixed income, a position we expect to maintain until we deem the compensation for interest rate risk to be more attractive.

Beyond investment-grade fixed income, we still see value in middle-market direct lending. While this market is not immune to declining interest rates and tightening credit spreads, investors can receive an illiquidity premium over broadly syndicated loans, better loan documentation and financial covenants and more timely financial information from borrowers, to name just a few. BBH takes a conservative approach to this asset class and believes that by partnering with an exceptional manager that has extensive experience underwriting credit, we can produce attractive risk-adjusted returns for our clients.

Looking Ahead

Although we are fundamentally bottom-up investors, it is our practice each year to develop capital market estimates for major asset classes. While we do not rely on these estimates for making investment decisions, we do utilize them to help frame expectations for returns, and in certain instances, to prioritize our research efforts during the year. Notably, these estimates are based on index returns and do not include estimates of manager alpha.

For 2020 our capital market estimates are as follows:¹

As we look ahead, we believe that markets are poised for moderate long-term growth. Our forecast for U.S. large-cap equities includes roughly 5% for earnings growth and a 2% dividend yield, for a total expected return of 7%. In 2019, however, the market rose by 29% while earnings rose around 4%, leading earnings multiples to expand. As a result, our 2020 20-year forecasts call for U.S. large-cap equity returns of just under



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2020 Capital Market Expectations - 20-Year Time Horizon

| Asset Class | Pre-Tax Expectations | | |
|--|----------------------|-------------------------|--------------------|
| | Yield | Geometric Return (CAGR) | Standard Deviation |
| Inflation | | | |
| Inflation | 0.0% | 2.0% | 1.0% |
| Cash | | | |
| Transaction Cash | 2.5% | 2.5% | 1.0% |
| Fixed Income | | | |
| Strategic Reserves | 3.2% | 3.2% | 2.0% |
| U.S. Investment Grade Taxable Bonds | 2.9% | 3.1% | 4.0% |
| U.S. Investment Grade Tax Exempt Bonds | 2.1% | 2.1% | 3.0% |
| Non-Investment Grade Debt | 3.7% | 4.3% | 12.0% |
| Inflation-Linked Bonds | 2.5% | 2.6% | 5.0% |
| Private Debt | 3.5% | 5.8% | 12.0% |
| Equity | | | |
| U.S. Large Cap Equity | 2.0% | 5.8% | 15.0% |
| U.S. Small/Mid Cap Equity | 1.5% | 6.9% | 17.0% |
| Non-U.S. Developed Equity | 3.3% | 6.5% | 15.5% |
| Emerging Markets Equity | 2.8% | 7.3% | 18.0% |
| Global Equity | 2.6% | 6.2% | 15.3% |
| Long/Short Equity | 0.0% | 4.8% | 11.0% |
| Private Equity | 0.0% | 9.4% | 23.0% |

As of December 31, 2019.

6% per year, down over 1% from the prior year. Most other equity sub-asset classes experienced similar declines in expected returns. If history is any guide, actual returns over the next 20 years will be anything but a smooth ride. Despite some clarity on the U.S.-China trade war and Brexit, market participants need to look no further than what is sure to be a bitterly contested 2020 election between candidates with radically different views for the future of the United States. As our clients know, we think that the true measure of risk is permanent loss of capital, and price declines simply provide us with opportunities to buy high-quality securities at better prices. As always, we will continue to utilize bottom-up, fundamental research to make investments that will protect and grow our clients' capital successfully over time. ■

¹Definitions Yield: A measure of cash flow received from an investment over a given period of time expressed as a percentage of the investment's value. For fixed income, the cash flow is composed of interest income; for equities, the cash flow is made up of dividend payments. Geometric return (CAGR): The compound annual growth rate (CAGR) is a geometric return that represents the single rate of return that an investment would have achieved by growing from its beginning balance to its ending balance assuming all cash flows were reinvested at the end of each year. Standard deviation: Measures the historical volatility of returns. The higher the standard deviation, the greater the volatility.



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