Madison's Multi-Asset Solutions Team Perspectives

Third Quarter 2019

Review

Despite a rather steep mid-quarter sell-off, global stocks rebounded to produce generally mixed results during a rather topsy-turvy quarter for equities. For the quarter, U.S. stocks (Russell 3000) climbed 1.16%, while foreign equities (MSCI ACWI-ex U.S.) declined -1.80%; meanwhile, U.S. bonds (Barclays U.S. Aggregate), posted returns of 2.27%.

David Hottmann, CFA
Portfolio Manager
Industry since 1990

Perspectives

> *"Everything in moderation, including moderation."*
>
> - Julia Child

Let's review one of our core long-standing investment principles. Our approach to portfolio management is concisely summarized as follows (from our own Investment Policy Statement):

Approach – Valuation Driven

Portfolio allocations are driven by our assessment of valuation-based expected returns. We understand that rich valuations are typically followed by sub-par performance. Investment success can therefore be enhanced by embracing an evidence-based approach in conjunction with a flexible mandate and then repeatedly and opportunistically differentiating between relatively undervalued and overvalued asset classes.

Patrick Ryan, CFA
Portfolio Manager
Industry since 2000

Accordingly, we believe that financial markets can be notably inefficient. We will therefore, at times, utilize a "contrarian" mindset, identifying out-of-favor or misunderstood asset classes where investor expectations are not excessive, and worthwhile outcomes are attainable.

Our approach can be described as both fundamentally-based and conservative. You will also note that "momentum" is not a factor that we pay heed to. Conversely, we tend to look in the other direction to identify securities that have been "left behind" when momentum or speculation becomes an overly dominant or extreme factor for financial market participants.

Momentum-based markets, which have been more common recently, tend to be highly price-insensitive. Investors (or algorithmic traders) see what is working and then pile into these same securities. If perpetuated, these securities can become very pricey and untethered from their own fundamentals. In our view, this is not investing – it amounts to speculative trend following. At some point, it can become a game of "Old Maid" where some investors are suddenly and unexpectedly stuck holding the wrong cards. We'll pass and instead rely on our evidence-based approach. We'll leave it to other investors to press their luck against today's modern-day "dealers."

Past performance does not predict future results.

Outlook

The message from financial markets is a cautionary one. Safe-haven assets like Treasuries and gold continue to attract investors. Likewise, year-to-date Utility Sector returns are broadly outperforming other more cyclically sensitive sectors like Industrials, Financials and Materials. This is also a global phenomenon. We are pleased that our own positioning is very much aligned with this emerging picture of slowing global economies. To the point, we are notably and intentionally underweight cyclically sensitive asset classes.

Global central banks have essentially "nationalized" risk; they've done their best to perpetually soothe and medicate financial markets with extreme forms of monetary accommodation. Historically low, and often negative, global interest rates are but one example. This has led to investor complacency and a valuation disconnect between many richly priced risk assets and their true underlying intrinsic valuation. Thoughtful investors understand that this is a uniquely challenging investment environment. In our view, investor expectations should be tempered.

Portfolio Positioning

An optimal and efficient response to today's "unusual" investment climate likely requires a corresponding "outside the box" approach. What are the most unique, telltale attributes that we should be focusing on? For starters, inflation remains low and global debt levels remain extraordinarily high. These same elevated global debt levels also imply that global economies are operating in a perpetually fragile economic condition. This backdrop is likely to motivate global central banks to keep interest rates extraordinarily low for an extended period-of-time.

If this holds true, this should favor stable, relatively safe, long duration assets that have highly predictable future cash flows. Accordingly, high leverage and cyclical exposures should be carefully evaluated. The tortoise may beat the hare in this scenario. In other words, boring is beautiful.

Putting this together, our portfolios are comfortable with holding long duration assets such as Treasury bonds and high-quality, blue-chip stocks that are less susceptible to disruption risk, excessive leverage and economic cyclicality. U.S. large cap stocks with a long, stable and predictable history of growing their dividends are a good example of the type of equities we are particularly focused on. Foreign equity positioning has a similar profile. From a country perspective, Japan (positive economic reforms), the U.K. (attractive contrarian valuations) and China (durable economic growth) are relatively compelling in our view. On the other hand, continental Europe (dysfunctional governance), Australia and Canada (housing bubbles) are less appealing.

Summary

We are confident our Multi-Asset managed portfolios remain well-positioned for a growth-challenged global economy. We also understand and embrace our ongoing responsibility to insightfully differentiate between attractive and less attractive asset classes as we strive to deliver superior risk-adjusted returns. As always, we truly appreciate your confidence and your support.

Sincerely,

David Hottmann, CFA　　　　*Patrick Ryan, CFA*

See the following page for important information.

Additional Information:

Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only, and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

The Russell 3000 Index measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market. The Russell 3000 Index is constructed to provide a comprehensive, unbiased and stable barometer of the broad market and is completely reconstituted annually to ensure new and growing equities are reflected. Russell Investment Group is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes. Russell® is a trademark of Russell Investment Group.

The MSCI ACWI ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets countries (excluding the US) and 23 Emerging Markets countries. With 1,843 constituents, the index covers approximately 85% of the global equity opportunity set outside the US.

Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged index of U.S. fixed income securities. The U.S. Aggregate Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS sectors.