



October 4, 2021

Dear Clients and Friends:

I assume when clients hire an investment advisor that they believe they are hiring...investors, those purportedly intelligent souls tasked with ferreting out the best ideas and strategies, building portfolios with the best potential return, or at least their opinion of what that is. So it was with some amusement that I read a recent article decrying the return of the Hong Kong market, which has returned an annualized rate of 7.10% for the 10 year period ending 9/30/21 vs the S&P 500 at 16.61%. The advisor was proud of their modest 0.5% "underweight" to that market versus the global benchmark and thought it represented a validation of their investment prowess. The client was somewhat taken aback, and asked the advisor why they owned it at all if they did not like that market. To that, the advisor replied, "It's in the benchmark." The point of this is that the vast majority of investment advisors are simply index-driven investors. Rather than a portfolio representing the best of their ideas, it is instead a portfolio of relative value.

This concept of relative value has worked reasonably well, as most markets have been going up at a rate that is historically rather high. This is especially true in fixed income where the broad market index tracked by most managers, the Bloomberg U.S. Aggregate Bond Index, has compounded at a rate of 7.70% for 40 years as of 9/30/21. Just beating the index, even by a little, made clients very happy and met most, if not all, of their goals.

We will posit the idea that the era of successful index-based investing in fixed income is largely over. It is like an airplane at 30,000 feet with engines that have been off for a minute or so. The flight remains smooth; it is actually very quiet. The passengers have no idea what is about to come, but an impact would be unpleasant. Such is the case with global fixed income tied to this aggregate index. By the measure that counts, duration or interest rate sensitivity, it has never been riskier, and the potential return going forward has rarely been lower. Yet the game remains afoot for managers and consultants alike. Many of these advisors fail to reassess the potential return versus the associated risk. These risks include not only likely negative returns but also the low probability that such an investment style has even a remote chance of satisfying most investment objectives. This is the true definition of risk, and investing in a manner almost certain to collide head on into it is the very definition of irresponsibility.

However, we believe there is time. We are likely in a period that will be quite lengthy. Goals can be reassessed, new strategies can be implemented, and risk can be redefined. Those who recognize the world has changed and will be starkly different for the foreseeable future will have a chance at success. Those who proceed as a monolith, mired in the ways of the past, are likely doomed to be disappointed. The good news is that manager of yours may very well "beat the market." They will not understand why you are not impressed.

Sincerely,

A handwritten signature in black ink, appearing to read "Mark M. Egan".

Mark M. Egan, CFA
Managing Director

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