CLEARBROOK

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4 Key Pillars

Over the years we have spoken frequently about how we use the Four Pillars of the market to determine our allocation decisions on a forward-looking basis for the next 6-12 months. For many of our clients this can be the difference between achieving their return goal or missing it by a few percent. The Four Pillars that we focus on are Growth, Valuation, Sentiment, and Capital Flows. Each pillar is discussed and assessed by Clearbrook's Investment Committee until we have a consensus view of whether it is a tailwind or headwind for a particular geographic region, asset class, and investment strategy. It is important to note that specificity is not the goal of the exercise. We try to avoid getting bogged down in the weeds of uncovering, analyzing and predicting every data point. Instead, we actually take a step back from this mass of information, and concentrate on the most important factors to paint a clearer picture of the direction of a particular asset class, industry/sector, and capital flows. After we have determined the pluses and minuses behind each pillar, we aggregate them together to give us a view on the global economy and investment landscape. The process enables us to have a "pro-active" forward looking view to asset allocation. This is contrary to the reactive posture many investors take, making alterations to their asset allocation after changes in growth, valuation, sentiment or fund flows have already occurred.

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Growth

We do not have one standard measure of growth, rather we apply what we believe is the best measure of growth in a geographic region/country, industry/ sector, and asset class. Usually, this involves some measure of economic growth, whether that is GDP, the unemployment rate, retail sales, etc. and a measure of a particular industries growth rate (revenues and earnings). If we are discussing large-cap US equities then we are concerned with the expected earnings growth of the S&P 500, the expected growth rate of the US economy, and the strength of the economy and stock market (is the growth expected to be relatively high or low compared to recent history). This exercise is not exclusive to equities either, if we want to determine the growth rate of the German economy we will look to its expected GDP growth, expected rise/fall in unemployment, and the expected change in the industrial production measures and service industry measures, amongst others. If we determine that the German economy is likely to expand over the next 12-18 months we may decide to overweight international equities or underweight international bonds, depending on our valuations and determinations of the other pillars.

Valuation

Similarly, to our measures of growth, we use broad based measures of absolute and relative valuation to determine if an industry or asset class is over or undervalued. Amongst equities we employ a discipline of comparing fundamental metrics such as forward P/E or P/B across industries, and relative to their historical averages. We do not rely solely on the market's view of comparative valuation either. For example, when we access the valuation of the S&P 500 and we determine the forward P/E of the equity index is above its historical average, we need to understand the current and forward macro environment to make a fair comparison. Specifically, during the COVID-19 induced recession and market correction, corporate earnings dropped by historical levels due to the economic "shut-down," sending the S&P 500 P/E higher. As the US re-opened and we expected the US economy and corporate earnings to grow at a faster rate than their historical averages, we recalibrated our valuation view to accept a higher current P/E which should decline as corporate earnings accelerate. This environment would have us isolate sector/industry groups that would be the greatest beneficiary of the revival in corporate earnings, such as US large cap equities.

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Sentiment

Sentiment is more difficult to quantify than traditional measures such as economic growth or equity valuation, as this branch of behavioral finance can be an overriding factor in the movement of markets in the short-term and over the long-term as well. Often times when fundamental data appears to be decoupled from market movements, such as the past six months, investor sentiment is the cause. Global markets are forward looking mechanisms and will typically move in price six to twelve months in advance of actual changes in economic or earnings growth. At Clearbrook, there are a number of factors we follow to track sentiment such as consumer confidence, investor sentiment and business confidence which are leading indicators that reflect prevailing conditions and likely developments for the months ahead. If indicators are positive, they would provide a positive and expansionary forward view. Similarly, investment flows into broad asset classes (i.e. equities, money market funds, fixed income, etc.) can reveal positive or negative sentiment for a particular asset class. Sentiment is an important factor that we use to determine our tactical as well as long term strategic portfolio positioning. The foundation of our investment process is based on fundamental data, but it is important to understand sentiment will typically drive short-term asset price and direction. Outsized valuation moves in financial markets have historically been prompted by a dramatic geo-political or economic event, which causes a substantial shift in sentiment. Two recent events during Q4 2018 (shutdown of the US government and US/China trade tensions) and Q1 2020 (COVID-19 pandemic) caused market sentiment to turn decisively negative, and ignited a severe market correction or bear market. These types of events offer an opportunity to asses the market environment and take advantage of fundamental mispricing because of overly positive or, in this case, negative sentiment.

Capital Flows

Capital flow is a specific measure we use, to track the inflows and outflows of capital across regions, countries, asset classes, investment strategies and securities. The increase or decrease of global liquidity by central banks and government policies can have a profound effect on global markets, particularly those that are less efficient and smaller in total capitalization. A few of the measures we use to track capital flows are M1 and M2, trading volumes, investment flows, and central bank action within the global bond currency markets. Each of these measures can have greater or lesser effect depending on the size of a region, country and capitalization of a particular market/ asset class. For instance, in the emerging markets asset flows and currency valuations (relative to the USD) tend to have a greater effect on asset prices than they would on the larger US markets. As such, it is important to understand what the liquidity profile and the direction of capital in the emerging markets before making portfolio allocation decisions for this asset class. The best example which highlights the importance of liquidity and understanding the direction of capital flows was observed in the credit markets during the COVID-19 induced bear market. Massive price dislocations occurred in securities ranging from investment grade corporates to high yield, sending bond prices lower by several points and yield spreads to expand by hundreds of basis points. The massive downside price reaction caused a number of fund closures, as liquidity dried up, prompting securities prices to decline further in an endless spiral. If not for the Fed's swift actions to inject massive amounts of liquidity into the credit markets, the situation could have likely mirrored what occurred during the GFC in 2008. Without understanding the liquidity profile of an asset class and the outlook of flows within it, investors can often miss a key driver of asset prices and risks. Investors can subject themselves to perhaps unknown or unrecognized risks, and conversely miss out on profit opportunities when they present themselves.

Conclusion:

While there are many factors that can influence the direction of each pillar, the simplicity of our approach is its strength. As asset allocators, we must have the ability to step back from the day to day gyrations in the markets and take a stance for our clients. Remaining focused on our Four Pillars allows us to take a clear view of the market outlook and enables us to act swiftly and decisively, especially in moments of uncertainty and stress. With that focus in mind we continue to enable our clients to strive for and achieve their goals.

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