STRATEGIC ASSET ALLIANCE
THE INSURANCE INVESTMENT SPECIALIST

Stargazing into the Past for Directions into the Future

March 30, 2023

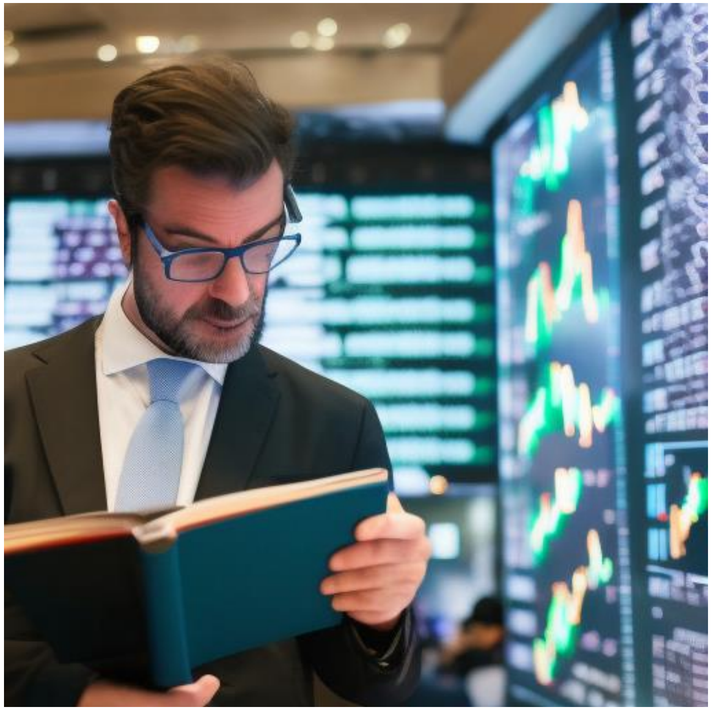
Alton Cogert, *CFA, CPA, CAIA, FDP, CGMA*
President & CEO
Strategic Asset Alliance

Stargazing into the Past for Directions into the Future

- **Why study financial history?**
- **Why expert predictions are often wrong!**
- **Peering into the future of financial markets**
- **How to improve your financial decision making**

Why study financial history?

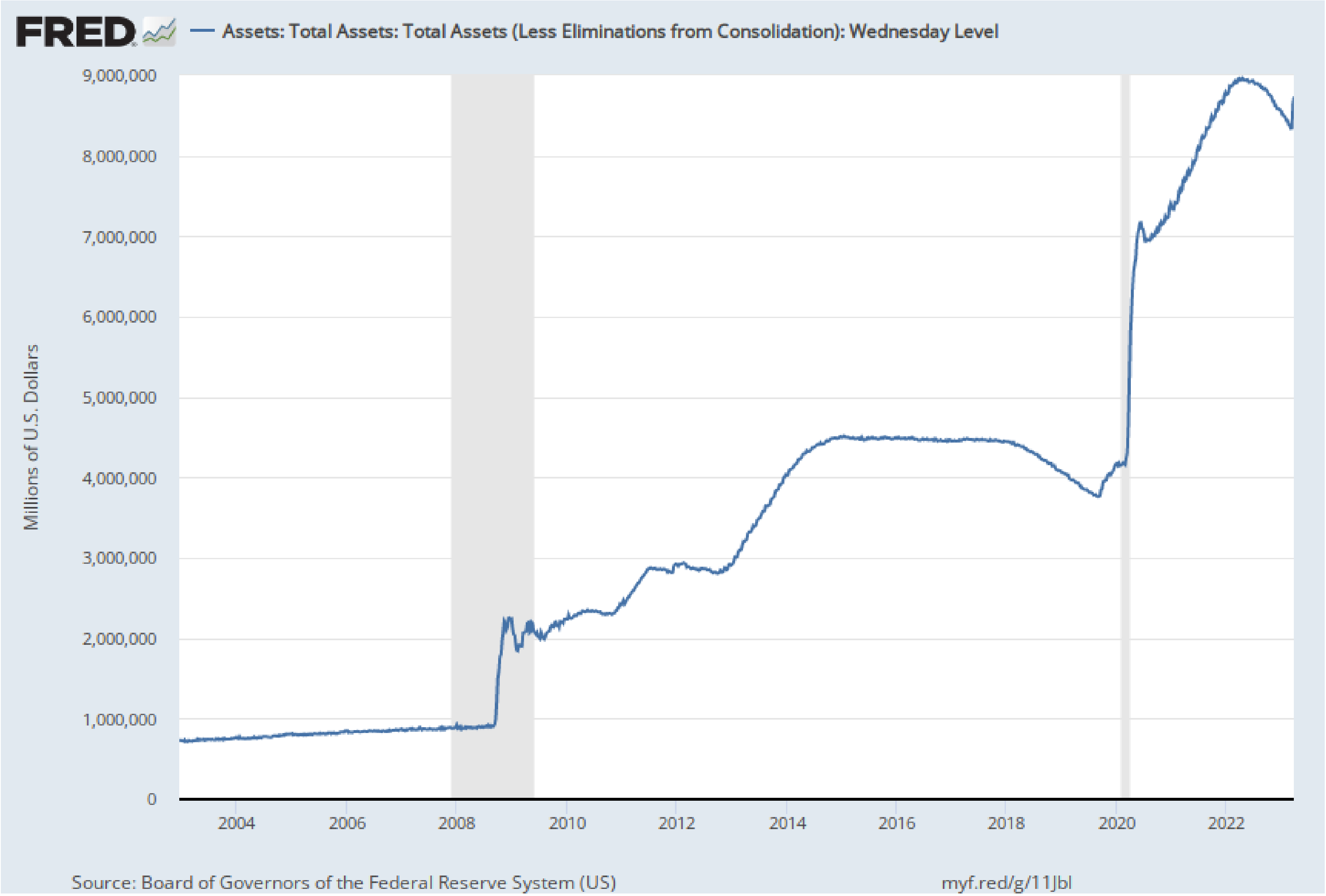
- Case studies of historical market behavior and trends
- Key principles derived from past events and market crises
- The successful investors' playbook – minimum requirements:
    - Diversification
    - Discipline
    - Long term approach



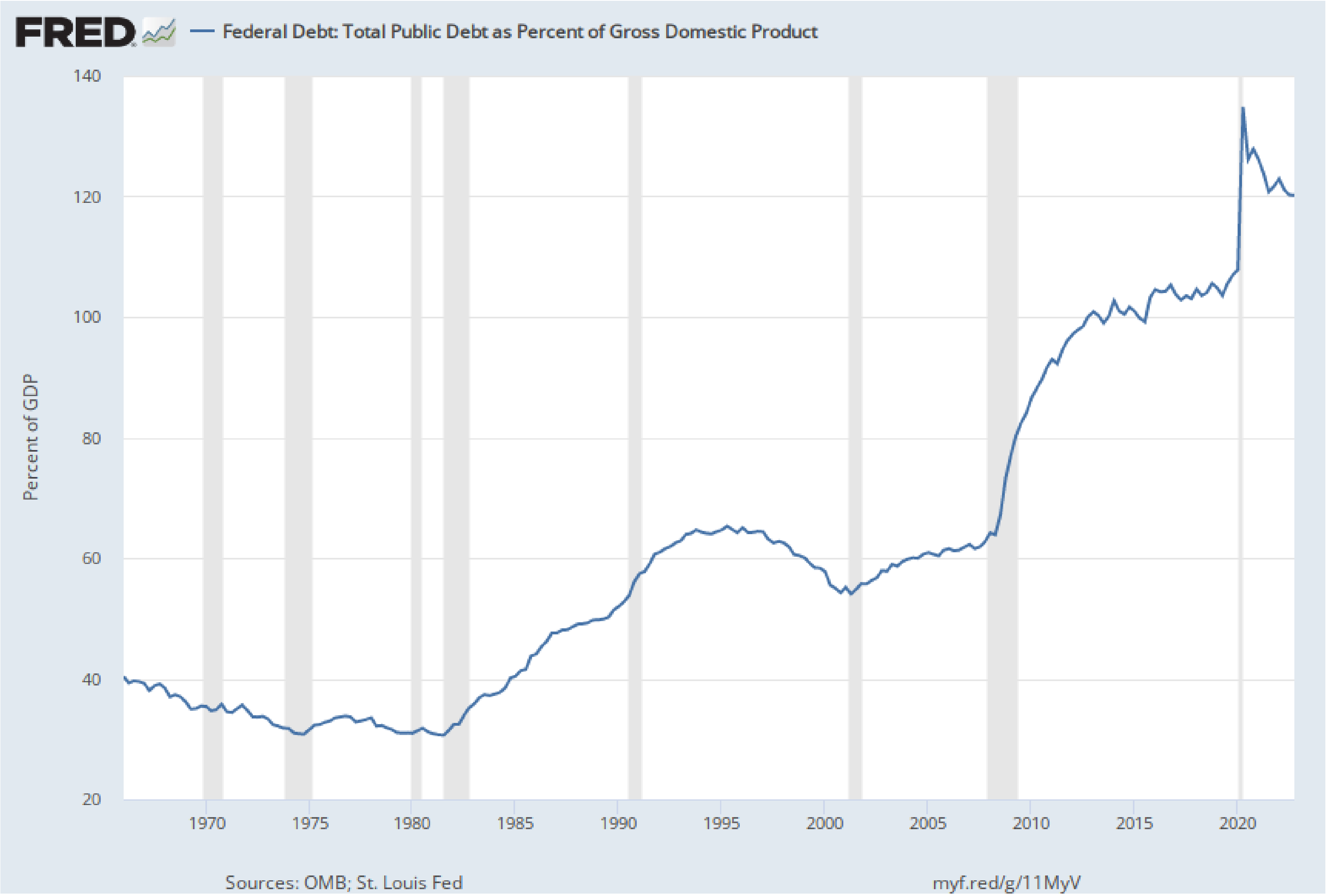
Why study financial history? A brief comparison

	Great Depression	Great Recession
• Bank failures	9,096 – 50% of banks (Jan. 1930 – March 1933)	57 – 0.6% of banks (Dec. 2007 – May 2009)
• Unemployment rate	25%	8.5%
• Economic decline	-26.5% (1929 - 1933)	-4.1% (Last quarter 2007 - Second quarter 2009)
• Biggest decline in Dow Jones industrial average	-89.2% (Sept. 3, 1929 – July 8, 1932)	-53.8% (Oct. 9, 2007- March 9, 2009)
• Change in prices	-25% (1929 – 1933)	+0.5% (Dec. 2007-March 2009)
• Emergency spending programs	1.5% of GDP for 1 year (Increase in 1934 budget deficit)	2.5% of GDP for 2 years (2009 American Reinvestment and Recovery Act)
• States response	Raise taxes, cut spending	Federal stimulus plan gives fiscal relief to states to lessen impact of tax increases
• Increase in money supply by Federal Reserve	17% (1933)	125% (September 2008 – May 2009)

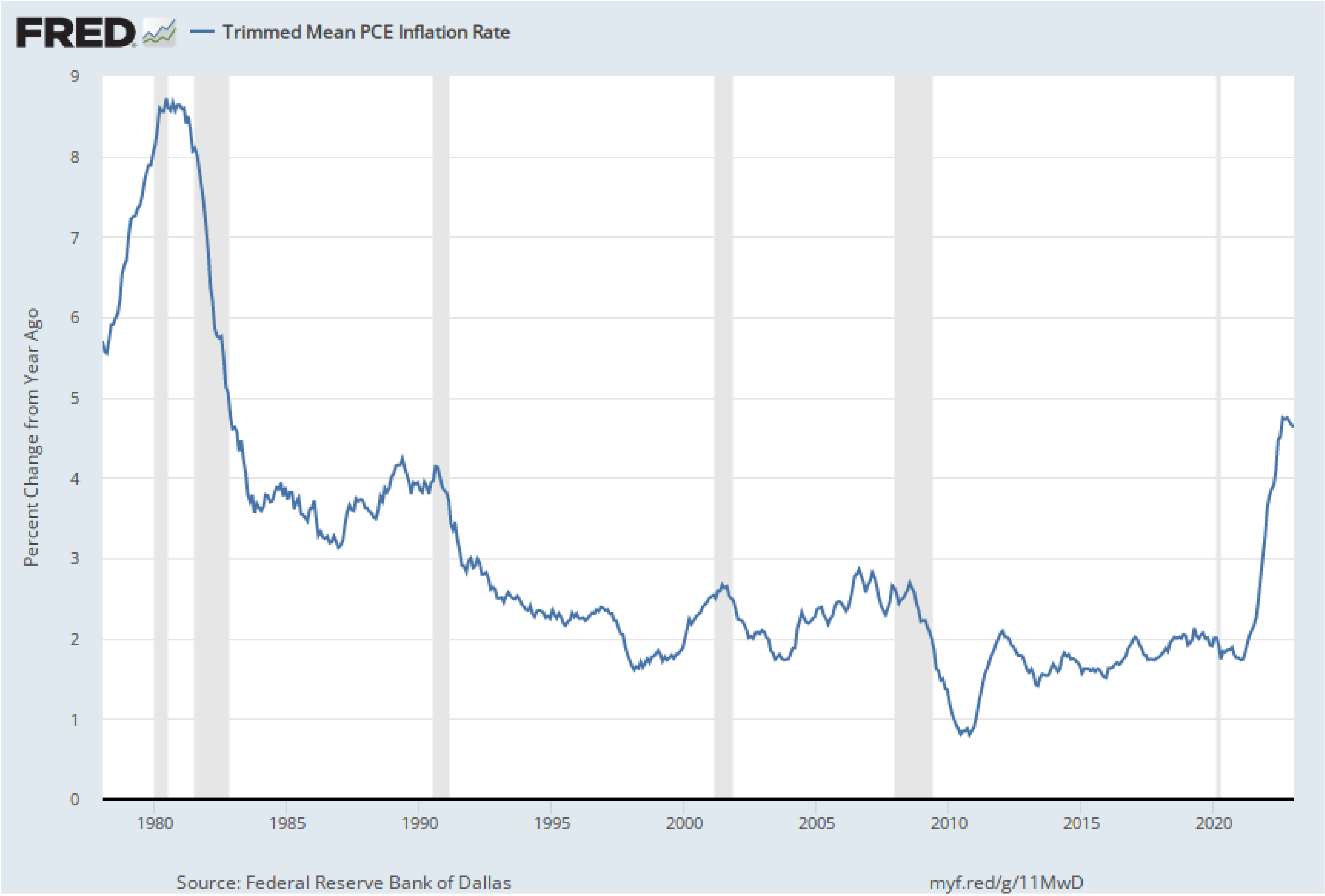
Why study financial history? Monetary Policy



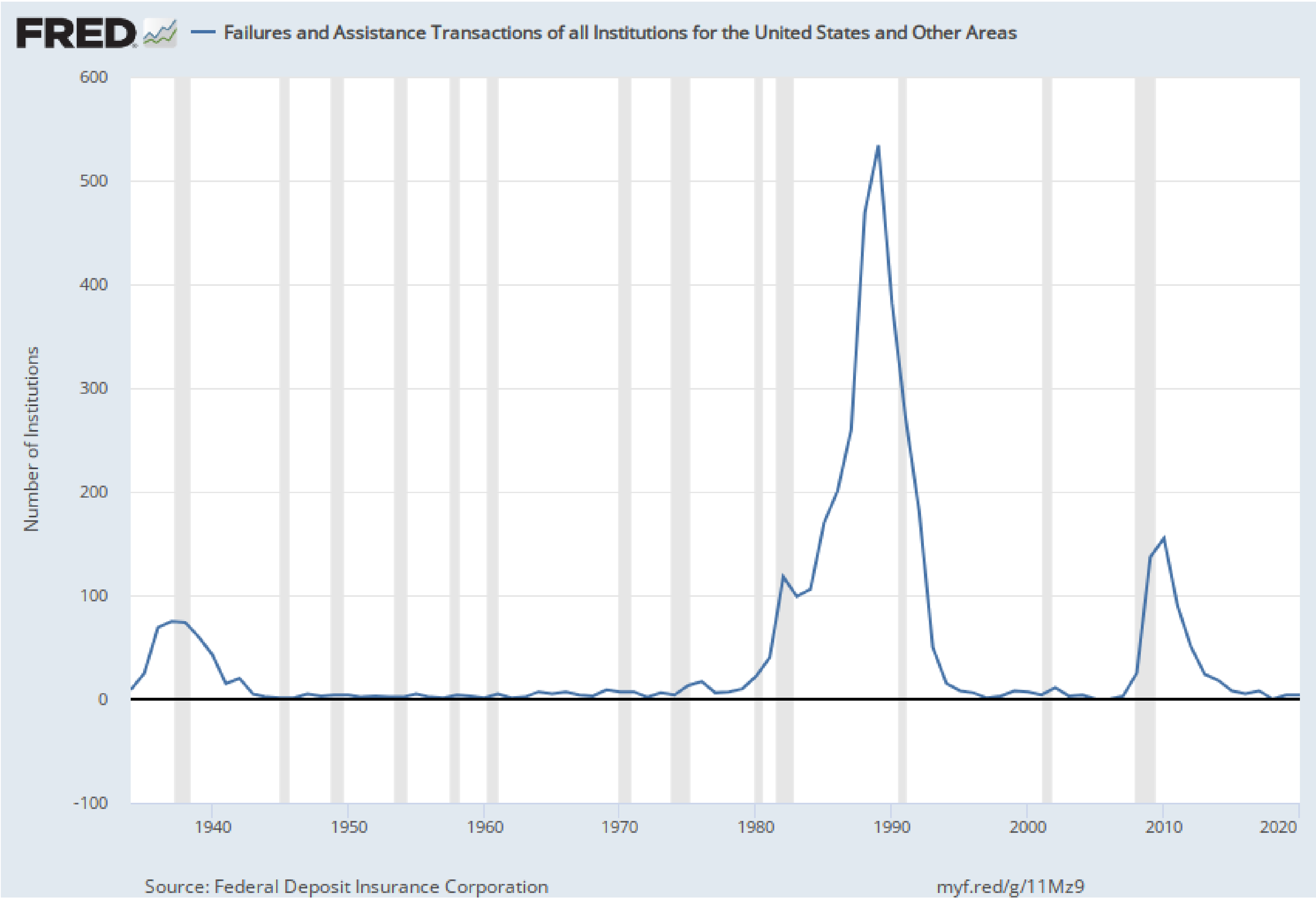
Why study financial history? Fiscal Policy



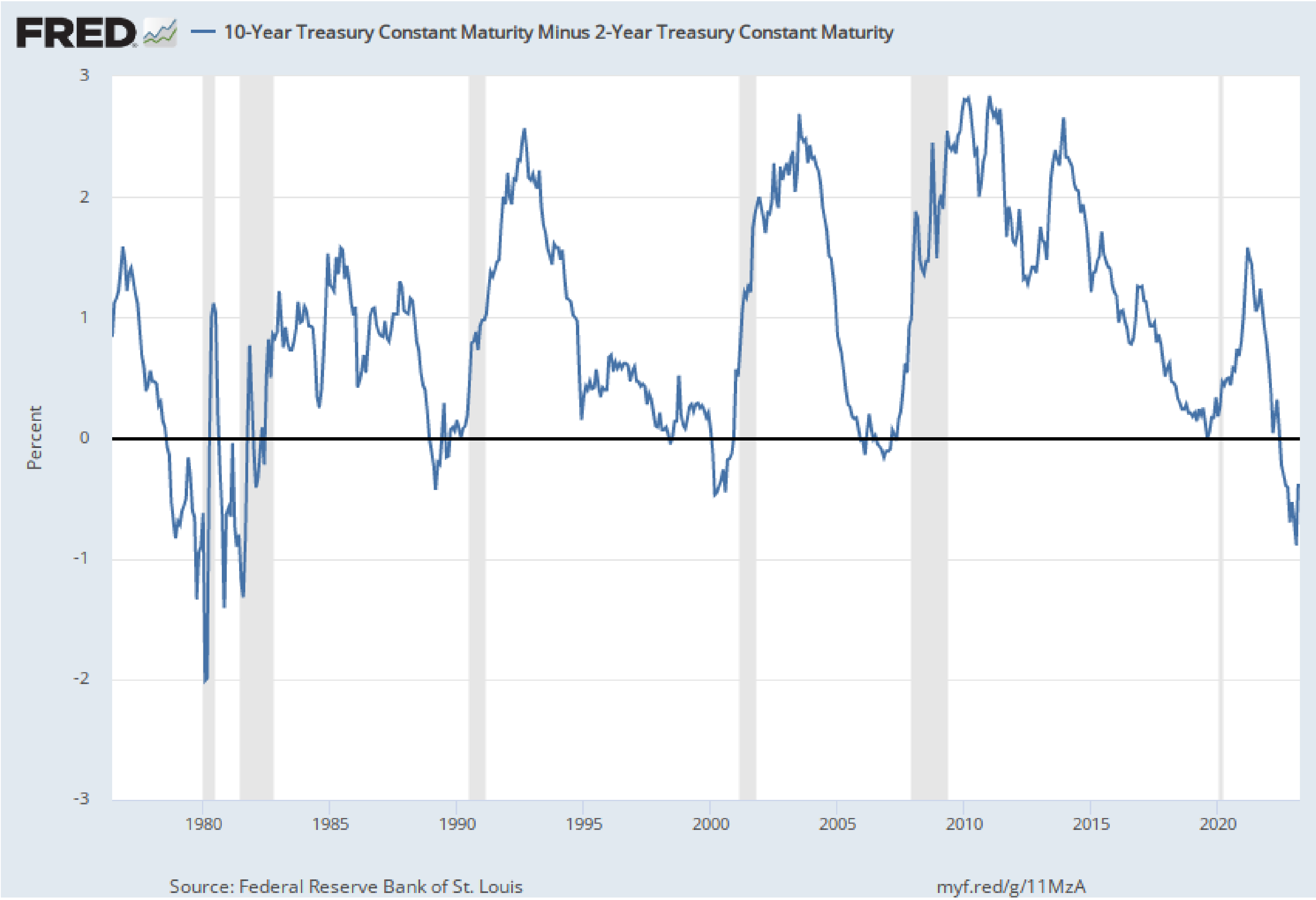
Why study financial history? Inflation direction not a surprise



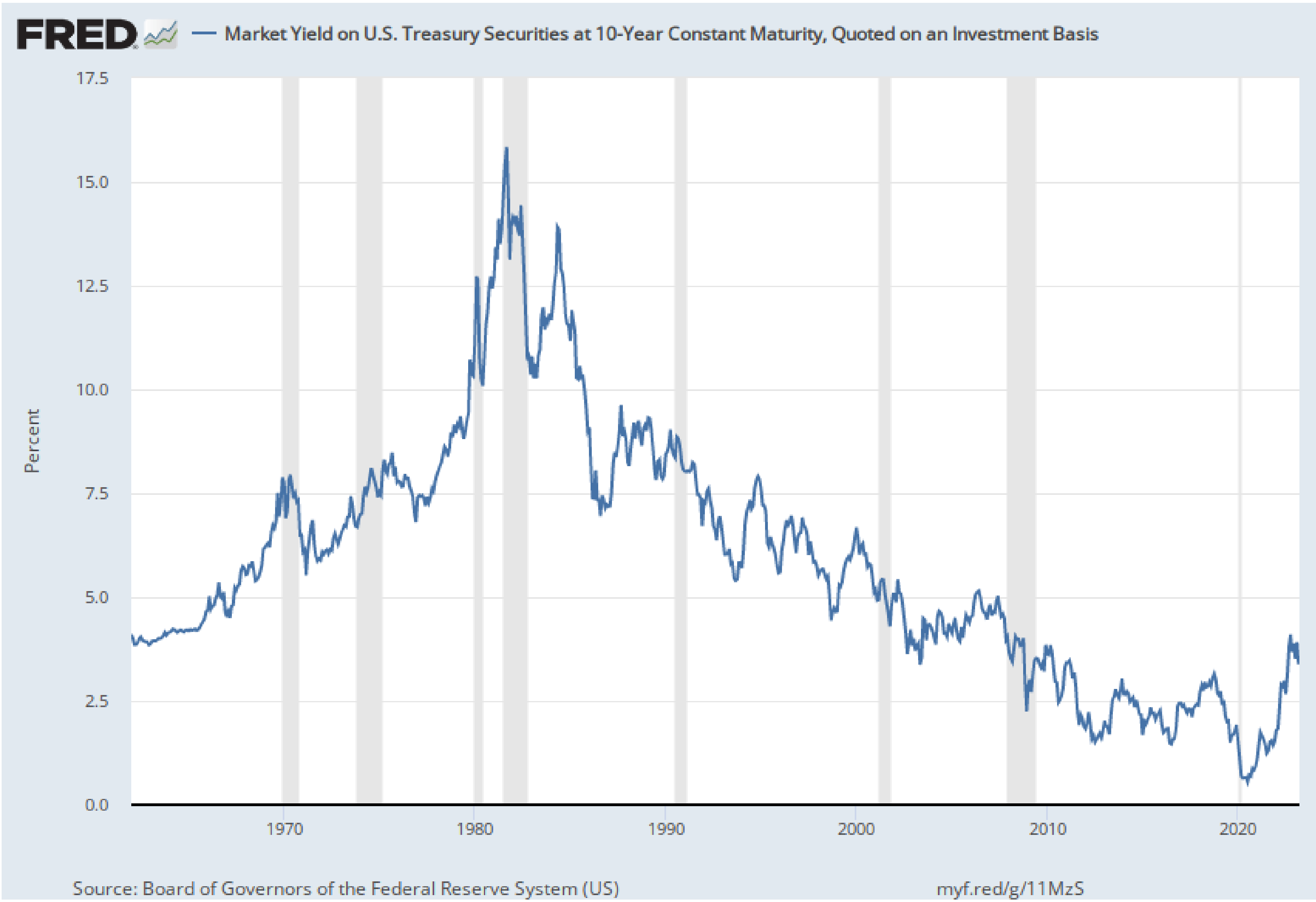
Why study financial history? Banking problems, the long view.



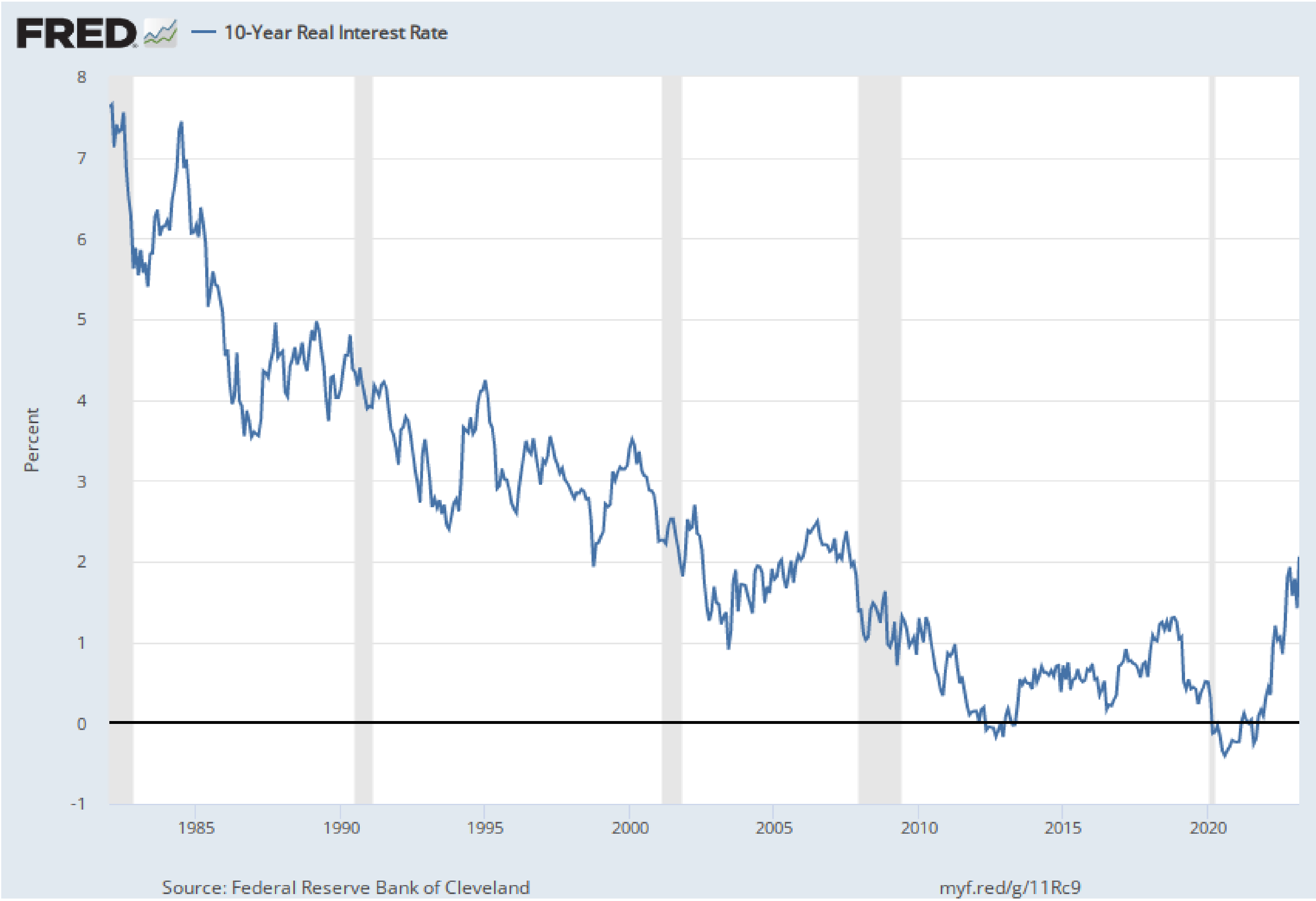
Why study financial history? Look out when the curve normalizes



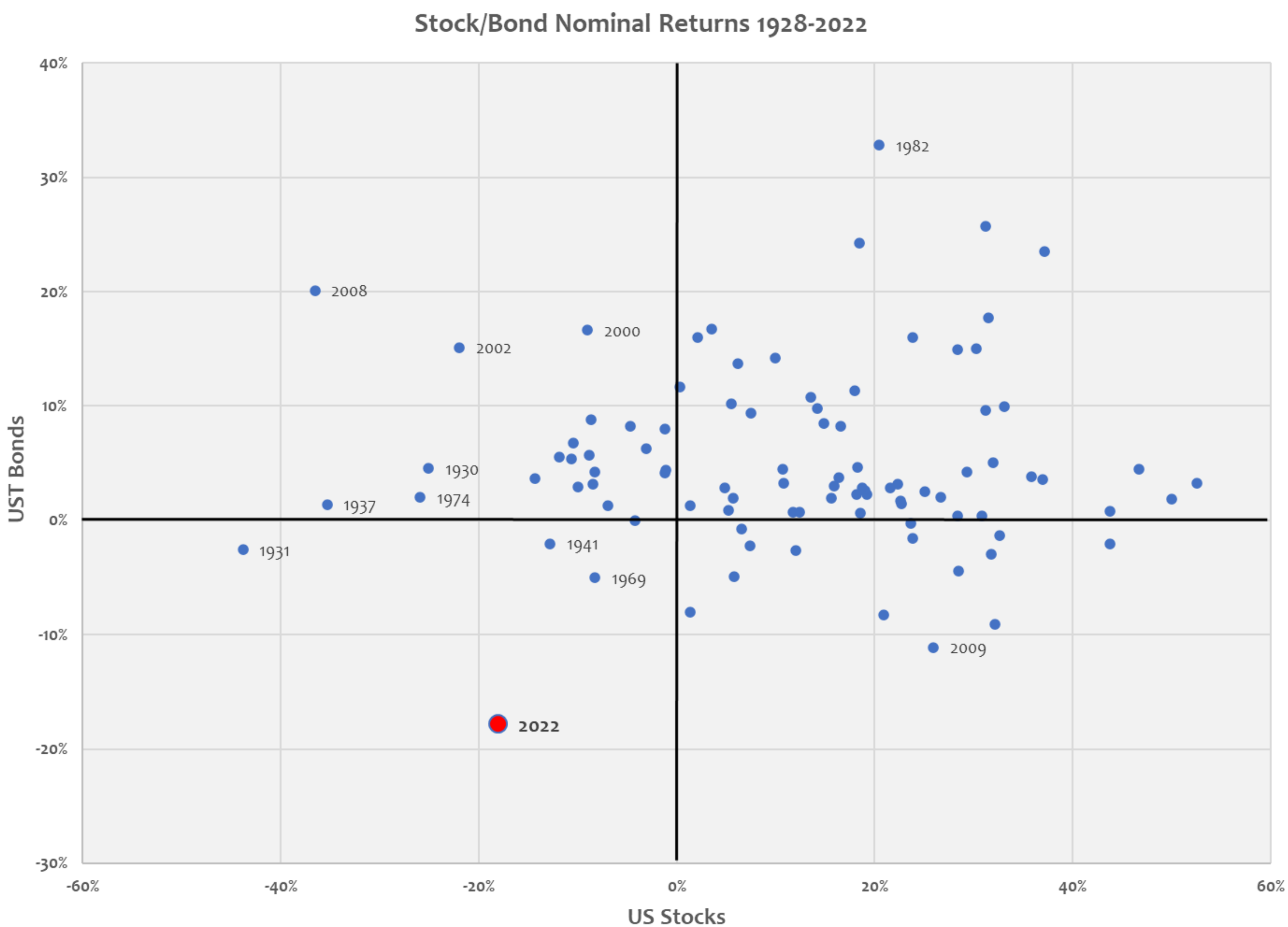
Why study financial history? Higher for longer, or just positive real yield?



Why study financial history? Higher for longer, or just positive real yield?



PERSPECTIVE: Stock/Bond Nominal Returns – 1928 to 2022



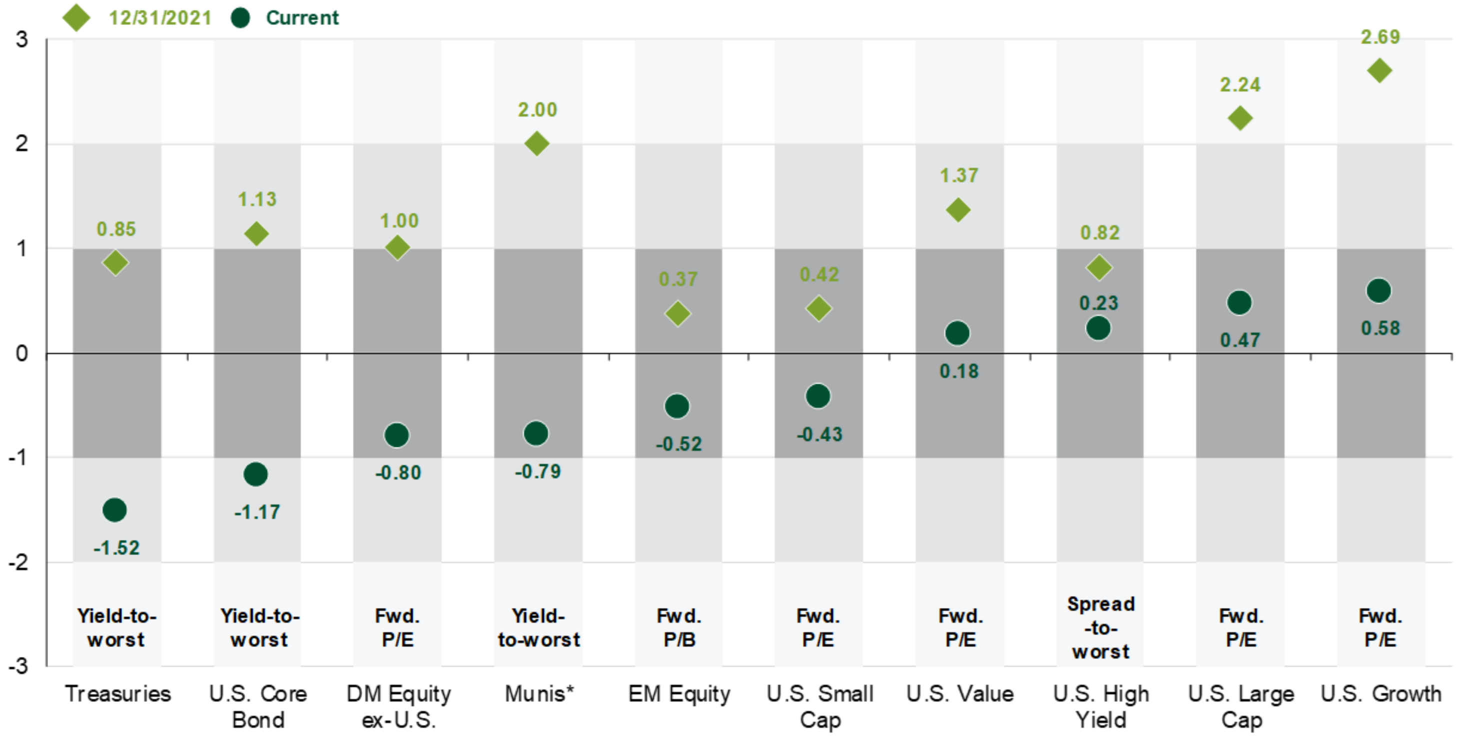
Source: https://www.stern.nyu.edu/~adamodar/New_Home_Page/data.html

Key Take Aways:

- **Although equities markets have historically performed significantly worse than 2022, the combination punch of significantly negative fixed income and equity performance for 2022 places this year in its own category.**

Asset Allocation Implications – Valuations Monitor

Asset class valuations
Z-scores based on 20-year average valuation measures



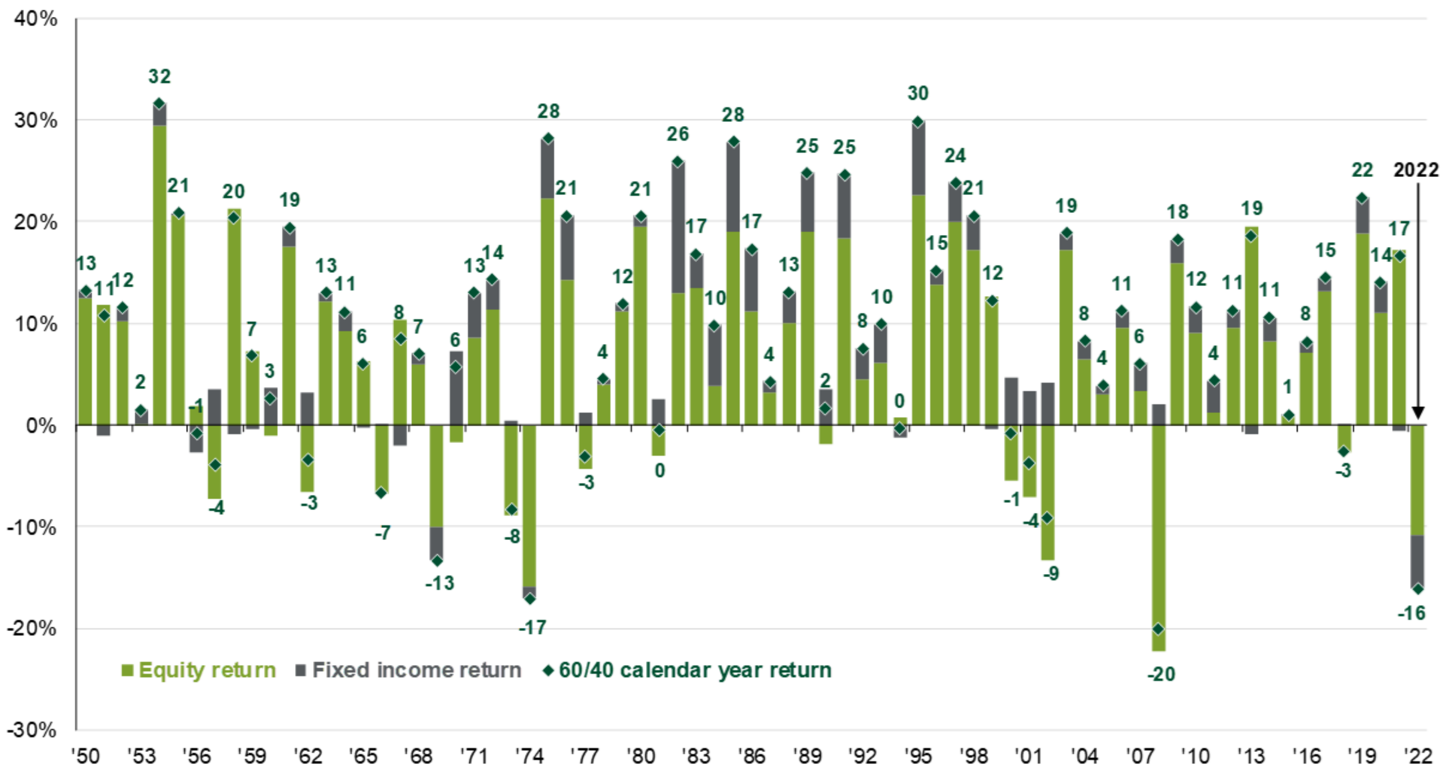
<u>Key Take Aways</u>:

- **Elevated inflation and tighter financial conditions across the globe sparked a global reset in valuations that spared few asset classes.**
- **The above exhibit shows 10 major asset classes and styles and their valuations, expressed as z-scores versus their respective 20-year history. Using z-scores allows us to illustrate how normal, or abnormal, current valuations are compared to history. Most asset classes are much cheaper today compared to the end of 2021. In particular, the sharp rise in yields have left U.S. Treasuries and core fixed income about 1 standard deviation below their average valuation levels.**
- **With fixed income reinvestment yields double or triple what they were just a year ago, the opportunity cost of holding cash and cash equivalents has been significantly diminished. With rising claims payments and reinsurance premiums, having additional liquidity may be prudent in 2023 with minimal opportunity cost as short-term yields move toward 4%-5%.**

<u>Source</u>: Bloomberg, BLS, CME, FactSet, MSCI, Russell, Standard & Poor's, J.P. Morgan Asset Management.
U.S. Large Cap: S&P 500, U.S. Small Cap: Russell 2000, U.S. Mid Cap: Russell Midcap; EM Equity: MSCI EME, DM Equity: MSCI EAFE, U.S. Value: Russell 1000 Value, U.S. Growth: Russell 1000 Growth, U.S. High Yield: J.P. Morgan Domestic High Yield Index, U.S. Core Bond: Bloomberg US Aggregate, Treasuries: Bloomberg U.S. Aggregate Government – Treasury, Munis: Bloomberg Municipal Bond. *Munis yield-to-worst is based on the tax-equivalent yield-to-worst assuming a top-income tax bracket rare of 37% plus a Medicare tax rate of 3.8%.
Guide to the Markets – U.S. Data are as of December 31, 2022.

Asset Allocation Implications – 60/40 Annual Returns

60/40 annual return decomposition
Total returns, 1950 – present



Key Take Aways:

- Performance in 2022 was unique because the bear market in stocks was accentuated by a bear market in bonds. Diversification took a vacation during 2022 as the Fed's aggressive inflationary policy pivot negatively overwhelmed all nearly asset classes. A portfolio with 60% invested in the S&P 500 and 40% in the Bloomberg U.S. Aggregate Bond index fell 16% in 2022, marking the second worst year for a 60/40 portfolio since 1974.
- However, a negative correlation between stocks and bonds is still overwhelmingly the norm. As shown in the exhibit above, most drawdowns in equity markets have been offset by gains in fixed income. Moreover, as investors assess performance going forward, large drawdowns in both stocks and bonds have never repeated themselves the next year.
- In today's investing environments and ever-changing headlines, it's easy to lose sight of long-term strategic asset allocation. Don't! Unless underlying operations are facing material changes, long-term asset allocation targets should most likely remain in place.

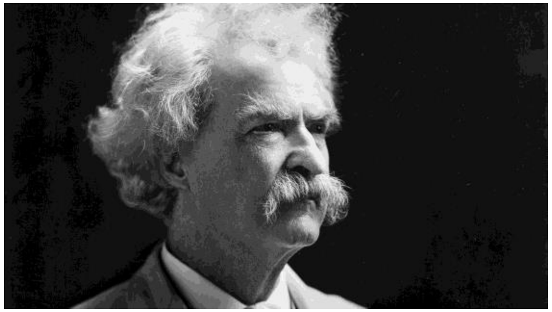
Source: FactSet, Standard & Poor's, Robert Shiller, Yale University, Bloomberg, Ibbotson/Strategas, J.P. Morgan Asset Management.
The 60/40 portfolio is 60% invested in S&P 500 Total Return Index and 40% invested in Bloomberg U.S. Aggregate Total Return Index. S&P 500 returns from 1950 – 1970 are estimated using the Shiller S&P Composite. U.S. fixed income total returns from 1950 – 1975 are estimated using data from Strategas/Ibbotson. The portfolio is rebalanced annually.
Guide to the Markets – U.S. Data are as of December 31, 2022..

Why study financial history?

- Reversion to the mean – Z values, but over what time frame?

- Learn from past mistakes

- "History never repeats itself, but it rhymes" – S. Clemens



- Contextualize current events
  - Tangled up in short term events
  - Focus on long term trends

- Evolution of financial theories and models – Single best return to Efficient Frontier to ?

- Anticipate regulatory and rating agency response
  - STAT accounting response (negative IMR OK to 5% of surplus)
  - Best surplus haircut 2008
  - 2008 impact of change to MTM for GAAP.

Why expert predictions are often wrong!

- **Investment themes that emerge from complexity – complicated v complex**

- **Unpredictable nature of financial markets**
  - **Regime change**
  - **Exogenous events**
  - **Black swan events**

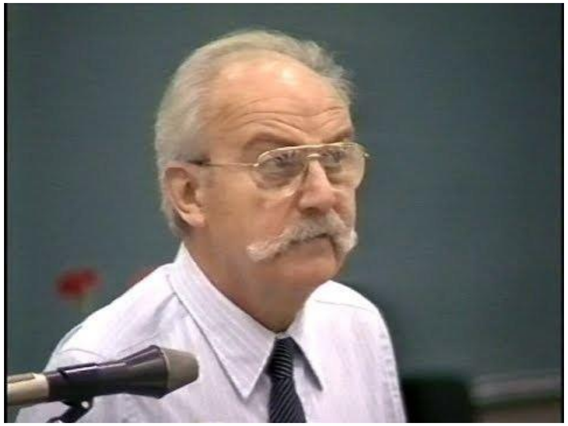
- **Cognitive biases of the predictor**
  - **Overconfidence**
  - **Anchoring**
  - **Confirmation bias**
  - **Recency bias**

- **Herd mentality, group think**

- **Inherent uncertainty – predictions of a specific number are usually wrong.**

Why expert predictions are often wrong!

- **ST versus LT focus**
  - **No LT without ST, but volatility is high in ST and then falls with longer time frames**
- **Data limitations – incomplete or inaccurate**
  - **We don't have enough data! Will we ever have enough data?**
- **Overreliance on historical data – History is important as a guide, not as an absolute**
- **Model limitations – "All models are wrong, some are useful."**
- **Emotional influences – Our gut gets in the way**



Peering into the future of financial markets

- Harnessing technological advancements
  - AI/ML, 'Handbook of Artificial Intelligence and Big Data Applications in Investments'
  - Improved financial and non-financial measures

- ESG factors – Political, but why? Sometimes only E viewed, but S and G are part of the focus of many regulators and the rating agencies

- Preparing for future market disruptions and uncertainties
  - SVB is only the start, but as old as the history of banking; Rapidly rising rates – we've seen before

How to improve your financial decision making – Setting the table

- **Stay informed and adaptable!**
- **Encourage critical thinking.**
- **Learn from the past. What applies and what doesn't?**
- **Foster a spirit of curiosity and humility**
- **Be open-minded**
- **Apply numeracy and probability skills**
- **Encourage collaboration**
- **Maintain a healthy skepticism toward predictions**

How to improve your financial decision making – Ten Steps

1) **Triage – prioritize questions based upon importance, relevance and potential impact**

2) **Break problems into smaller parts**

3) **Balance inside and outside views**

4) **Look for the ‘base rate’ – historical frequency or probability**

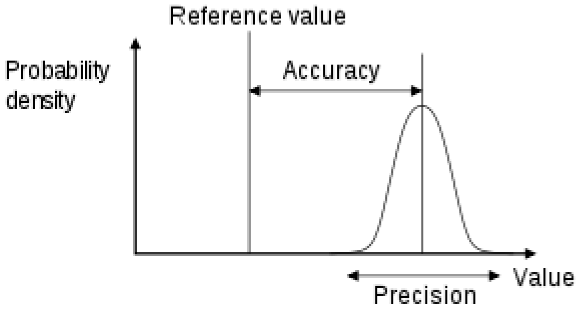
5) **Strike the right balance between under- and over-reacting to evidence**

How to improve your financial decision making – Ten Steps

6) **Beware of biases and heuristics**

7) **Update beliefs incrementally**

8) **Pay attention to both accuracy and precision**



9) **Use ensemble methods – 'wisdom of the crowd', multiple forecasts**

10) **Master the 'error balancing bicycle' – fine tune by analyzing past errors**

Stargazing into the Past for Directions into the Future

- **Look to the Past, but**
- **Question the Experts**
- **Consider Alternative Futures – from Multiple Perspectives and Interrelationships**
- **Use a Disciplined Approach**
  - **Diversification**
  - **Discipline**
  - **Long-term Approach**
- **The Great Mental Models**