WEALTHSHIELD WHITE PAPER SERIES

THE INVESTMENT FRAMEWORK

FEDERAL RESERVE POLICY

Max Rockwell |July 2020

INTRODUCTION: PROCESS OVER OUTCOME

Process over outcome. This, in our opinion, is the ultimate motto for successful investing. Unfortunately, most investors fall victim to outcome bias and fail to follow a disciplined, rules-based process for making decisions. Outcome bias leads investors to overemphasize the outcome of an investment without thinking critically about what led to that outcome. Therefore, we believe there is an advantage to following a disciplined process. The investment process must have sound academic underpinnings, be tested for robustness and historical efficacy, and be evaluated in the real world. The investor must also remain disciplined to follow the process during times when it doesn't work. In any investment approach, following the rules will sometimes result in an undesirable outcome. These negative outcomes are unavoidable and part of the game. What an investor should seek to avoid is abandoning or violating the rules of an investment approach, regardless of the outcome.

We created the WealthShield Investment Framework with the goal of building a process that could be followed with discipline regardless of the type of outcome faced. This requires discipline and conviction. To gain that conviction we researched the most notable investors, traders, Nobel prize winning economists, and academics in the industry, including but not limited to Benjamin Graham, David Dodd, Seth Klarman, Jeremy Grantham, Clifford Asness, Stanley Drukenmiller, Ray Dalio, and many others. Through this study we arrived at a framework that is grounded in academic discipline, thoroughly tested and scrutinized, and consistently validated in practice. The framework started with the belief that the economy, markets, and business environment all experience cycles, and these cycles are grounded in human behavior and observable phenomena. Instead of focusing our efforts on predicting cycles, we decided to concentrate on measuring, mapping, and observing.

Through this series of whitepapers, we'll introduce the four prongs of our framework, and how they can work in unison to structure investment portfolios around a business cycle. Observing Valuations, Market Sentiment, Economic Growth and Inflation, and Monetary Policy informs us of approximately where in the business cycle we fall and what that means for our positioning, from risk mitigation to return enhancement. The idea is that when valuations are low, market sentiment is improving, economic growth is starting to accelerate, and monetary policy is accommodative, we are positioned to enhance returns and take adequate risk. On the flip side, when valuations are high, market sentiment is deteriorating, economic growth is decelerating, and monetary policy is tight, we want to be in full risk mitigation mode, shifting portfolios more defensively. In between these two poles, portfolios fall along the spectrum in accordance with the weight of the evidence. This white paper series will provide a detailed review of each component of our framework, and how this framework is applied during construction of investment portfolios.

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FEDERAL RESERVE POLICY: THE ELEPHANT IN THE ROOM

Chances are as an investor you have heard the term "Fed Policy" more than once in your time. This popular jargon can be heard or seen across financial news outlets around the globe. However, some investors may be scratching their heads when this term is thrown about, wondering what exactly is "Fed Policy"? For the purpose of this paper, we'll examine the United States Federal Reserve (the Fed), their decisions/actions (their Policy), and how we incorporate that information into our framework to guide our investment decisions.

So, what is "Fed Policy"? Fed Policy is common shorthand for monetary policy that is instituted by the United States Federal Reserve. Monetary policy is the combination of actions taken by the Fed that influence short-term interest rates and liquidity that is available in the economy. There are many tools in the monetary policy toolbox that the Fed has at their disposal. Their control of the Federal Funds rate, or Fed Funds rate, is by far the most well-known tool. The Fed Funds rate is the rate at which banks and other institutions lend to each other. The Fed holds periodic meetings to discuss when and where changes to this rate should be made, which garner substantial buzz from the financial media. However, while the Fed may state what the target Fed Funds rate should be, it does not control the banks and the interest rates they establish to lend to each other.

The Fed can exercise some indirect control over said interest rates using their monetary policy toolkit, which enables them to help guide these interest rates to their intended ranges using a few different strategies. Specifically, the Fed controls levels of reserve requirements at financial institutions, controls the discount rate at which banks can borrow directly from the Federal Reserve, controls the interest rate paid on reserves, and conducts open market operations[1].

WHAT DO HAWKS AND DOVES HAVE TO DO WITH FED POLICY?

The mandate of monetary policy set forth by Congress is to promote maximum employment, stable prices, and moderate long-term interest rates [2]. As such, the Fed monitors a variety of indicators to determine what the current economic backdrop looks like. After evaluating the current environment, they will then act as they see fit to promote their mandate. There are two main courses of action that the Fed typically takes to promote their mandate: easing or tightening monetary policy.

[1] FRBSF.org.
[2] FederalReserve.gov

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When the Fed is easing policy, it is thought of as an expansionary approach, leading most to characterize the Fed as "dovish". To ease policy, the Fed is typically reducing the Fed Funds rate or conducting purchases of bonds in the open market. As the name implies, these actions tend to ease credit conditions, leading to more liquidity in the marketplace. An abundance of liquidity, paired with lower trending interest rates, tends to serve as a tailwind for risky assets. Individuals and companies can borrow at lower rates, incentivizing them to increase spending on items that, in turn, generate economic growth. This type of easing is traditionally seen in recessions when the Fed is attempting to stimulate the economy.

When the Fed is tightening policy, it is thought of as contractionary and most will begin to call the Fed "hawkish". The Fed is usually acting in direct opposition to what was stated above if they are tightening policy. The goal of tightening policy is for the Fed to control excessive economic growth and inflation in order to keep the economy from overheating. Therefore, the Fed will typically raise interest rates and/or sell bonds from its own balance sheet to achieve these policy targets.

WHAT ARE *YOU* LOOKING AT?
PRIMARY FED POLICY INDICATORS WE USE

We believe that Fed policy has an impact on the business cycle, and in turn, the financial markets. Regardless of whether or not the Fed is easing or tightening financial conditions, both of these measures will affect the market in some form or fashion. When we evaluate Federal Reserve policy, we look at few different indicators. The primary indicators we monitor are the Federal Funds rate, the yield curve, and the Fed's balance sheet. These three indicators encompass the various tools that the Fed can use.

As mentioned before, the Federal Funds rate is the target rate at which banks lend to one another. Lower interest rates not only entice institutions to lend to others to increase their bottom line, but they also entice others to borrow at lower rates. When you can borrow money for next to nothing, the hurdle rate for prospective investments tends to decrease, which can lead to more risk taking. As such, when we see the Federal Reserve cutting interest rates this is indicative of easing policy.

The second indicator we use is the yield curve. The yield curve is the structure of interest rates across a variety of timeframes. As you begin to plot yields for respective time frames, a curve begins to emerge.

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When we look at the yield curve, we hope to see a normal, upward sloping curve with interest rates increasing as the duration for those rates lengthens. This normal, upward sloping curve typically indicates that market participants are being paid appropriately for the additional risk they incur for tying up their capital for longer periods of time.

When we look at the yield curve and begin to see flattening or inversions occurring amongst various interest rate timeframes, that is worrisome. Inversions typically have signaled recessions in the past. As you can see in the chart below, inversions in the yield curve (when the red and blue lines dip below zero) have occurred before most recessions.

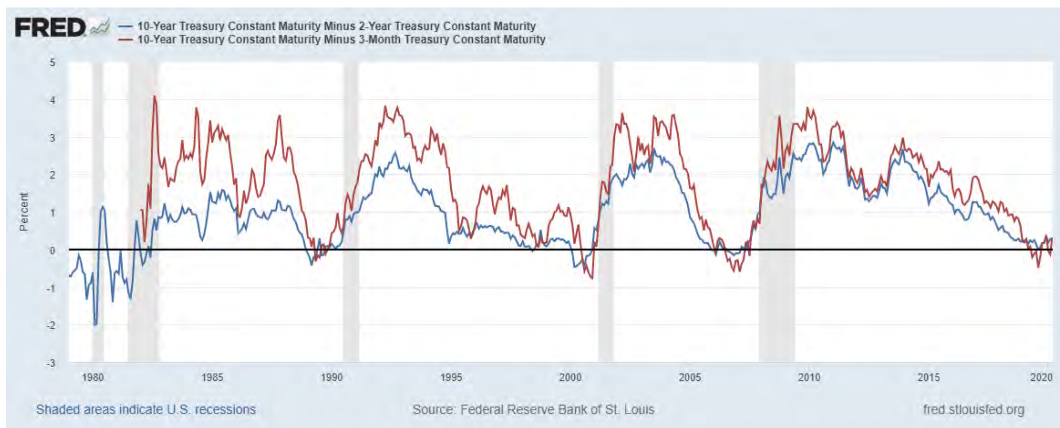

Figure 1 as of March 10, 2020; Source: Federal Reserve Bank of St. Louis

We don't look to the yield curve as a crystal ball to tell us when a recession will come, but rather, we use it as a barometer for future expectations of growth and inflation. (as a side bar, attempting to predict when a recession will hit is useless, as soon as you realize you are in one the damage has already been done, but I digress). Due to the responsiveness of the short end of the yield curve to interest rate adjustments, the yield curve is highly responsive to changes set forth by the Fed.

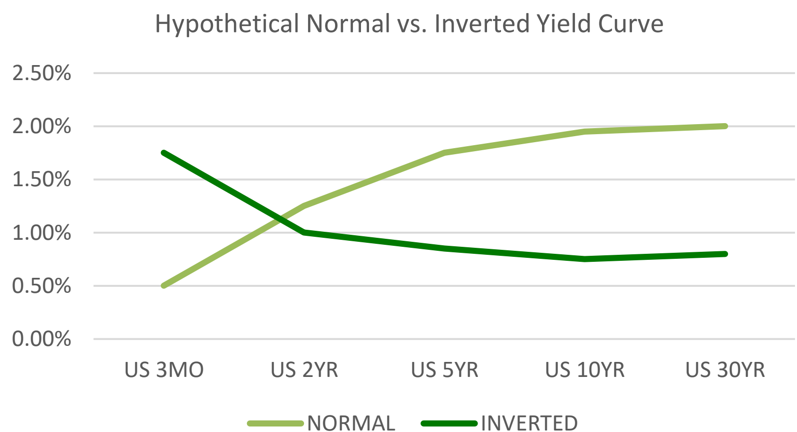

Figure 2 as of March 10, 2020; Source: Morningstar

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Lastly, when we monitor the balance sheet of the Federal Reserve we look to see if it is growing or shrinking. When the balance sheet is growing, the Federal Reserve is buying assets and thus injecting money into the banking system. When the balance sheet is shrinking, the Federal Reserve is either selling bonds or simply allowing them to mature and not reinvest those proceeds into new investments. The movements in the balance sheet are crucial to understanding liquidity in markets. As balance sheet expansion is taking place, we can expect liquidity to continue to be more abundant than if it were shrinking.

As you can see from Figure 3, the chart from the St. Louis Federal Reserve Bank, the Fed's balance sheet grew rapidly during the Great Financial Crisis of 2008 and 2009 as the Federal Reserve began their first quantitative easing (QE for short) program. This unprecedented liquidity injection helped to buoy financial markets.

Fast forward almost a decade and you can see the Fed began quantitative tightening (QT for short) in late 2017 through mid-2019. This just so happened to overlap with bouts of instability in financial markets. Coincidence? We think not. As markets began to show signs of cracking, the Federal Reserve began the infamous "Not QE", expanding its balance sheet once again. You can see the rather pronounced rate at which they began "Not QE" illustrated by the V-shaped uptick on the right side of the chart.

Figure 3 as of March 4, 2020; Source: Board of Governors of the Federal Reserve System (US)

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INCORPORATING FED POLICY INTO OUR INVESTMENT FRAMEWORK

We believe that monitoring Fed Policy is an integral part of our framework. Understanding whether the Federal Reserve is easing or tightening monetary policy is key to positioning portfolios for the knock-on effects of those actions. A prime example was our ability to pick up on the Federal Reserve's policy tightening in 2018. Interest rate hikes, balance sheet shrinkage, and moves in the yield curve prompted us to shift the Federal Reserve Policy prong of our framework to red. Shortly thereafter, market sentiment shifted red as the Fed's actions began to impact markets.

This illustrates that, while it is important to listen to what Fed officials say, it is far more important to watch what they do. That is why we will continue to monitor the Federal Funds rate, the yield curve, and the Federal Reserve's balance sheet to determine if we are dealing with doves or hawks and be sure we don't end up becoming bird food.

WHERE DOES THIS LEAVE US TODAY?

DESPARATE TIMES CALL FOR DESPARATE MEASURES

There is absolutely no doubt that what we have seen in 2020 is unprecedented. The COVID-19 pandemic has ravaged the globe leaving no person unaffected in some way, shape, or form. While we examine the impacts of COVID-19 through an economic and financial lens, we would be remiss not to acknowledge how devasting this was on a human level. We continue to keep everyone who has been affected by these events in our thoughts.

Unfortunately, COVID-19 was neglected at the beginning of the year, not garnering much attention and largely dismissed by some prominent figures. However, as the virus spread, the markets were quickly met with the realization that COVID-19 was triggering a shutdown of the global economy. For those of you not keeping tabs, here are just some of the events that took place after domestic markets hit all-time highs in early 2020 and that realization kicked in. First, the quickest bear market in history took place, followed by an equally expedient recovery.

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Treasury yields continued their descent from their 2018 highs to historic lows, economic data plummeted on all fronts, and unemployment rates skyrocketed. Despite all those remarkable feats, we believe that the response concocted by governments and central banks across the world was the most astonishing. As shutdowns took place and fear spread, financial markets unraveled and a mad dash to cash ensued. To prevent any further fallout, the proverbial kitchen sink was thrown at the situation. The chart below from Yardeni Research illustrates that the kitchen sink was in fact comprised of various asset purchasing endeavors that central banks began to help steady financial markets.

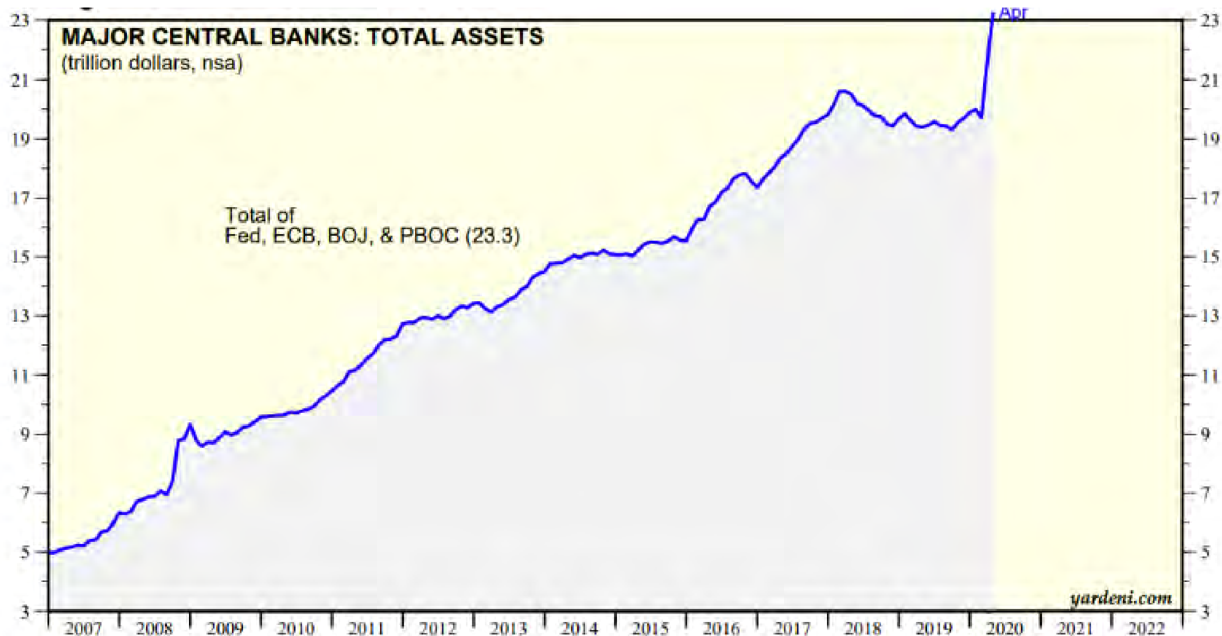

Figure 4 as of May 14, 2020; Source: Yardeni Research, Inc.

For purposes of this paper, we will focus our analysis on the actions taken by the Fed, which are plentiful. To date, the Fed has dropped the Fed Funds rate to zero once again and launched a myriad of special programs to address various "interruptions" or "disfunctions" in the financial markets and the economy. These programs vary quite a bit in their objective but are all aimed at keeping market liquidity flowing freely. These programs range from helping backstop money market funds, providing liquidity to businesses, and opening swap lines to other countries to name a few. We do not refute that the actions from the Fed were done with the best intentions to keep further chaos from erupting, however, it is important for us to analyze their actions and determine how they will impact us for years to come.

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We think that the best way to understand the consequences of the Fed's actions is to understand the definition of moral hazard. Moral hazard is the lack of incentive to protect yourself from risk because you know that you are protected from the consequences of taking such risk. The Fed has taken moral hazard to a new level with their latest rounds of monetary stimulus. Via their various special programs, some even making their triumphant return from Great Financial Crisis era, the Fed is now backstopping most financial markets. The issue with creating this moral hazard is that it has allowed, and encouraged, excessive risk taking in financial markets. Asset prices are being bid up to obscene levels that leave little hope for prospective returns. Due to the inflation of asset bubbles, future return expectations have collapsed with some of those expected returns even dipping into negative territory. Essentially all potential returns have been fast forwarded to today as asset prices have continued their ascent. For those assets that have the glimmer of hope of an expected positive forward return, when taking inflation and fees into account, that hope fades rather quickly.

To quantify the obscenity in valuations, let's look at where valuations stand today as a result of trillions of dollars of monetary support. First, let's look at "The Buffett Indicator" or total market capitalization of the stock market versus GDP. Despite a market that is roughly 13% off all-time highs, at which point it was even more overvalued, this measure still remains at levels seen in the years 1999 and 2000 [3].

Figure 5 as of May 26, 2020; Source: YCharts.

[3] YCharts

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Now let's look at the Hussman Margin-adjusted CAPE (cyclically adjusted price to earnings ratio). Boasting a negative correlation of -0.89 to 12-year subsequent total returns on the S&P 500, this measure too reads at one of the highest levels it has ever been. Given its negative correlation to subsequent total returns, the prospects for returns are not bright [4]. We are not just picking on equities here either, in fact, there are a rather large amount of asset classes set for dismal returns. By Research Affiliates' measure, almost all fixed income asset classes have negative expected 10-year returns and a traditional 60% equity and 40% bond portfolio will get you a whopping 40 basis points over the next ten years. These measures show us that in the face of deteriorating financial prospects, most asset classes continue to charge higher on the hope that the Fed's liquidity will solve all problems [5].

A dovish Fed has perpetuated two issues; the destruction of income-oriented investing and capitalism. While the Fed's reduction of the Fed Funds rate towards zero is not new, it was recently dropped back to zero in extreme fashion with an emergency rate cut in-between Federal Reserve meetings. A low interest rate environment has pushed investors in search of yield to places they should not go. Yield hungry investors, many of whom could be older and more conservative and thus do not need excessive amounts of risk, have largely been forced to move up the risk spectrum in order to get the income they need. Let's use the following chart as a guide to illustrate our point.

Interest Rates								
US Treasuries	**As of**	**Latest****	**1 Month Ago**		**1 Mo. % Change**	**1 Year Ago**		**1 Year % Change**
Effective Federal Funds	5/25/20	0.05%	0.05%	▲	0.0%	2.38%	▼	-97.9%
3 Month Treasury	5/26/20	0.14%	0.12%	▲	16.7%	2.35%	▼	-94.0%
2 Year Treasury	5/26/20	0.18%	0.22%	▼	-18.2%	2.16%	▼	-91.7%
5 Year Treasury	5/26/20	0.35%	0.36%	▼	-2.8%	2.12%	▼	-83.5%
10 Year Treasury	5/26/20	0.69%	0.60%	▲	15.0%	2.32%	▼	-70.3%
30 Year Treasury	5/26/20	1.43%	1.17%	▲	22.2%	2.75%	▼	-48.0%
US Corporates	**As of**	**Latest****	**1 Month Ago**		**1 Mo. % Change**	**1 Year Ago**		**1 Year % Change**
US Corporate AAA	5/22/20	1.72%	1.83%	▼	-6.0%	3.17%	▼	-45.7%
US Corporate AA	5/22/20	1.69%	1.93%	▼	-12.4%	3.06%	▼	-44.8%
US Corporate A	5/22/20	2.09%	2.36%	▼	-11.4%	3.34%	▼	-37.4%
US Corporate BBB	5/22/20	3.18%	3.73%	▼	-14.7%	3.97%	▼	-19.9%
US Corporate BB	5/22/20	5.34%	5.98%	▼	-10.7%	4.77%	▲	11.9%
US Corporate B	5/22/20	7.64%	9.16%	▼	-16.6%	6.65%	▲	14.9%
US Corporate CCC	5/22/20	17.41%	16.97%	▲	2.6%	11.08%	▲	57.1%

Figure 6 as of May 26, 2020; Source: YCharts

[4] HussmanFunds.com
[5] ResearchAffiliates.com

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As you can tell, the low interest rate environment has depressed yields significantly. The ease of borrowing money has allowed the US government and investment grade companies to refinance old debt or issue new debt at extremely low levels illustrated by the double-digit declines in yields over the past year. This is great news for borrowers, but not so much for lenders (aka investors). As old investments mature and new capital must be put to work, where should it go for an investor that needs income from a portfolio to survive? If income is a necessity, investors may be forced to turn to non-investment grade companies, whose yields have actually increased as credit spreads have widened. Remember that yield moves inverse to price when thinking of fixed income securities so the hikes in yield are reflective of the speculative nature of these companies. If the average yield for a US Corporate CCC rated bond has increased 57% year-over-year, there must be speculation from investors that these companies may become insolvent and unable to pay their debts. If investors are forced to look in these dark corners of the markets for yield, they are undoubtedly taking on more risk than is appropriate.

The destruction of capitalism via a dovish Fed may sound dire but hear us out for a moment. If you do believe in capitalism, when a company is no longer viable for whatever reason most would agree that market forces should take over and that company should go out of business. The term zombie company, or a company that does not produce enough income to cover its interest expense, comes to mind when I think of this scenario. In our opinion, there is simply no utility in a company like that. Via an accommodative Fed providing easy monetary conditions for quite some time, these zombie companies have been able to survive with easy access to capital. As we write this paper over 350 companies in the Russell 3000 do not earn enough through normal business operations to cover their interest expenses[6]. Investors, often the yield hungry investors we described above, will invest in the debt from companies such as these to get some sort of yield for their money. Some may place blame on investors here for continuing to lend to these companies, but should you blame the 10-year old kid for crashing his parent's car, or do you blame the parents for handing the kid the keys and telling them to drive?

When taken in whole, we believe that the Fed has put investors in quite the predicament when it comes to where to generate returns for the foreseeable future. Obscene valuations across the board, income producing assets not producing adequate income, and the perpetuation of subpar companies we believe is not a recipe for easy investing. We believe that there are two ways to help navigate these tough times. First, investors will need to rely on a rules-based approach to making portfolio decisions to largely remove emotion from investing. It is easy for investors to get caught up in the short-term narratives of the media and lose sight of what prudent investing looks like. Second, utilizing strategies outside the traditional equity and fixed income spectrum will be necessary to help provide adequate returns. This means that investors should look to implement strategies that can help mitigate risk as the global economy works through the current contraction. When the worst is behind us and the data points to a recovery, return enhancing strategies should be allocated to in an effort to capitalize on the revitalization of the economy and financial markets.

[6] Companies included here were determined by the following equation: EBITDA (TTM)/Total Interest Expense (TTM) < 1.0.

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