FEG INSIGHT

Fund Evaluation Group®
investment advisors

A VETERAN CIO SHARES HIS EXPERIENCES
YOU CAN'T TEACH AN OLD DOG NEW TRICKS

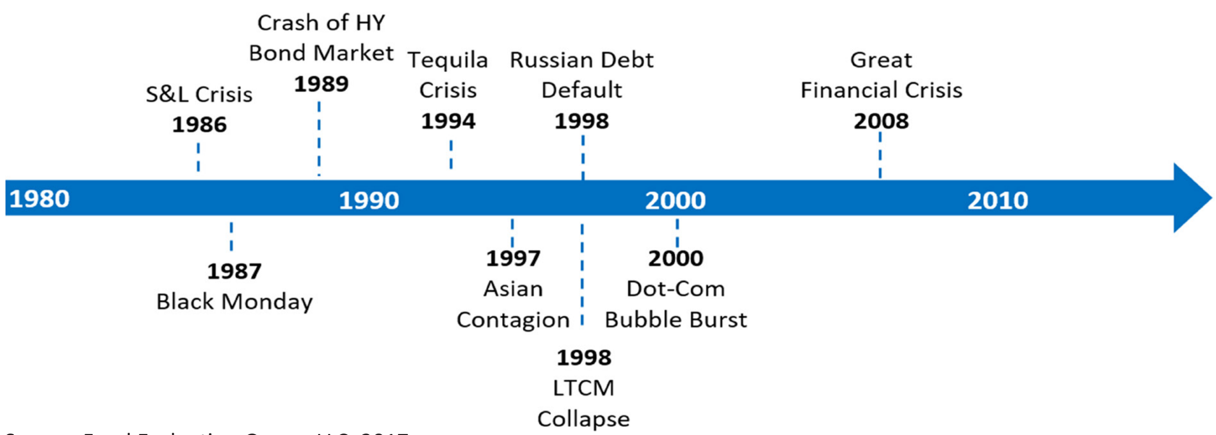
Michael A. Condon, CFA **Senior Vice President / Institutional Investments**

I was not at FEG long before a colleague of mine said to me "Mike, we would like you to write something on the lessons you've learned throughout your career." Now, I have been a lot of things to a lot of different people throughout my career, but I never thought the day would come where I felt like the old dog. But you know what? I have more than 20 years of experience as the Chief Investment Officer at several large endowments, I have lived and worked at several great colleges, and I have been privileged enough to meet some of the most interesting people in the world. Maybe it is time for reflection and hopefully some will find my thoughts useful.

Hindsight Is 50-50

Just because someone is "experienced" does not necessarily mean they are wise. You have to actually learn from the past to develop wisdom. One of my old football coaches in Alabama said to me: "Hindsight is 50-50," meaning looking back is still not perfect and it never will be. There have been at least nine severe crises that have occurred while I was serving as a fiduciary and portfolio manager that have given credence to coach's advice. You can look backward and note what you "should" have done differently, but there are an infinite number of variables that affect each outcome. Learn from your experiences, but always while facing forward.

All of these "events" were very different, but there is a common thread among them: It is not apparent to many investors during the immediacy of such crises that these things happen far more often than one might think, and that most of the time, rather than causing the end of the world, a crisis creates opportunity.



Source: Fund Evaluation Group, LLC. 2017

S&L's and Junk Bonds

The 1980s saw the Savings & Loan (S&L) industry posturing to be like banks, and junk bonds becoming the new "thing" in investing. A major issue faced by S&Ls in their quest to be more bank-like was the low-cost deposits, which relative to traditional banks made the cost of capital much higher. Lax regulatory oversight allowed S&Ls to try undercutting banks by engaging in higher risk practices like over-investing in high yield corporate bonds and lending to risky real estate projects with little to no equity. Depositors in S&Ls continued funneling money despite the risk profile of the investments; their deposits, after all, were insured by the Federal Savings and Loan Insurance Corporation (FSLIC).

About the same time, the high coupons and low default rates of junk bonds made them attractive to investors, and the ensuing increase in demand allowed issuers with more levered structures (some exceeding 9x leverage) to begin accessing the market.

The levered structures became unsustainable. What followed was insolvency for the FSLIC, a failure of more than a thousand S&Ls across America, and a $124 billion bailout of the junk bond investments.

What lessons came out of the 1980s? Leverage works both ways, for one. Think of leverage like you think of sweets. A little bit can do wonders, but have too much, and–well, you know. Also, risk is good–provided that you are paid for it. Finally, excessive easy credit will eventually stick its foot out to trip you just as you reach full speed.

The (This Time is Different) Tech Bubble

I remember visiting with a venture capital (VC) manager the week after an online grocery delivery provider, Webvan, went public. I mentioned to the manager that it was hard for me to believe that a grocery delivery service with the name Webvan debuted at such a high market cap. The guy replied that Webvan should not be valued like a grocery company, but like a logistics company (I believe he mentioned UPS). Webvan was initially valued at $4.8 billion while having reported cumulative revenues of $395,000 and cumulative net losses of over $50 million.[1] Not one of Webvan's senior executives had any management experience within the supermarket industry. Webvan went bankrupt the following year. For whatever reason, this particular instance has really stuck with me.

Investors tend to pay up for growth (both real and projected) and it eventually costs them. Many investment committees and plan sponsors struggled to stick to their value bias during the tech ascension. After all, the word "tech" became the new Midas–everything it touched turned to gold–and the performance disparity between growth and value continued to stretch. Many investors abandoned their value bias at the wrong time and missed a real opportunity to grow their portfolios. Significant valuation disparities can exist for extended periods of time, but disparities tend to revert to true value. You can remove emotion from your portfolio management decisions, but you cannot remove it from trading in the market–stick to your guns.

The Financial Crisis

I do not feel I need to go into great depth describing 2008. It was the biggest crisis of (most of) our careers. Would I react differently today if it happened again? It was very easy then to make the case that the banking system was going to collapse and that any recovery in financial assets was a long way off. It was very easy to say "this time is different." It was the most difficult time of my career to rebalance back to strategic targets.

I had many private equity managers pass through my office shortly after the crisis, most of whom said they would never do "this" again. They would never in their lifetime pay such high multiples or use leverage the way they did between 2006 and 2008. Well, turns out a lifetime is only seven years to some people, because in 2015 leverage and acquisition multiples were back to pre-crisis highs.[2] Investors really do have short memories–too short.

Today

Naïve 70% U.S. equity/30% fixed income (70/30) portfolios generally have outperformed more diversified ones over the past few years, leading many to conclude that simple is better. The valuation difference between the U.S. market and international markets has continued to widen, and most "experts" agree that the expected 10-year return for a simple 70/30 portfolio is very low relative to historical performance. The S&P 500 has returned over 14% annualized over the past five years with modest earnings growth and historically high profit margins. Investors should remember that trees do not grow to the sky. I believe a more diversified portfolio that includes international equities and private investments is almost sure to outperform in the future.

The macro outlook for the U.S. is among the best in the world. Investors have taken note and driven prices upward, thereby lowering expected returns. I believe that the domestic equity market is fully priced and that other alternatives on the margin offer better return potential. Many people I have talked to over the years mistakenly believe that a country's growth is significantly correlated to future equity returns–I have learned that it is not. Investment dollars tend to flow to faster growing areas which lowers expected future returns. The slower growing areas that do not attract as much capital flow therefore have a higher cost of capital–this is what usually translates into high returns.

[1]Webvan IPO Prospectus
[2] Source: Prequin

Grin and (Don't) Bear It

Not everyone can be the Yale Endowment. Much of Yale's success is due to the out-of-the-box thinking of the experts they have employed, as well as the resources the school has at its fingertips. Portfolio management cannot be learned by watching *CNBC* or by reading *The Wall Street Journal*. It takes years of successes and failures to become truly "good" at managing money, and I am afraid that this has been lost on some because of the investment landscape of the last few years. Investment committees and plan sponsors are tasked with the fiduciary responsibility of managing their assets in perpetuity, and it is my opinion that you should manage to your strengths, focus on what you do well, and seek help from others where help is needed. Managing a global portfolio requires significant resources, and attempting to do so without the proper tools is risky.

Speaking of professionals, early in my career at Georgia Tech, an Investment Committee member by the name of John Staton said to me "Let's be proud of whom we lose money with." John has been a mentor of mine so this really stuck. Invest with good, reputable people where there is an alignment of culture, mission, and values. Invest with conviction and with people with conviction. People that do things the right way are most likely to experience success.

I started my career analyzing high yield credit. I spent my days hoping for a bad market where high yield bonds would trade down and could be bought at a discount. I found this impacted my mood and outlook. Although there are times to be cautious, like today, life is better when you are bullish. Bulls are right more than they are wrong, and everyone likes happy people (including investment committees).

You Can Teach an Old Dog New Tricks

I came to FEG because I wanted to challenge myself, and because I feel that I have unique insights from my years of sitting on the other side of the desk. I hope you are able to find something valuable in this piece. Below is the entire list of learned lessons that I put together–some have been touched on, and some speak for themselves:

- Excessively easy credit points toward problems down the road
- Leverage works both ways
- Investors have short memories
- When someone says "this time is different," do not take note–it is probably not
- Trees do not grow to the sky
- Risk is good, provided you are paid for it
- It pays to rebalance
- Do not follow the crowd, especially when it is large and moving fast
- Investors tend to pay up for growth and it eventually costs them
- Valuation disparities can exist for extended periods of time, but eventually revert to true value
- A broadly diversified portfolio works best over the long term
- Be proud of whom you lose and make money with
- The required return on capital is much more important than a country's growth
- When managing money, lean to your strengths
- It is better to be a bull than a bear

Although some of my younger colleagues might view me as "long in the tooth," I think, like my two aging chihuahuas, Bama and Lola, there is still a lot of bark left in me. The change of scenery has invigorated me, and I am eager to do what I can to help our clients. There are always things to be learned and I look forward to the future. I am blessed to work in this industry.

DISCLOSURES

This report was prepared by Fund Evaluation Group, LLC (FEG), a federally registered investment adviser under the Investment Advisers Act of 1940, as amended, providing non-discretionary and discretionary investment advice to its clients on an individual basis. Registration as an investment adviser does not imply a certain level of skill or training. The oral and written communications of an adviser provide you with information about which you determine to hire or retain an adviser. Fund Evaluation Group, LLC, Form ADV Part 2A & 2B can be obtained by written request directly to: Fund Evaluation Group, LLC, 201 East Fifth Street, Suite 1600, Cincinnati, OH 45202, Attention: Compliance Department.

The information herein was obtained from various sources. FEG does not guarantee the accuracy or completeness of such information provided by third parties. The information in this report is given as of the date indicated and believed to be reliable. FEG assumes no obligation to update this information, or to advise on further developments relating to it. FEG, its affiliates, directors, officers, employees, employee benefit programs and client accounts may have a long position in any securities of issuers discussed in this report.

Index performance results do not represent any managed portfolio returns. An investor cannot invest directly in a presented index, as an investment vehicle replicating an index would be required. An index does not charge management fees or brokerage expenses, and no such fees or expenses were deducted from the performance shown.

Neither the information nor any opinion expressed in this report constitutes an offer, or an invitation to make an offer, to buy or sell any securities.

Any return expectations provided are not intended as, and must not be regarded as, a representation, warranty or predication that the investment will achieve any particular rate of return over any particular time period or that investors will not incur losses.

Past performance is not indicative of future results.

This report is prepared for informational purposes only. It does not address specific investment objectives, or the financial situation and the particular needs of any person who may receive this report.

Any opinions or recommendations expressed in the article are those of Mike Condon, CFA, and FEG does not assume responsibility for these opinions or recommendations. Neither the information nor any opinion expressed in this report constitutes an offer, or an invitation to make an offer, to buy or sell any securities.

RES-6010 03-31-2018 EXP. 08-31-2017

Fund Evaluation Group®
investment advisors

HEADQUARTERS
201 East Fifth St.
Suite 1600
Cincinnati, Ohio 45202
P: 513.977.4400
F: 513.977.4430
www.feg.com