

Please note: This is a transcription so there may be slight grammatical errors.

Mission + Markets Episode 10

Hello, and welcome to *Mission + Markets*, a podcast by CAPTRUST, where we explore trends and best practices for endowments and foundations related to mission engagement, fiduciary governance, and investment management, hosted by CAPTRUST. It's Heather Shanahan, director of the Endowments and Foundations Practice.

Each episode shares research, resources, and recommendations from industry insiders so your nonprofit can focus on what's most important: the mission.

Heather Shanahan: Welcome to our latest episode of *Mission and Markets*. My name is Heather Shanahan, and I am joined today by Andy Marino as we take a deep dive into the markets portion of Mission and Markets for an update on investment strategies, economic conditions, and things that we should be mindful of. As a reminder, take a listen please to our last episode, if you haven't already, with our interview with Jade Bristol from GivingDocs as we take a look at donor diversity and diversity in planned giving and systemic barriers to planned giving in the United States.

Andy serves as an investment strategist for us here at CAPTRUST and is the partner on many of our endowment and foundation client relationships. He brings to the table over 35 years in an investment career advising diverse investment portfolios, both institutions and families for national firms, including SEI, Arthur Anderson, U.S. Trust, and UBS.

So, please join me in welcoming Andy Marino.

Andy Marino: Thanks. Happy to be here. I like both aspects of this podcast. The mission part and the markets. Markets are a little more of my expertise, but I love the mission part and doing that with our clients that are directed in that fashion.

Heather Shanahan: Fantastic. We feel like we spent a little time on some of our past episodes talking about the mission piece and that it was time to circle back and lean into markets, which is certainly confusing and volatile and a lot going on right now. So, let's start with a recap of assessing where we were as Q3 closed and get some feedback from you.

Looked a lot like 2022. What are you seeing in terms of similarities and differences?

Andy Marino: Sure. Yeah. It might've been better for us to have this conversation in the middle of the year when markets were still positive, across the board, or at least more optimistic. So, we had a little bit of a pullback here. The high for the stock market so far this year was in July. So third quarter rhymed a lot with 2022. That's your reference there.

So it was a little bit of a pullback, but it's important to say that we have positive capital market results, for stocks in, in the biggest. Allocation for most clients' portfolios is large-cap U.S. stocks, and those continue to lead the way. A hugely different outcome than if you had asked anybody what they would have expected for 2023 after what had happened in 2022. So I don't think it's quite the same. So 2022, of course, was such a surprise because we were still in the middle of zero interest rate policy, and that ended early in 2022.

So we're at the end of that cycle. I don't want anybody to mishear me and say that we're saying there aren't any more interest rate increases to come. There may be and are, but we're so much further along in that, no longer the surprise that it was. And so, bond returns are, largely speaking—at least at the income level—much more like what people would hope for: mid single digits.

A little bit of a, again, a little bit of a pullback on that part of the market in the third quarter, just because rates are still rising. So you get a little bit back on performance there, market value change, but you've got pretty good income mid-single digits.

Heather Shanahan: OK. Corporate earnings. Where are things coming in? How is that impacting the market? As we're talking today, we're certainly seeing some of that, so what would you share with us there?

Andy Marino: Yeah, I'm glad you brought it up. Important driver, overall of markets, interest rates are one variable and where the market trades on a multiple basis, but the overall driver for investors in terms of long term. Returns from stocks is what happens with earnings. So earnings are expected to grow mildly from last year.

The numbers are coming down a little bit here late in the year, but they're not demonstrably different than they've been over the last couple of quarters. The S&P is expected to earn, so almost 220. That puts the market at about 20 times. So it's healthy—it's a healthy multiple.

It's not a cheap multiple by any stretch of the imagination, but if we can do that, that puts the market in an OK place. I would [not] be—nobody here would be—either overly excited about buying or feeling like you need to be selling at that mark of multiple. And I guess I would add [that] there's also growth expected still for next year. You may have a separate question later about recession, but it's been the most repeated word perhaps—at least on CNBC—in 2023, but we don't see it showing up in the actual measured growth numbers for the U.S. economy. If we were to have one—we're not ruling it out; obviously, it easily could happen next year—it would reduce corporate earnings somewhat, but they're expected to grow at a pretty healthy clip. So there's some leeway there that we could give some back if we had to.

Heather Shanahan: OK. So let's go ahead and talk about that. So it sounds like our take on things is soft landing that maybe the Fed tightening has done its job. What are your thoughts there?

Andy Marino: That's everyone's hope, of course. It's a very difficult job that the Federal Reserve has there. They're trying to reduce inflation that caught everyone by surprise in terms of how quickly it increased and where it ended up, high single-digit numbers. A little over a year ago at this time on CPI [consumer price index], so those have come down, fairly dramatically, they're in the 3 percent range, a little high threes, which is importantly north of the long-term target that the Fed has of 2. So I think that's why the Federal Reserve has suggested there may be some more rate hikes to come.

They may not be done, but again, there's a big difference between going from a 0 percent fed funds rate to 5 and 5 and a quarter—which is what's happened over the last 15 months here—and adding another couple of quarter-point rate hikes that the market is probably prepared to digest.

Because that's exactly what they're expecting now. Back to the original topic about will that cause a recession or a soft landing, it's really hard to know exactly how that's going to go again, just using the past 12 months, think about earlier this year, two things were on the horizon as far as most forecasters were concerned.

We would have already been in recession, if listen to people in January, February, March, would have already been in recession in 2023, and the Fed would be cutting rates next month. That was the expectation, about a year ago. And we try to be very, very humble about the prediction business.

Things surprise you.

Heather Shanahan: A broken crystal ball. So there's been a lot of buzz this year about the “Magnificent Seven” or the “Elite Eight.” How do we help clients understand about what's going on in the equity market this year and the impact of those stocks?

Andy Marino: Yeah. So just to make sure everybody understands the term, very few stocks, whether that's seven or eight. And I guess the leadership sometimes changes, based on which month we're talking about this, but largely speaking, very-large-cap technology, household names, Amazon, Microsoft, Apple, Google, you can throw NVIDIA in there, which is one of the controlling chip makers for the most popular.

I'm sure we'll talk about this later too because you can't have an investment conversation [without it]. We'll talk about AI [and] the chip providers to AI. But those are very large stocks in and of themselves. They're already very-large-cap companies. Those are probably within the top 10 in the S&P 500.

And so the way the S&P 500 works is it's weighted by market capitalization. So the biggest companies have the biggest influence on returns. And those few companies have been very rewarded in terms of stock price performance over the last 12 months. You've probably stretched that, by the way, longer, the last five years or 10 years, frankly, but because they're so much of a component of the return, if you take them out, then the other.

Four hundred ninety-two or 493 companies—in terms of their returns year to date—look fairly average and lackluster. In fact, maybe that would be the kind of market everybody might've expected would happen in 2023: flat to slightly down is if you take away those returns. But again, thinking about it from the client's perspective in terms of how their portfolios are constructed, almost every client that we work with has some significant allocation to large-cap U.S. equities, perhaps owning the S&P 500 itself in an index fund or something like that. And maybe as well as likely having large-cap growth in a manager or a fund. And they would be highly exposed to those companies. But it's a good thing for us to point out to clients, just because there can be a very big difference between the average manager, let's say, or the average portfolio in 2023 and the S&P 500. And it's mostly driven by very few companies, which everyone's happy to own for the percentage ownership they have. But very few people own them exactly the same way, as they're weighted in the index.

That's a pretty bold place to be, and again, it's one of the reasons why we have a big component of indexing in a lot of portfolios. Because it's tried and true, and it works over time that the winners get rewarded and the less-weighted companies just don't move the needle so much.

So it'd be important to think about what might happen if that were to reverse. But again, since you're asking about these particular companies, it's important to know, or at least to observe, that the reason that they are as large as they are is that they are powerhouses in terms of producing corporate earnings.

Heather Shanahan: So let's stay on the client perspective. And given that our discussion today is in support of nonprofit clients, what advice do we give in terms of how to navigate this uncertainty? A lot of nonprofit organizations—if it's university endowments or whatever it is—experienced some upheaval and loss in 2022. How are we coaching our clients? I think it's important for us to face this uncertainty at this point.

Andy Marino: Yeah, I think one of the most important jobs we can do for. Especially nonprofit clients, where they're just so driven by the mission that they have to support others and they want to be confident that their resources will allow them to do that is to just, set expectations properly and, We always, we all say this, we say think long term and plan long term, and then we get together and talk about markets every three months, which is an ironic circumstance.

It's important that they do that. Obviously, there's fiduciary responsibility and nobody wants to be uninformed about what's going on. But we could rewind this conversation five years or 10 years or 20 years or 25 years,

and it would be a different list of worries and concerns and difficult circumstances that were on the horizon. And largely speaking, not that volatility, especially when it's on the downside, is not very unpleasant to go through, but there isn't a great way around it. And it'd be fantastic if you could time the market and know how to step aside for a short period of time while the bad things happen and then make a second decision to, quote unquote, "Get back in," when it's safe to go back in the water, so to speak, but it's just not possible.

So I guess the first thing I would say would be keep your long-term hat on, regardless of what is going on in the markets or the news or the headlines, because very rarely will any of that impact your long-term asset allocation and investment put in place that's supposed to be supportive for decades, unless something has changed in the circumstances for your organization.

And that too tends to be a pretty rare event.

Heather Shanahan: Yeah. Let's talk about another term that we're hearing a lot about: deglobalization. What is it, and what are the potential impacts on our economy and on our outlook?

Andy Marino: OK, so what is it? I guess globalization was, in one sense, a very long process, centuries in the making. but [I] think maybe post-1970s, the United States acknowledging the People's Republic of China as the official party there, and their entry into global markets and the enormous ability of companies to change the cost structure of their supply chains by putting them in less-expensive places from the perspective of doing business overall—that was a big tailwind to corporate profitability and a tailwind, frankly, to consumer price inflation being as low as it was. In the '80s, '90s, and here in the 21st century, one of the requirements for that is global stability and global, at least, agreement that the economic outcomes are more important than anyone's in particular geopolitical goals.

Another point we might make is—backing up, not as far as I just did, but just to the pandemic—one of the primary triggers of deglobalization, which I guess we haven't even defined yet. So let me do that. So that's just, instead of spreading your supply chain and your construction of products, as a global company, widely across your geographic footprint and probably the production part being far away from where your end markets are, just going to the place where you can get the lowest cost of production. Moving those things closer to where either your home headquarters is or where your customers are, rather than just the lowest-cost place to produce things, is what you might call deglobalization. Sometimes it's called onshoring. So, lots of production and capacity and people and technology were moved offshore from wherever companies were headquartered.

Moving them back closer to headquarters is onshoring. And largely speaking, if you're a U.S. company, that's probably going to be more expensive [than] the trend we saw over several decades. Partly because labor is more expensive here in the United States, and partly because the facilities are not as mature.

We've been doing this for 30 years. We're just doing add-on to existing facilities. When you're growing capacity where it is now, if you're starting from scratch, let's say, think about the CHIPS Act, where we're going to produce silicon chips here in the United States. You've got to find a greenfield place to do that; in Arizona or Iowa or wherever they put those.

The impact of that is it will probably be something that companies have to overcome from a cost perspective. I don't know if it's quite going to be a headwind net basis, but it's hard to argue against that. If it was a huge cost savings over three decades to go to the lowest costs production, then putting it back where it was in higher-cost markets is probably going to at least be challenging. And if companies are going to maintain their margins, they're going to have to find cost savings somewhere else, which they may well do. I know we'll probably talk about AI here sometime.

Heather Shanahan: Yeah, that's actually the perfect segue. I have onshoring results and higher labor costs, then how does AI potentially play into that? And obviously the speed of information continuing to move, and what do you see on the horizon as all this comes together?

Andy Marino: Yeah, that, I think we've said now for probably the better part of a year that there seems to be a two-phase aspect to artificial intelligence kind of bursting onto the scene here. Again, that groundwork has been getting done for decades, slowly but surely, but it's been ready for its closeup or its debut here only in largely speaking in 2023, getting people's attention.

The providers of that technology are going to be rewarded, and that's happening in the marketplace right now. It's part of that Magnificent 7 or Elite 8 concept we talk about. They are the producers of that technology and they're being rewarded. But more broadly across the economy and across the company landscape, to one degree or another, every company in America, I would argue, unless you're tiny, is involved in some kind of AI initiative or initiatives across their company.

And some of those will prove unsuccessful. I suspect that whatever process is in place is perfectly fine and can't really be enhanced, but a lot of them in surprising ways will be very successful and they will be cost-saving. There are lots of examples already. We don't need to do anecdotes to know that, if you're a teenager, [AI] can do a term paper quickly. And that doesn't sound like a great idea.

Heather Shanahan: For better or for worse. Yes.

Andy Marino: You want somebody to, if you want your kid to read Dickens or whatever, then it's not great. But similarly, you don't have to start from scratch as a professional on lots of things that otherwise there just was a lot of legwork involved in getting something to a beginning point where then somebody can take it and refine it and get it to the final product. Cutting out a lot of that on the front end is potentially a very significant savings for a lot of companies. Overlapping in our conversations here, right? So these are very long-term trends.

It's hard to know which one of them will dominate deglobalization. Let's keep the simple case. Yes, deglobalization should be more expensive and more inflationary, all else being equal, and all artificial intelligence should be cost-saving and disinflationary. And so which one of those plays out more strongly over time is hard to know, but that's a good way to set it up—almost, they are revealing trends.

Think about the way we try to present our information for clients, the fair and balanced, headwinds and tailwinds, one of those is a headwind and one of those is a tailwind.

Heather Shanahan: Yeah. OK, yield curve. How do we see that eventually normalizing? Will it? What are your thoughts?

Andy Marino: It's been a very odd circumstance to watch the yield curve be inverted. And so we don't get too technical over people's heads, to have short-term rates higher than long-term rates, the way lending money usually works is that you will accept a lower return to get your money back quicker—three months, six months, nine months, a year—than you will for lending it out long, just because there's so much uncertainty.

If you're going to lend somebody money for 10 years, you want a higher return. That has been turned literally on its head. And I think we're going on 15 months or more of an inverted yield curve. The reason people talk about it so much is that it has been a fairly reliable predictor of future recessions. Not an infallible record, but a pretty good one.

There've been false positives, so to speak. We may be in one now, or at least we are so far. What has been happening in terms of normalization—to the second part of your question—is, of course, that longer-term interest rates have been rising, and that's been a phenomenon really of this year, but mostly, the last six or eight weeks here, where 10-year and 20-year and seven-year securities are increasing in yield, catching up to the shorter end of the curve, which is much more under the influence of Federal Reserve policy.

Andy Marino: I wouldn't feel any more confident on a prediction about how and when that will normalize than I would about any other, future unknown item.

Heather Shanahan: There's a list of them, for sure. OK, any parting thoughts **for us**, especially for our nonprofit clients, that you think are important for takeaways and for folks to be mindful of?

Andy Marino: Yeah, I guess just back to the expectation setting. We try to think in seven- to 10-year increments when we help clients set asset allocation returns for stocks. On that basis, for our way of thinking in the next seven to 10 years are in the 7 percent range. That is lower than long-term average. I would hope we're wrong, but we're trying to be both conservative and accurate. [It's] important to remember that over the last decade or two, frankly, you've gotten a lot more than that. The market has—stock market in particular—has really been on fire, offering you much more than long-term-average returns.

And that's part of why we'd expect it to be lower. It's not quite like a helium balloon, where what goes up must come down, but there is something sort of reversion to the mean. If you get 7 percent on stocks on a go-forward basis, that's not a bad outcome for that percentage of the nonprofit portfolio.

It allows you. A return above what you're giving away and some flexibility there for inflation. The second part of the asset allocation pie—the second biggest part—is bonds. The good news there is despite the difficult markets that are now behind us, to get here from zero interest rate policy, you now have mid-single-digit yields.

So those are an attractive piece of the pie. There are other options depending on your portfolio size or desire to take on alternative investments, and you can add those to the mix, I guess, thinking in terms of keep your eye on the long term. So notwithstanding all of our discussion about fun topics and topical topics, they're hard to know how they're going to impact the long term.

And it really doesn't help anybody plan. So you should probably again, unless they're exogenous changes to what's going on for you personally at your organization, it's not something you should react to. And then keep thinking about returns that are in the mid- to high single digits on a long-term basis and think about how to set up your organization to be successful in that scenario.

And if we get better than that, then great. And of course there's always a possibility to be less than that. But that's part of organizational scenario and risk planning anyway.

Heather Shanahan: Bottom line: Buckle up. Enjoy the ride. It's going to be a long one, huh?

Andy Marino: Yeah, there certainly will be some downside. 2022 is recent enough for people to remember that the old adage about “your mileage may vary” is alive and well.

Heather Shanahan: Fair enough. All right. Andy, thank you so much for your insight and wisdom and for taking the time to join me here today, and for all the work that you do to support our nonprofit clients. You are a tremendous partner to all of those that you have the pleasure of working with. We are grateful for your time here today.

Thanks for joining us.

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