

Evoke Insights: The Best Asset Class

March 2017

What is going to be the best performing asset class over the next 3-5 years? This is a question that “experts” frequently answer with a high level of conviction. In our view, it is dangerous for investors to overly rely on such predictions for two main reasons:

1. The best asset is highly dependent on the economic climate; and
2. Guessing how the economy is going to evolve is very difficult.

Dependence on the Economic Climate

The economic environment largely explains asset class performance. The logic is straightforward and intuitive. The best asset class in an economic downturn is different from the best in an economic boom. Likewise, if inflation suddenly spikes then certain assets are biased to do well, while a fall in inflation benefits other market segments. Table 1 provides a summary of the economic climate in which each major asset class tends to outperform.

Table 1: Economic Bias of Asset Classes

Economic Climate	Best Asset Class
Rising Growth	Equities, Real Estate, Industrial Commodities
Falling Growth (Recession)	Treasuries, TIPS, Gold
Depression	Treasuries, Gold
Rising Inflation	TIPS, Industrial Commodities
Falling Inflation	Equities, Treasuries

To prove the point with historical data, Table 2 shows cumulative asset class returns since 1973, broken down into distinct economic periods. The table also lists the dominant driver to help you connect the economic bias of each asset class to how it performed during the period (note that there are additional influences that also impact prices so the correlation won't be perfect).

Table 2: Asset Class Performance in Different Economic Environments⁽¹⁾

Stagflation (↓Gro ↑Inf) 1973-82		Disinflation (↓Inf) 1982-87		S&L Crisis (↓Gro ↑Inf) 1987-90		Internet Boom (↑Gro ↓Inf) 1990-99		Tech Crash (↓Gro) 2000-03		Housing Boom (↑Gro) 2003-07		Financial Crisis (↓Gro) 2007-09		Recovery (↑Gro ↓Inf) 2009-16	
GLD	437%	EQ	351%	COM	163%	EQ	290%	TSY	61%	EQ	143%	TSY	26%	EQ	175%
COM	233%	TSY	200%	TIP	36%	TSY	229%	TIP	58%	GLD	136%	GLD	18%	RE	77%
TIP	199%	RE	67%	TSY	35%	TIP	72%	COM	41%	RE	92%	CSH	3%	TSY	68%
RE	188%	COM	63%	RE	29%	RE	68%	RE	31%	COM	88%	TIP	-2%	TIP	65%
CSH	126%	CSH	53%	CSH	27%	CSH	57%	GLD	17%	TSY	38%	RE	-3%	GLD	22%
EQ	28%	TIP	47%	EQ	-10%	COM	-2%	CSH	13%	TIP	37%	COM	-53%	CSH	1%
TSY	-17%	GLD	32%	GLD	-10%	GLD	-29%	EQ	-45%	CSH	15%	EQ	-54%	COM	-29%

EQ=equity; RE=real estate; TSY=Treasuries; TIP=Treasury Inflation-Protected Securities; GLD=Gold; Com=industrial commodities; CSH=cash

You can observe the relationship between asset class returns and economic outcomes, as well as the constant changes in leaders and laggards. Notice the wide swings in asset class returns as the environment changes. Often times the best asset in one environment becomes the worst in the subsequent environment (and vice versa). This highlights the danger of investing in those asset classes that have recently performed best. Sadly, human emotion leads most investors to adopt this exact approach.

Difficulty in Predicting the Economic Environment

If we know which assets tend to perform best in certain economic climates, then why don't we just invest according to our economic estimates? Surely, experts in the field should offer useful insight into the changing landscape.

Unfortunately, this is simply not the case. Guessing the economic environment that is likely to transpire over the next market cycle is extremely perplexing. Honestly ask yourself if you or anyone you followed expected interest rates to be this low or the economy to come precariously close to a second Great Depression? Probably not.

Note the wide range of duration of each environment in Table 2. Some climates lasted two years while others went on for nine years. The current period has lasted eight years. This sort of variation is common and adds to the trouble of timing the next turn, even if you know what the next environment will be (which you probably don't).

Indeed, predicting outcomes is exceptionally challenging, even for professional, experienced and well-resourced forecasters like the International Monetary Fund (IMF). In 2016, *The Economist* did a study of the IMF's accuracy in predicting GDP by looking at their semi-annual forecasts across 189 countries between 1999 and 2014.⁽²⁾ In 220 instances where the economy shrank following a positive year, the IMF failed to predict a single contraction.

Adding to the complication of anticipating market moves is the fact that simply knowing the economic environment is not enough. In order to profit from this foresight, your view would have to be different from the consensus. If the majority of investors expect a certain economic outcome, then asset class prices will discount this result (e.g., long term bond yields will be high if investors expect high inflation). It is economic surprises that materially move the needle. Note that the cycles presented in Table 2 were all unexpected economic turns that shocked the majority of investors and thereby resulted in massive price moves. We will cover this important topic in a future *ARIS Insights*.

The Conventional Portfolio

If these observations are true, then why do the vast majority of investors invest as if they know what the next investment environment will be? Most conventional portfolios own very little, if any, of the assets that tend to perform best during many potential economic outcomes as described in Table 1.

The majority of portfolios are invested in assets that are biased to perform well during a relatively small number of

¹Data sources: Bloomberg, Bridgewater Associates, Federal Reserve Bank of St. Louis, Ibbotson, Roger G. 2016 *S&P 500 Yearbook*. Indices used: equities (MSCI World Index); real estate (NCREIF Index 12/31/77-12/31/16, FTSE NAREIT Index 12/31/72-12/31/77); Treasuries (Barclays US 20-30 Year STRIPS Index 1/31/97-12/31/16, 190% of Barclays Long Treasury Index excess returns plus cash 1/31/73-1/31/97, Ibbotson: 190% of Long-term Government Bonds excess returns plus cash 12/31/72-1/31/73); TIPS (Barclays US Treasury Inflation Notes 10+ Yr. 6/30/00-12/31/16, 170% Barclays US Treasury Inflation Unhedged Index excess return plus cash 3/31/97-6/30/00, 140% Bridgewater TIPS simulated excess returns plus cash 12/31/72-3/31/97); gold (gold spot price); commodities (S&P GSCI Total Return Index); cash (Merrill Lynch 3-Mo. US Treasury Bill Index 12/31/77- 12/31/16, FRED 3-Mo. Treasury Bill 12/31/72-12/31/77). Note: in order to compare asset classes at a similar risk level (so that they have similar magnitude price moves), we are using long duration indices for both Treasuries and TIPS. Periods used: Stagflation 12/31/72-7/31/82; Disinflation 7/31/82-8/31/87; S&L Crisis 8/31/87-9/30/90; Internet Boom 9/30/90-12/31/99; Tech Crash 12/31/99-3/31/03; Housing Boom 3/31/03-10/31/07; Financial Crisis 10/31/07-2/28/09; Recovery 2/28/09-12/31/16.

² A Mean Feat." *The Economist*. January 9, 2016

potential economic climates. The largest percentage of assets held in portfolios today is equities (which happens to be the best performing asset over the past eight years). This concentration means that portfolios are positioned for a strong growth and low inflation environment. It is as if everyone has very high conviction that the future will continue to look like the recent past. Certainly, recent strong returns have added to the comfort and complacency in maintaining an equity-oriented allocation. However, history has taught us that the economy frequently experiences sudden and dramatic changes, leaving investors exposed to painful losses. In fact, in just the past 17 years, we have seen the global equity market fall approximately 50% on two occasions.

Concentrating in a single asset class (typically equities) is one of the biggest mistakes that investors make. At least a portion of portfolios should be allocated to market segments that perform well in different environments simply because the future is unpredictable. Given the wide range of potential economic outcomes in today's unique and uncertain times, we continue to believe that a balanced portfolio that includes these diversifying assets is sensible and prudent.

IMPORTANT INFORMATION

Past performance is not an indication of future results.

Advanced Research Investment Solutions, LLC ("ARIS") and Evoke Wealth, LLC ("Evoke Wealth") (collectively referred to hereinafter as "Evoke Advisors") are SEC-registered investment advisers that provide investment advisory services and investment consulting services to a select set of clients and pooled investment vehicles. None of Evoke Advisors' services are intended to represent a complete investment program.

This publication is for educational, illustrative and informational purposes only and does not represent investment advice or a recommendation of or as an offer or solicitation with respect to the purchase or sale of any particular security, strategy or investment product, or any Evoke Advisors investment product mentioned herein. Past performance is not indicative of future results.

Different types of investments involve varying degrees of risk, including possible loss of the principal amount invested. Therefore, it should not be assumed that future performance of any specific investment or investment strategy (including the investments and/or investment strategies recommended and/or undertaken by Evoke Advisors), or any non-investment related content, will be profitable, equal any corresponding indicated historical performance level(s), be suitable for a client's portfolio or individual situation, or prove successful. Nothing contained herein is intended to predict the performance of any investment. There can be no assurance that actual outcomes will match the assumptions or that actual returns will match any expected returns.

This publication does not constitute, and should not be construed to constitute, an offer to sell, or a solicitation of any offer to buy, interests in any Evoke Advisors-sponsored fund, which can only be made by means of an offering memorandum and other governing documents for the respective fund.

This publication does not take into account your particular investment objectives, financial situation or needs, should not be construed as legal, tax, financial or other advice, and is not to be relied upon in making an investment or other decision.

Certain information contained herein constitutes forward-looking statements (including projections, targets, hypotheticals, ratios, estimates, returns, performance, opinions, activity and other events contained or referenced herein), which can be identified by the use of terms such as "may," "will," "should," "expect," "anticipate," "project," "estimate," "intend," "continue" or "believe" or other variations (or the negatives thereof) thereof. Due to various risks, assumptions, uncertainties and actual events, including those discussed herein and in the respective analyses, actual results, returns or performance may differ materially from those reflected or contemplated in such forward-looking statements. As a result, you should not rely on such forward-looking statements in making any investment decisions.

Certain information contained herein has been obtained or derived from unaffiliated third-party sources and, while Evoke Advisors believes this information to be reliable, neither Evoke Advisors nor any of its affiliates make any representation or warranty, express or implied, as to the accuracy, timeliness, sequence, adequacy or completeness of the information.

The information contained herein and the opinions expressed herein are those of Evoke Advisors as of the date of writing, are subject to change due to market conditions and without notice, and have not been approved or verified by the United States Securities and Exchange Commission (the "SEC"), the Financial Industry Regulatory Authority ("FINRA"), or by any state securities authority.

This publication is not intended for redistribution or public use without Evoke Advisors' express written consent.