



## TRENDING NOW IN SENIOR LIVING INVESTMENT PORTFOLIO ALLOCATION

A paradigm shift is an important change that happens when the usual way of thinking about or doing something is replaced by a new or different way. Paradigm shifts very often relate to new technologies. Remember when we composed letters and papers on a typewriter? Or when we pulled an encyclopedia off the bookshelf for an authoritative explanation? Yes, the internet and smart phones have changed everything, but that's ancient history (just check Wikipedia). Today the new emerging paradigm is artificial intelligence, or AI. With the potential to catapult progress and at the same time wreak undeterminable havoc, AI is the new shiny thing that has the potential to change the way we live, just like the internet.

But there are other kinds of paradigm shifts that occur across many disciplines that may not quite be life-changing but are important turning points, nonetheless. When a group of entrepreneurs decided to lay cable into homes across America to deliver dozens and eventually hundreds of TV channels, that was game changing. As was the development of a Covid 19 vaccine. All of these things changed the way people thought about things.

What does this have to do with asset allocation, a discipline dear to our hearts and central to investment management success? Once upon a time, portfolio construction was deemed to be simple; 60% stocks and 40% bonds for many institutional and high net worth investors. We could expect stocks to return 10% vs 5% on bonds and we could expect that when the more volatile stock portion suffered, bonds would move in the opposite direction and would provide both income and a portfolio buffer as bond yields declined and their prices increased, adding to portfolio total return.

The paradigm shift that turned this on its head ironically started after the bursting of the internet bubble in the early part of this century. Internet stocks with little revenue and no earnings crashed, quickly followed by the tragic and unforgettable events of 9/11. This double blow and its portent ushered in the era of extreme interest rate cuts to bolster the economy and, importantly, to support the value of assets such as stocks. The biggest advocate of this plan to increase asset levels and thereby wealth, was former Fed Chair Ben Bernanke. As a member of the Fed under Alan Greenspan, he was referred to as "helicopter Ben" for his proclamation that we should rain dollars on the economy to avoid a fate similar to the Great Depression, which reflected a major part of his economic scholarship. This era of very low interest rates (1%) produced great speculation in residential real estate and when rates began to be lifted by Greenspan in 2004 and Bernanke (who then ascended to Fed Chair) in 2006, the roof caved in on the real estate market and led to the Great Financial Recession. Since that time, interest rates have fluctuated in a range unusually low from an historic perspective. The final blow was Covid 19, and the lessons learned from the recent past influenced the Fed Reserve to push interest rates to zero until just recently. So, for almost 20 years, interest rates were at extremely low levels and asset prices of all types benefited.

The acronym T.I.N.A ("there is no alternative", borrowed from Margaret Thatcher) evolved some time ago in asset allocation conversations and it basically posits that for investors there is no good alternative to stocks. Why? When bonds paid 5%, the interest paid on bonds could help stabilize portfolios through a rocky market. When they paid nothing that cushion disappeared. Of course, if the economy weakened, yields could still go from 1.50% to 1.00% and would produce a nice total return. But most could not imagine lower yields (and often were wrong during this long period)

The idea that super low rates could spur the economy never really played out as long-term GDP growth was lower in the 21st century than in previous periods (2.08% vs. 3.39% since 1960) But the theory that super low rates could cause stocks and other assets to increase in value did work. Think of a shopper who is comparing interest rates on bonds with potential returns in stocks. For many there was no alternative to avoiding bonds which didn't pay anything. This temporary (if one takes a very long view!), emergency shift to zero rates changed investor behavior. And it changed the mindset for asset allocators.

Increasingly, and with good reason, investors turned to alternative investments such as hedge funds and private equity. And they increased their allocation to equities while decreasing allocations to bonds. Under normal circumstances the power of the market would have been self-correcting; bond prices would fall as investors sold into tepid demand. But Bernanke's Fed did not stop at lowering interest rates to zero. In a herculean effort to save the world, they engaged in something called quantitative easing which entailed the Fed using its balance sheet to buy all the bonds that investors were shunning. Pretty incredible stuff when you think about it.

Whether a result of 15 years of super low rates and Fed bond buying or emergency stimulus of the pandemic and ensuing supply chain bottlenecks, our old friend inflation has entered stage right. In response, the fed has raised the funds rate 500 basis points higher than it was just over a year ago. This caused a collapse in growth stocks, a historic decline in bond prices and has cast doubt on the continued recovery from the pandemic.

So, where's the catalyst for the next paradigm shift in asset allocation? Higher interest rates on bonds for sure! You can buy a 2-year US Treasury at 4.50% and you should be able to find good investment grade corporate bonds at yields between 5 and 6.50%. You can buy mortgage-backed securities at 6% and a high yield mutual fund that yields 8%. Let's say that with a diversified portfolio of bonds as you might find in a highly rated intermediate term core-plus bond fund, you will have an underlying portfolio with a yield of 5.25%. How do I compare the stock market's potential to this bond? You have probably heard a lot about price-to-earnings ratios over the past year. It measures the stock price divided by the forward earnings market forecast. Currently the P/E on the S&P 500 is 18.37. Why is this relevant to a comparison with bond yields? If you flip the P/E and turn it into E/P, or the ratio of forward earnings to stock price, we get what is called the earnings yield. The reciprocal of 18.37 is 5.44% and this is the earnings yield that the S&P 500 is forecasting. Again, it is the forecasted earnings consensus divided by the price you are paying for the market, and it is 5.44%. The S&P 500 pays a dividend that is currently 1.67%, so the total return forecast would be 7.11%.

Two years ago, the earnings yield plus dividend was about 5% and bond yields were skimpy to zero. Many allocators tilted portfolios further towards stocks, ignoring the risks that the 5.00% forecasted return was balanced against, namely that eventual higher interest rates would prompt a revaluation of equity P/E multiples and a tumble in stocks. But in a steady state and very simple analysis, this decision process made sense to some.

Today you can buy a 6-month T-bill at 5.50% or invest in a diversified portfolio of bonds at 5.25%. So do we take 5.50% with no risk, 5.25% with 75% less risk than equities, or do we buy the S&P 500 at 7.11% (earnings yield plus dividend)? Clearly today's higher interest rates have changed the metrics of this very basic allocation decision! And there is an alternative (T.I.A.A!) to equities.

The point of all this is that the basic math around comparisons of stocks and bonds broadly has changed, and that it is important. This is the perfect time to be talking about asset allocation in your investment committees. Asset allocation is about comparing relative risks and returns, but much more importantly it

is about constructing a portfolio that is appropriate for an organization in terms of enterprise risk. We can attempt to measure the return expectations of asset classes and the associated risks, but how do we factor in operational risk? Generally speaking, senior living is weaker financially than it was before the pandemic. Fitch Ratings has indicated that it is negative on the sector in the near-to-intermediate term but bullish long term. Does it not make sense to look at asset allocation in the context of both the leverage in the organization and the specific weakness in the senior living sector?

We didn't think that senior living organizations with challenging bond covenants should have been increasing allocations to equities over the past few years. And we don't necessarily think 6-month T-bills are the answer today. What we do believe in is diversification. That means diversification of asset classes (stocks, bonds, real assets, alternative investments), diversification within asset classes (market caps, styles, indexing for stocks, duration, credit for bonds) with controlled tactical underweights and overweights to a strategic long-term allocation.

If you are a leveraged organization with significant liabilities in the form of entrance fee refunds, you should be carefully measuring the risk in your portfolio as you also consider the risks in your operations. From an enterprise standpoint these risks should be balanced.

We would love to have a conversation with you about your organization and the risks in your portfolio and how they relate to one another.

Let's talk.

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