

## Active Management for All Seasons

By Eric G. Warasta, CFA, Vice President and Investment Officer, 617-441-1490

### Passive Investing is Low Cost if You Don't Mind Doing All the Work

Spring is a great time to visit Washington, D.C., and millions flock there every year to see the cherry blossoms that surround the Tidal Basin in full bloom.<sup>1</sup> As you emerge onto the National Mall from the escalators at the Smithsonian metro station and take in the patriotic panorama that stretches from the U.S. Capitol to the Washington Monument, you will notice thousands of tourists, many of whom are enhancing their experience with the aid of a paid tour guide. In exchange for a fee, tour guides provide a valuable service – they keep you on schedule, provide in-depth insight into your experience, offer local touches and personal anecdotes, and perhaps most importantly (to this writer anyway), make sure you never miss a meal. While access to most of the museums, monuments, and other attractions is available without a ticket<sup>2</sup>, you may get the most out of your trip by hiring a guide.

Similarly for investors, passive investments are relatively low cost, but lack the value provided by an investment advisor, someone actively and directly engaged with you, serving as a personal tour guide, navigating your unique situation and tailoring asset allocation to your specific objectives while monitoring risks in financial markets.

### Our Process as Investment Advisor

Our definition of active portfolio management goes beyond security selection and encompasses a disciplined investment

process focused on preservation of capital and managing risk, with an emphasis on long-term, risk-adjusted total return. Our investment process begins with determining the attractiveness of available investments across asset classes – a process known as asset allocation. Asset allocation takes client-specific investment goals and constraints, and weighs them against the relative attractiveness of available investment categories and market conditions – specifically and most importantly, valuation. A simple illustration of the process of thinking about asset allocation and valuation was put forth earlier this year in an essay by John Cochrane of the Booth School of Business at the University of Chicago:

After all, if tomatoes are expensive today, you should put fewer of them in your salad. It doesn't matter whether the sale comes from a "rational" bad harvest, or an "irrational" bubble in the tomato futures market. Likewise, it behooves an investor to see what risks are on sale today, no matter what their source, or have his manager do so.<sup>3</sup>

A disciplined approach to asset allocation is the first step to controlling risk in a portfolio – determining where value exists in the market and aligning the portfolio appropriately given individual client goals.

### Setting Realistic Expectations

Several commentators have suggested that investors may experience low returns for some time. Most prominently, Pacific Investment Management Company (PIMCO) has branded this environment the "new normal" – low interest

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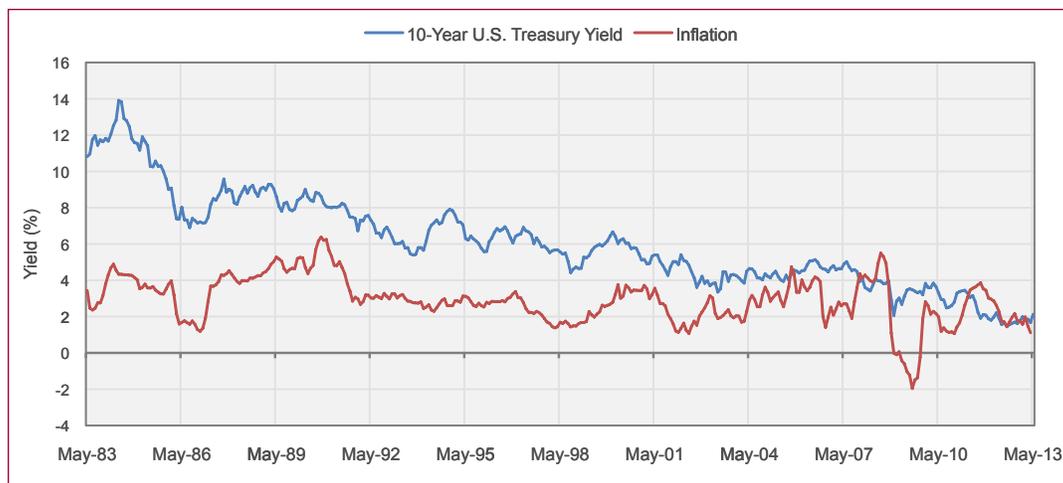
## Active Management for All Seasons *(continued)*

rates and low growth as the global economy continues to work through a massive debt crisis.<sup>4</sup> The combination of aggressive policy action from central banks and a strong investor preference for “safe” assets created excess demand for bonds and pushed interest rates to very low levels. Low rates have been a significant source of pressure on retirees and other savers, with cash investments yielding 0.01% (let’s call it zero) and the yield on 10-year U.S. Treasury bonds ranging from 1.70% to 2.50%. Compare this to the long-term rate of inflation (roughly 2% annually over the past 10 years) and the real, inflation-adjusted expected return is close to 0% and has even been slightly negative.<sup>5</sup> (See Chart 1 below.)

return world, our view is that stocks are attractive relative to bonds and cash. Select portions of the bond market such as certain emerging market debt and investment grade corporate bonds are slightly more attractive, but even here we remain selective as spreads have tightened, and absolute borrowing costs remain very low indeed across the spectrum of borrowers.

While bond yields are very low – notwithstanding a recent uptick, the dividend yield on the S&P 500 Index is currently 2.1%, and the index trades at 14.9x expected 2013 earnings, or broadly in line with historical valuation levels. Relative to bonds, stocks look cheap, but in the above paragraph we

**Chart 1.** Real U.S. Treasury Yields are Low



Data Source: FactSet

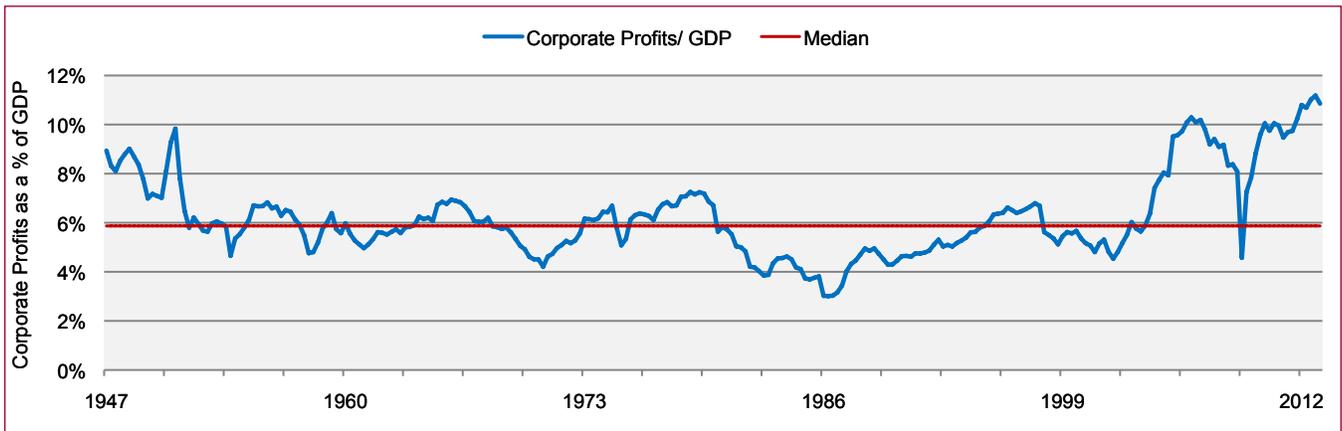
Very low interest rates (and tight credit spreads) support our current asset allocation recommendation, which favors equities over fixed income. Our thesis is further supported by strong corporate balance sheets, moderate expected growth in corporate profits, rising dividend payments, and reasonable equity valuations. In the above tomato analogy, our view is that today’s expensive tomatoes are bonds. As a reminder, while interest rates and inflation remain relatively low today, bond prices decline (as they did in May of this year) when interest rates and inflation rise [See Eric Jussaume’s March 2013 article, “What Happens to Bonds if Interest Rates Rise?”].<sup>6</sup> While we believe bonds should continue to play a role in portfolios by mitigating volatility, we remain cautious and are positioning clients’ bond portfolios with relatively short durations and with a bias toward capital preservation. In today’s low interest rate, low inflation, and potentially low

categorized equity valuations only as “reasonable” – this is largely because corporate profits as a share of GDP (and corporate profit margins) are at or near historical highs (See Chart 2), and these levels may not be sustainable long-term. One can adjust for the possibility that margins are unsustainably high by looking at the cyclically adjusted P/E ratio (CAPE) based on the average earnings of the past 10 years.<sup>7</sup> On this basis, stocks appear more expensive, but still more favorable to bonds given current low interest rates (See Chart 3). As Chart 4 shows, the stock market historically has performed best when starting from low valuations, and thus our view that equities are reasonably valued curbs our enthusiasm for stocks. We concur that future returns for many asset classes (equities included) are likely to be modestly lower than recent history, but we still view equity returns as more attractive than bonds and cash.

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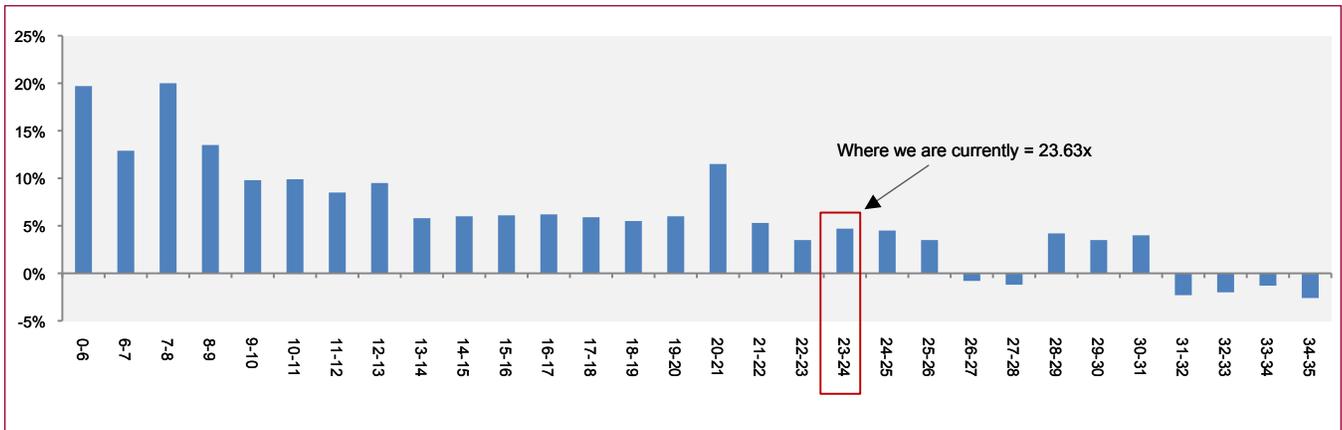
## Active Management for All Seasons *(continued)*

**Chart 2.** Corporate Profits to GDP Ratio: 1947 – 2013/Q1



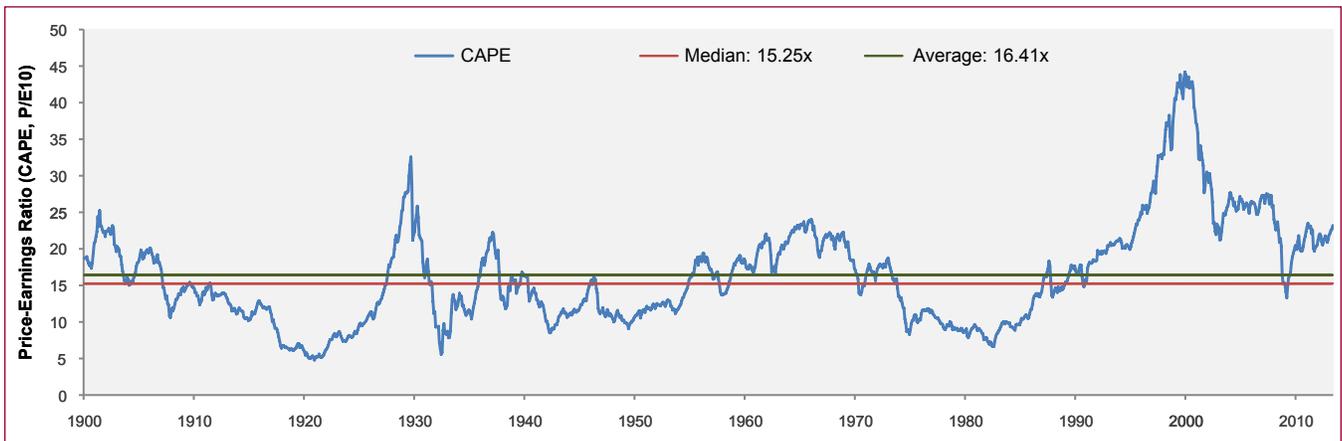
Source: U.S. Department of Commerce: Bureau of Economic Analysis

**Chart 3.** Annualized total real returns of the S&P for different levels of Shiller P/E over the following 5 years



Source: Credit Suisse Global Equity Strategy

**Chart 4.** Shiller P/E: 1900 – 2013 (May)



Source: [www.econ.yale.edu/~shiller/data.htm](http://www.econ.yale.edu/~shiller/data.htm)

Based on annual average earnings over the preceding 10 year period.

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# Residential Mortgage Market

*By W. Todd Spoor, Vice President, Private Mortgage Banking, 617-441-1570*

With historically low interest rates, the stock market reaching an all-time high, the economy recovering from the worst post-depression recession in history, employment improving, and prices of both single family homes and condominiums rising, why is the residential mortgage business still in a state of flux? Here are some observations from a mortgage veteran with 23 years of experience.

## Interest Rates

The good news is that residential mortgage rates are at an all-time low across the full spectrum of conforming loans (under \$417,000) and jumbo loans (above \$417,000). However, these low rates can be very elusive to procure for many reasons which are discussed below.

## Property Values

Property values in metropolitan Boston and in most of New England peaked in September 2005 according to Zillow.com, the on-line home and real estate marketplace. As such, many homeowners who bought in the past seven years, do not have enough equity in their homes to qualify for a new mortgage at a lower rate. There is some good news for these homeowners. Property values are rising rapidly as the limited inventory in metropolitan Boston is selling briskly and often above the asking price. The hottest locations within the Route 128 area are downtown Boston and Cambridge. However, many other towns in the area and across the country are experiencing increases in residential property values, although values are still well below the 2005 peak. It is anyone's guess when they may reach that level again.

## Underwriting

Banks and mortgage companies, in the face of the uncertain consumer regulatory environment, have implemented a stricter set of underwriting guidelines to avoid the mistakes that led up to the sub-prime mortgage fallout in 2008. Banks are being more conservative in analyzing every aspect of the mortgage application. Areas of particular emphasis include qualifying income, credit scores, and liquid reserves. In many cases, banks are discounting bonus/commission income as well as income from self-employment if under two years. They also require higher minimum credit scores, more post-closing reserves (cash, stocks, bonds), and detailed written

explanations of any deviation from their internal guidelines. This has made the application process arduous and time consuming, although not insurmountable. However, documentation of one's qualification is as important as the qualifications themselves.

## Appraisals

This aspect of the mortgage process is also now being impacted by the large number of foreclosures and the fall in property values occurring as a result of the recent recession. Appraised values are on the conservative side, which may require additional funds from borrowers to meet down payment requirements. I believe this aspect of the residential mortgage process should improve as new sales increase general property values.

## Inventory

Housing inventory seems to be at a historic low in and around Boston. Real estate brokers are lamenting a lack of listings and even fewer quality listings. One theory is that retirees are holding off selling their homes until the market returns to a palatable level. A second possibility is baby boomers, who have survived a tough recession and an uncertain employment market, including lay-offs, are not trading up. Lastly, first time homebuyers are not inclined to purchase because for the past seven years they have seen property values decline and they hope to see that trend continue. This group has become serial renters and may stay that way, although the deluge of news articles about rising property values and low rates may bring them into the market.

While the residential mortgage market is improving, hurdles still exist to qualify for today's record low rates. It is critical for you to deal with a reputable mortgage originator or private banker who can walk you through the process. The best advice is to be patient and follow your lender's instructions at every stage and help them to help you.

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# Cambridge Trust Profile

W. Todd Spoor

*Vice President, Private Mortgage Banking*

In November 2012, Cambridge Trust Company welcomed W. Todd Spoor to occupy the newly-created position of vice president, private mortgage banking. Todd is responsible for developing relationships with high net worth individuals and their families. Todd uses his extensive background in residential mortgage generation to provide hands-on assistance to his clients in need of residential mortgage products. At the same time, Todd provides his mortgage clients with access to decision makers in Wealth Management, Lending, and Retail Banking to meet their other financial needs.



With 23 years of lending and residential mortgage experience at Bank of Boston, JPMorgan Chase, and Wells Fargo, Todd's industry knowledge is comprehensive.

Todd earned his Bachelor of Science in International Business Administration from New England College in Sussex, England and resides in Dedham, MA with his son, Alex.

## Cambridge TrustLetter *Editor – Laura C. McGregor*

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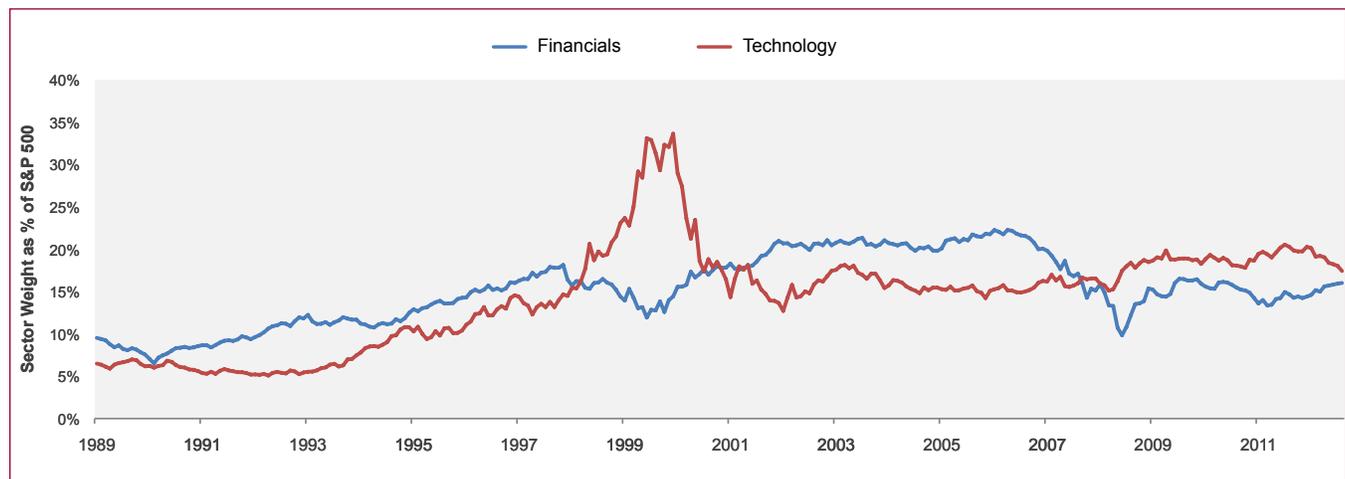
## Active Management for All Seasons *(continued from page 3)*

### Actively Minding the Store

Once we have determined the appropriate asset allocation, our investment process looks to find attractively valued individual securities. Our approach to active management is to conduct bottom-up fundamental analysis of individual securities, with investment ideas that tend to coalesce around

weighted indices. These indices by default are backward looking – that is they buy large positions in stocks that have already performed well. For example, the performance of technology stocks in the late 1990s caused the S&P 500 weight in information technology stocks to balloon to 33%; similarly in 2006 as the housing bubble was peaking the

**Chart 5.** Finance & Technology: Sector Weights as a Percent of S&P 500



Source: ISI Group

investment themes. These themes frequently arise from changes in secular trends within an industry, or a disparity between geographic or sector valuations. For example, we have been finding attractive opportunities in health care, financial services, and international stocks. More recently, valuations on technology stocks have improved on both an absolute and relative basis.

Over the past fifty years an academic debate has raged in investment circles over whether active management adds value over passive strategies in security selection.<sup>8</sup> Active managers try to outperform a specified index (the S&P 500, for example) while passive investors seek to match index returns while minimizing cost.<sup>9</sup> Passive investing has several elements to recommend it including low expenses and if done appropriately, investors obtain approximately the index return.<sup>10</sup> Indexing has become a popular tool and it is useful in certain situations but carries potential drawbacks. In our view the chief flaw in most passive vehicles is that little consideration is given to monitoring potential risks, particularly across sectors.

This arises from what may be characterized as a “momentum effect” and is most prevalent in market-capitalization-

largest sector weighting in the S&P 500 was Financial Services at 22%.<sup>11</sup> (See Chart 5.) Passive investors in S&P 500 index and exchange traded funds (ETFs) went along for the ride both times with fairly discouraging results.<sup>12</sup> Passive investments in other asset classes may also carry unique risks including difficulty tracking an index (fixed income), lack of appropriate diversification (international - many foreign indices are heavily concentrated in a small handful of companies, sectors, and countries), and counterparty risks (some exchange traded products are backed not by a portfolio of securities but by the credit of the institution managing the product).

The discussion of passive products need not be limited to index funds and ETFs. Many investors have recently opted for target date funds which automatically shift the portfolio’s asset allocation over time. While these funds automatically rebalance as you age, there are wide discrepancies among products (and corresponding returns) available in the marketplace, and investors may discover that their asset allocation is not appropriate for their profile.<sup>13</sup> The Wall Street Journal recently highlighted the potential risks associated with bonds held by target-date funds as another potentially significant source of risk.<sup>14</sup>

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## Active Management for All Seasons *(continued)*

While risk takes many forms, most passive strategies narrowly define risk as volatility or the standard deviation of returns. A broader discussion of risk should include the risk of reinvesting in a rising asset class (stocks or bonds) at higher and higher valuations. A disciplined approach to rebalancing can help mitigate this by at a minimum looking to avoid buying expensive assets.

### A Personal Relationship

Every comprehensive relationship account at Cambridge Trust includes direct contact with a portfolio manager and a trust officer. Clients develop a real, working relationship with their team of professionals – not a toll free call center. Our conversations with our clients drive asset allocation with the goal of allowing clients to meet life's goals. Through discussions with clients we learn about what's important to

them and work with them to develop an estate and investment plan that will help accomplish these goals. We actively manage investment portfolios and seek to deliver consistent investment results within the context of a high access, personal relationship. We work with clients to determine what is possible (driven by current market conditions) and appropriate for each client, by weighing their ability to take risk against their willingness to take risk, and taking a comprehensive approach to understanding other important factors (taxes, family dynamics, real estate, etc.). On an ongoing basis, we evaluate the need to rebalance client portfolios to ensure they are consistent with their objective. As your guide, we try to take the work out of investing.

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<sup>1</sup> Average April daily high temperature of 67 degrees doesn't hurt either, especially for those of us in New England (Boston and Portsmouth, NH average April daily high in the mid-50 degree range). Source: weather.com For more information on the National Cherry Blossom Festival, please visit: <http://www.nationalcherryblossomfestival.org/>.

<sup>2</sup> Not every attraction requires a ticket, but some do and if you are not part of a tour, it still pays to plan ahead. If you would like to tour the U.S. Capitol, for instance, it is advisable to contact your congressional representative at least three months in advance.

<sup>3</sup> Cochrane, John H., "Is Finance Too Big?," January 7, 2013. Response essay for the Journal of Economic Perspectives to the Greenwood & Sharfstein article "Growth of Modern Finance." <http://faculty.chicagobooth.edu/john.cochrane/>

<sup>4</sup> "A New Normal," Mohamed El-Erian, PIMCO, May 2009.

<sup>5</sup> Pre-tax and assuming no change in interest rates.

<sup>6</sup> <https://www.cambridgetrust.com/LinkClick.aspx?fileticket=NKAoqrSiEFE%3d&tabid=3881>

<sup>7</sup> This is often referred to as the "Shiller P/E" after Yale professor Robert Shiller, or as the cyclically –adjusted P/E or "CAPE."

<sup>8</sup> Most prominently in the research of Eugene Fama and Kenneth French.

<sup>9</sup> The term "passive" is a bit of a misnomer. Stock indexes were originally created to track regional stock markets – the Dow Jones Industrial Average or the S&P 500 in the United States, the FTSE 100 in the United Kingdom, or the Hang Seng in Hong Kong (China). Index construction varies but is typically a function of market value (size), stock price, or other factors. However, index construction involves choices by the index provider, with key factors determining what goes in the index driven by somewhat arbitrary decision-makers. Indexes that purport to give similar market exposure can vary greatly in market breadth, depth, and liquidity.

<sup>10</sup> Less fees on the index fund and any tracking error, generally defined as the difference in standard deviation of returns between the portfolio and the index; for a passively managed portfolio it should be close to zero. For a variety of reasons, in practice not all index funds fully replicate the index they are designed to follow, so performance may have slight variations depending on the fund.

<sup>11</sup> ISI Group.

<sup>12</sup> Note that the Nasdaq Composite and KBW Bank Index remain more than 30% and 50% below their prior peaks, respectively.

<sup>13</sup> Maxey, Daisy. "Evolving Target-Date Funds May Require More Guidance," WSJ, April 13, 2013.

<sup>14</sup> Plevin, Liam and Light, Joe. "'Target' Funds Vulnerable to Rate Rise," WSJ, April 23, 2013.

# Cambridge TrustLetter

Summer 2013

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### Cambridge Trust Company

Wealth Management  
75 State Street, 18th Floor  
Boston, MA 02109

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