SIERRA
MUTUAL FUNDS

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OBSERVATIONS AND PERSPECTIVES: PASS THE PEPTO-BISMOL

As stocks reach record highs, it's worth re-visiting the ride to get here. It's not unusual to see pullbacks in stocks, but over the past 12 months, investors in U.S. stocks have suffered two 12+% drops in the S&P 500 and in the process made a full 2.85%. That includes dividends. As you likely recall, the U.S. market had the worst start ever to a calendar year in 2016. Happy New Year and please pass the Pepto-Bismol.

We took a look at stocks, as measured by the S&P 500 (including dividends), versus bonds, using PIMCO's Total Return fund, an intermediate-term bond fund that has been existence since 1987. From 1988 until 2000, that's a full 13 years, stocks pummeled bonds, giving investors 6.6 times their money compared to about 2 times for the bond proxy. Stocks were more volatile, but investors were paid handsomely for the periods of indigestion.

What about the new Millennium? Taking a look at the same two indicators over this 16+ year period, it's quite a different story. Bonds are up 178%, versus 96% for stocks, and have done so with one-fifth the volatility. It's not just because interest rates have been falling during this period. They have, but the yield on the 10-year Treasury has been falling since 1981 – not just since 2000.

It isn't easy to make money in the stock market, even when times are good. Sharp losses put a big dent in overall returns so it is critical to have a defensive strategy in place to protect against bear market drops. A disciplined use of stop-losses can limit losses on positions.

We would suggest going a step further. A number of asset classes have been generating solid returns with low volatility and we expect those trends to continue in the near future. Looking at risk and return for 2016 so far, holders of emerging markets debt, high yield corporate bonds, municipal bonds and floating rate debt have all outpaced U.S. stocks and done so with a fraction of the volatility. All of these asset classes suffered "stealth" bear markets in 2015 and into early 2016, falling 10-20% while the broader U.S. stock market clocked a small gain. The fall in prices earlier has allowed the solid risk-adjusted returns this year.

Skeptics may argue that rates will be rising in the near future and that will put a lid on bond prices going forward. For close to a year, now, we have suggested that the chances of a "one and done" or "lower for longer" environment were higher than most expected. The reality is that expectations about rate hikes have been far too aggressive. Even after a full-throttle stimulus in the form of aggressive quantitative easing by the Federal Reserve, the U.S. economy has yet to reach "escape velocity." Instead we find ourselves in a relatively tepid economic recovery as we learn to live with record levels of debt (public and private) without the cushion that could be provided by more rapid growth or higher inflation.

In this "New Normal", "New Neutral" or "Challenging New Century" – call it what you will – a key to successful investing is, as always, earning returns and minimizing volatility. If you want to skip the indigestion caused by a volatile U.S. stock market, consider the superior risk-adjusted returns offered by a number of asset classes in the fixed-income arena.

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The **S&P 500®** is an unmanaged composite of 500 large capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks.

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