DOUCET ASSET MANAGEMENT, LLC

Quarterly Newsletter
Q4 2016

Fixed Income Strategy
Doucet Value Momentum Portfolio
Doucet Value Income Portfolio
Mutual Fund Strategy

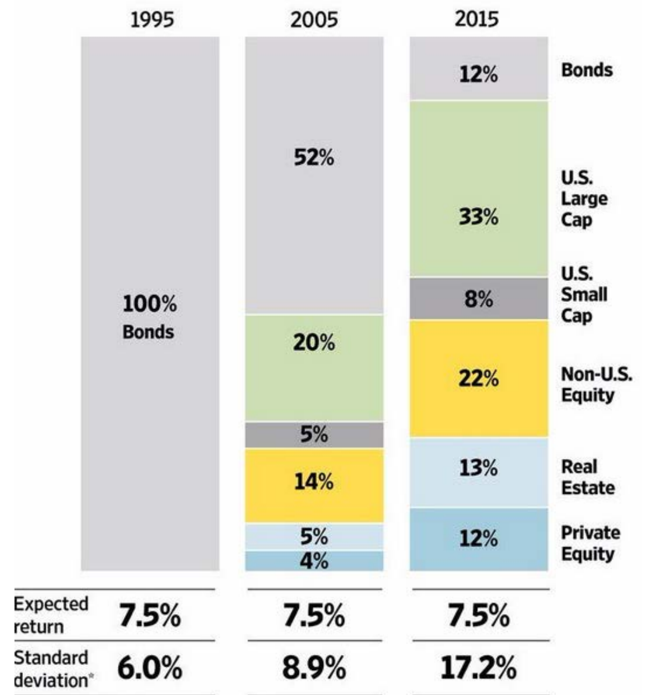
October 2016

Pen-shunned

Improbable events occur every day - a struggling waitress wins the lottery, a defeated football team throws a successful last second "Hail Mary" pass completion to win a game, and the doomed James Bond character extricates himself from a precarious situation with the use of some device invented by 'Q.' Just last week, Moody's Investors Service reported that state pensions are underfunded by $1.25 trillion, or about 119% of fiscal 2015 revenue. The funding deficit was exacerbated by the fact that "the median return for public pension plans in Fiscal Year 2016 was .52% compared to an average assumed investment return of 7.5%" according to Moody's Vice President & Senior Credit Officer Marcia Van Wagner. With the deficit expected to grow to $1.75 trillion in 2017, it might be prudent for our political leaders to level with the American public and stop holding out for their own version of an improbable saving grace.

Investors grappling with lower interest rates have to take bigger risks if they want to equal returns of two decades ago.

Estimates of what investors needed to earn 7.5%



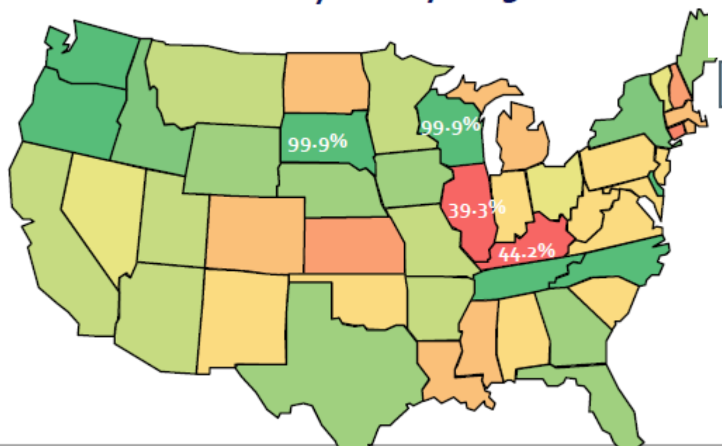
*Likely amount by which returns could vary
Source: Callan Associates
THE WALL STREET JOURNAL.

This is not Your Father's 7.5% Return

In the past, it was relatively easy for a pension fund manager to meet pension payout obligations using a plethora of low-risk investment options. According to Callan & Associates, "in 1995, a portfolio made up wholly of bonds would return 7.5% a year with a likelihood that returns could vary by about 6%." However, in 2015, to realize the same return, "investors needed to spread money across risky assets" and "returns could vary by more than 17%."

The Boston College Center for Retirement Research has suggested that the 7.6% average actuarial assumption rate funds use to determine the amount of funding needed in pensions is 'unrealistic.' Given that the 'risk-free' rate of return is virtually zero, this seems like a fairly obvious assessment. The same study goes on to suggest that the pension funding gap would widen to an estimated $5.6 trillion if funds assumed a more realistic 3.8% rate of return, which is an amount equivalent to about 150% of the entire municipal bond market.

Pension Funded Ratio by State, 2013[2]



[2]Source: Boston College *Public Plans Data*

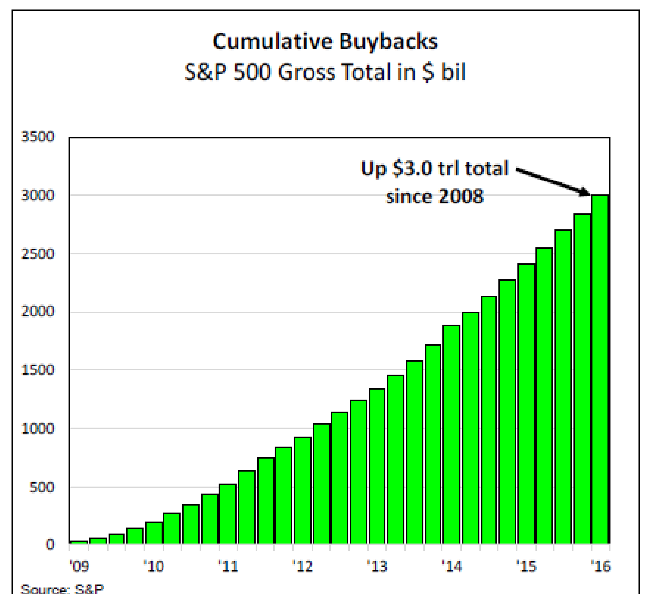
This is truly a remarkable number, and paints the picture of what may very well be an even more precarious situation than being strapped to a gurney with a laser beam slowly inching upward. Making matters worse, this is a widespread issue that is difficult to isolate and 'fix'. Only the states of South Dakota and Wisconsin can boast that their pensions are currently fully funded. On the opposite end of the spectrum is Illinois, which is estimated to be underfunded by over 60%. There, roughly 25% of the State's entire budget goes to paying government-worker pensions. [1]

So far, politicians and pension funds in Illinois have tried to incrementally improve their financial situation; however, their actions have been tantamount to Band-Aid solutions with short-term results, if that. For example, Bloomberg recently reported the Teacher's Pension Fund voted to cut its assumed rate of return from 7.5% to 7%. Just this small reduction (to what we would still argue is an unrealistic assumption) is expected to cost each individual Illinois tax payer an additional $421 in taxes annually. With Illinois being home to 667 government pension funds in five different systems, one starts to see just how difficult and politically untenable it would be to move towards a real meaningful resolution. There are simply no easy solutions.

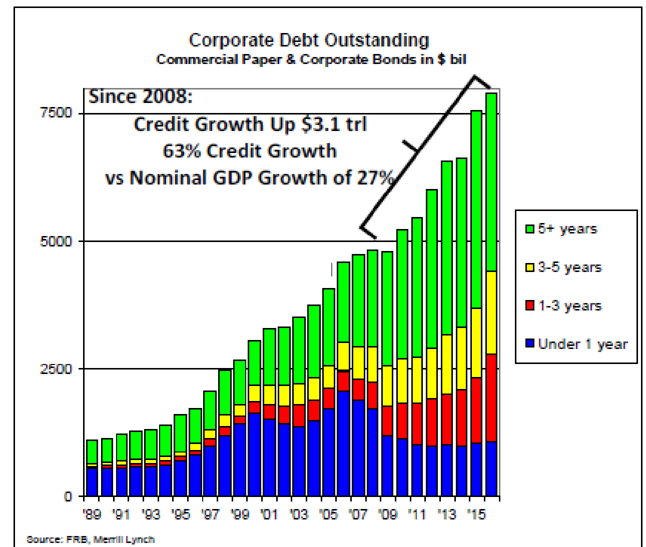
Just Fix It!

Faced with this somber reality, policymakers have two basic tools with which to address this funding problem. One, they could shore up the asset side of the balance sheet by adding more money or by earning a higher return on the money that is in the pool already. Two, they could decrease the liability side by reducing benefits through measures such as cost-of-living adjustments, extending retirement age, or outright renegotiations. Option two is the most politically expedient option and has been tried in several states with mixed results. Adding more money to the pot has been a relative dead-end, as well, as states largely just do not have the money to do so and politicians sign their employment death warrants with the mere suggestion of a tax hike. This has left the *non*-option of trying to earn their way out of it or the 'James Bond' option; and by failing to adjust expectations to the market's reality, this is the path policy makers have chosen.

Current market realities do not give much hope that the *sticking our collective heads in the sand* option will work out too well. Interest rates are hovering near 5000 year lows and the trailing 12 month P/E ratios on common stocks have only been this high three times since the 1880s. It is unlikely pension managers can achieve the holy grail of returns consistently over time in an artificially-inflated and fairly bloated market.



It would be a fool's errand to attempt to reconcile these current valuations and the state of financial assets using a fundamentalist point of view, but it is very basic and simple to comprehend from a financial engineering perspective. Central Bank helped engineer interest rates to zero. Corporations have taken advantage of low interest rates to issue debt in record amounts since the credit cycle began in 2008. About $1.5 trillion or roughly half of the $3.1 trillion cumulative credit flows since 2008 have been absorbed by pensions and insurance companies who are in a desperate search for yield to meet their obligations. S&P 500 companies have graciously accepted this cash and plowed approximately $3 trillion into stock buybacks on a cumulative basis during the same time frame. What happens when the Fed begins the unwinding process and pulls away the punch bowl from the market party?



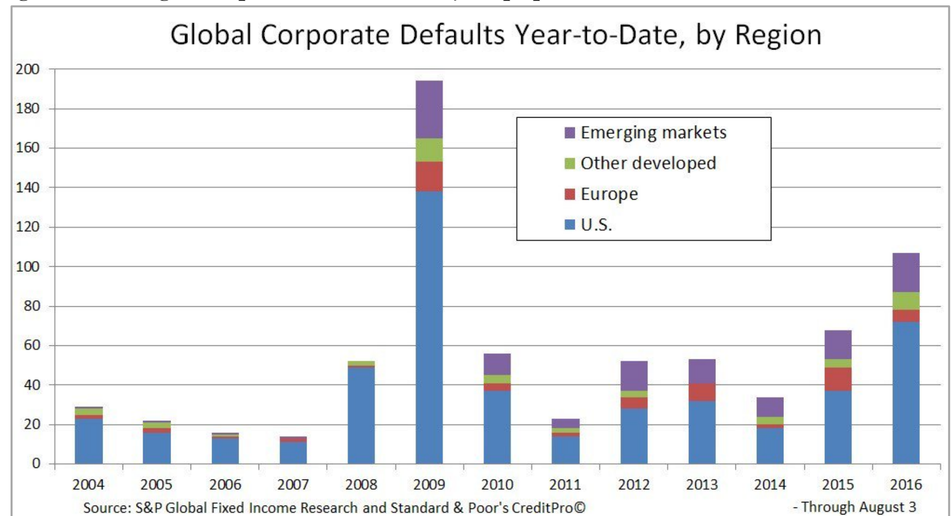
As evidenced by mantras like TINA (there is no alternative) and TTID (this time is different), the massive amount of cash flooding the market to fund pensions combined with the theoretical 'Yellin put' *if* stocks ever do go down again, it is hard to know exactly *when* this cycle will end. However, the one certainty is it will end just like every expansion fueled by debt ends-"when credit cracks." Simply put, markets will falter when companies begin to have problems servicing their debt obligations.

There have already been several shots across the proverbial credit bow both here and abroad. Global defaults have now reached levels not seen since 2010 and have been rising steadily for the past two years. As a matter of fact, the American Bankruptcy Institute recently reported that US bankruptcy filings increased by a whopping 38% in September and rose 28% in the first 9 months of

2016. While most people are aware of the carnage felt in the energy and mining sectors, bankruptcy filings have extended their breadth into other sectors like steel, restaurants and retail.

Conclusion

Pension managers are left with the Sisyphean task of adding risk to their portfolios to create alpha in a market where rates are zero and value does not exist. We believe it is imperative for investors to do the opposite of what pension managers are being forced to do and begin de-risking their portfolios. Contrary to popular belief, "this time is *not* different" and "there *is* an alternative." Sure, pension assets will continue to help support lower interest rates and the Fed will continue to be accommodative. But as investors witnessed earlier in the year, a low interest rate environment is little consolation for cash starved credits. When cash flow dries up, both the stocks and bonds of that company are likely to lose value.



It is important to look at this rebound in the market for what it is- a gift. We have chosen to take this opportunity to shorten the average life in our fixed income model to 1.61 years and raise the average credit rating in our portfolios much like we did before the downturn in 2008. We have temporarily raised the levels of cash in our equity portfolios an anxiously await a better and safer entry point back into the market.

According to *Investors Almanac,* the year following a Presidential election is typically the worst of the four-year term for both the economy and the market. As the current election crawls to the finish line, my hope is our politicians will finally be able to put the election behind them and address public pension issues. If they cannot, the market headwinds are so strong that not even an Ian Fleming could write an improbable James Bond-like escape from zero interest rates for pension managers.

Sincerely,

Chris L. Doucet, CEO

Firm Notes

As Doucet Asset Management celebrates its 10 year anniversary; I would like to thank our clients, my family and friends, and our employees for making this first decade such an enjoyable experience.

We are pleased to announce that we have relaunched our website with a new look. Please visit www.doucetcapital.com.

Footnotes

[1] Pensions 101: Understanding Illinois's Massive, Government Worker Pension Crisis

Admin Notes

- Form ADV: Please contact our office at (205) 414-9788 if you would like to receive a current copy of our Form ADV II or the Schedule H Brochure. Proxy Solicitations: If you receive calls regarding proxy voting, we suggest that you inform the caller that you have delegated Doucet Asset Management full authority to vote the proxy on your behalf. Please note that we are not able to prevent these calls from being placed to you directly.

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