Financial Sense

How the Current State of the World Is Impacting Financial Markets

moderated by Kelly Laffey ■ photographed by Jonathan Grassi

IN EARLY DECEMBER, as the tax law was going through the House and the Senate, *AVENUE* sat down with some of New York's top financial advisors to chat about the state of the economy, investment strategies and cyber security.

AVENUE: What has been President Trump's impact on global economic growth's sustainability?

BUONGIORNO: He clearly has had a policy of free and fair trade, which he wants to promote around the world. He wants to have a better business climate in the United States—lower regulations and lower taxes. I think that has given confidence to CEOs and small-business leaders, which has led to an increase in capital expenditure both here and abroad. That translates globally to other firms wanting to do more business with the United States. It can't be clearly ascribed to Trump, but you are seeing for the first time in many years a global increase that looks to be sustainable.

BROWN: You've seen that in an increase in corporate earnings as well. I don't think we can tack the last 12 months of corporate earnings back to Donald Trump becoming the president. I think 453 companies have already reported for the quarter; 90 percent are exceeding or beating estimates by something in the magnitude of 6 percent to 7 percent. We're in a highly regulated business, both by the SEC and FINRA, and one of the major problems about trying to start your own firm in this environment has always been: How do you make sure you're in compliance, and how do you pay for that? I have to see how this is all going to play out for the smaller businesses around. Because that's where a lot of his support is: in small businesses.

AVENUE: What has been the impact of recent global political events on the markets?

LEE: What continues to be interesting is that the markets continue to tick higher, while volatility remains generally low. Markets, for the time being seem to be shrugging off global macro events, which tells you there are other forces at play, such as fundamental business strength. While the markets have continued to hit new highs this year, we're anticipating a return to more normalized returns. We're talking to clients to make sure they are properly diversified.

GUERNSEY: The black swan that everybody is trying to evaluate is the influence of Bitcoin and other crypto-currencies (neither acceptable assets under our management at Wilmington Trust). The technology behind each currency is a truly global infrastructure. Therefore, in an inevitable drawdown in the markets, will cryptos be more correlated to international securities, or to the United States, or another asset class? We are sure we will have a future opportunity to find out.

BUONGIORNO: It's interesting when you just look at the earnings numbers. Over the last 18 months, all of the growth in the S&P 500 has come from earnings growth, and there's actually been a 2 percent decline in the P/E. The market's move has all been earnings driven.

AVENUE: With regard to insurance, what can people do, especially when travelling, giving the volatility of world events?

BRUSCO: It is so important for families to understand that they need an emergency plan before they embark on their trip. From a security perspective, a lot of people assume that they're safe because they're going to a five-star resort. But in such a volatile, changing world—where security issues due to terrorism, natural disasters, kidnapping and other events are becoming so commonplace—people need to be much more proactive and diligent. We recommend working with travel risk advisors to do professional-grade research for them, so they can determine what to avoid.

AVENUE: What does the future of real estate values look like? Is there a bubble?

BUONGIORNO: I don't think there's a bubble. Excluding the coasts, if you look at the national average real estate price on an inflation-adjusted basis, it's actually about 10 percent below its historical average. So you have seen a healthy real estate recovery, but I don't think you're in bubble territory. Affordability is still very high relative to history. Incomes are higher. Mortgage rates are lower. When affordability is at its historical median, home prices are still growing. It's only

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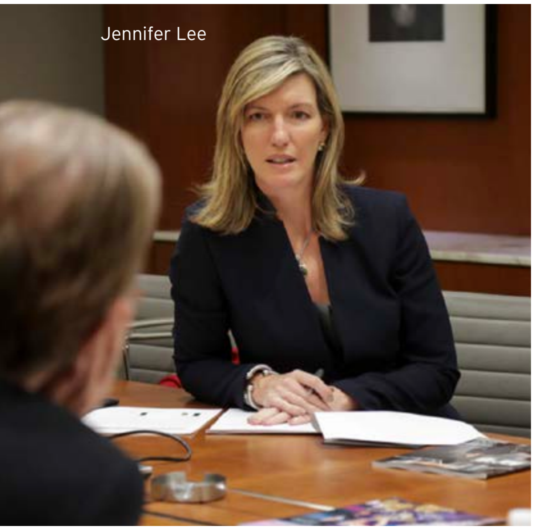

Jennifer Lee

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when you really get to a much lower level of affordability, like we saw in 2005–2006.

BROWN: I'm intrigued by the tax plan and what effect that's going to have on people moving out of high-tax states, especially if you do away with the deductibility of state and local income tax. We've seen this hedge fund migrate south to lower-tax states.

AVENUE: Could we talk about cybersecurity, ways that people can protect themselves?

BRUSCO: There's no doubt that the world is more connected than ever, but the explosion in the utilization of smart devices brings a whole host of cyberexposures. It is so easy nowadays to commit cyber-crime, and the best way to fight this is through education. There is insurance to address the financial loss if a home network is hacked, for example. But consider the vulnerability that comes from someone accessing your private information, photos or other materials—and the added burden of it being used to threaten or exploit your family. We encourage families to have cybersecurity professionals conduct an at-home assessment to ensure that personal networks are secure and that all members of the household, including private staff, change bad behaviors that can lead to problems.

BUONGIORNO: On a much lighter note, we had the pleasure of having an ex-ambassador in our offices just an hour or so ago, and as I was walking out, she said, "Tell all your clients and your friends and family, 'Disable 'Hey Siri.'"

BRUSCO: That's an interesting point. We did a recent study where we found that our clients invest in an average of 30 smart devices just in their homes alone. When any family hooks up these devices, are they reading the fine print within the terms and conditions? These devices aggregate tons of data and behaviors, and they are not immune to cyberattacks. That's why it's important to exercise caution. Understand the privacy and security settings, whether or not devices are password protected, and whether or not the manufacturer has taken extra steps to ensure the information being gathered is kept private and stored safely.

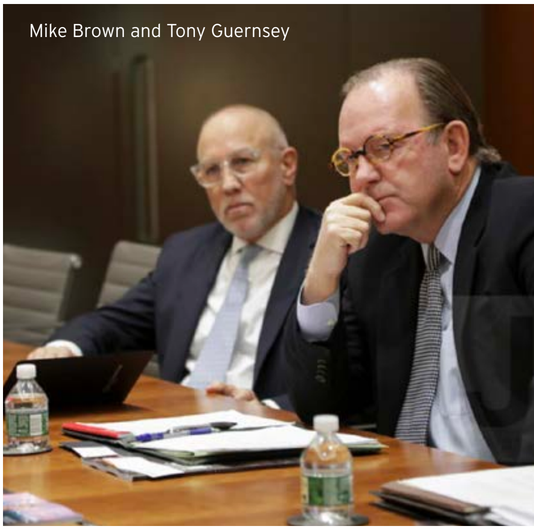
AVENUE: Are public equities today overvalued?

GUERNSEY: I think they're probably just about right in the United States. What scares me is the investor searching for yield in equity return securities to replace their recent low bond yields. I just think some are reaching out to some places where they're going to get hurt, as they do not have the same economic growth or geopolitical environment as the United States. Some international economies are recently strong outside the United States, but not all. In this country multiples are getting toppy, but earnings are and look strong in the next year justifying the strong 2017 performance and a continuum in '18.

BROWN: We would agree with that. I think right now, if you look at S&P earnings and where the domestic markets are, they are probably fairly to slightly overvalued. This could go on longer. P/Es could expand. As Paul said before, we haven't really had P/E expansion. We've had earnings expansion. Overall, I think the U.S. markets are fairly valued. International developed looks undervalued. Emerging still looks undervalued, although it depends on how you define "emerging."

LEE: Just because something is fairly valued or maybe even slightly overvalued, it doesn't mean that we're exempt from sort of a short-term pullback. We think equities are fairly valued are remaining neutral to slightly overweight—if they were appropriately allocated to start with. To the points about the non-U.S. markets: We continue to believe in a long-term secular trend of a rising middle class around the world. We do believe that non-U.S. markets are slightly undervalued and they have the long term trend in their favor. Again, that doesn't mean they are exempt from volatility, so you have to have the right allocation and plan in place.

BUONGIORNO: I think part of the question relates to how long your lens is. I f you go back 50 years and you said, "Okay, let's use that as the market multiple," you'd say we're



Mike Brown and Tony Guernsey

about 30 percent overvalued. If you go back 20 years, you have about a 2 percent inflation rate, which is about where are today, and about a 4 percent 10-year. Under that lens, we're about 10 percent overvalued.

AVENUE: How much return above inflation can we expect in today's environment?

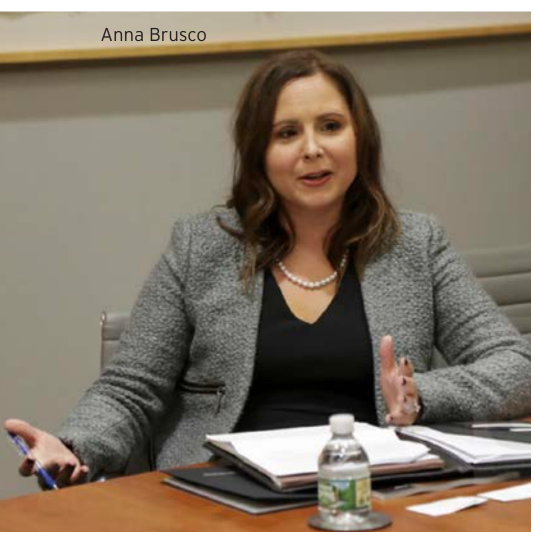
BUONGIORNO: We see somewhere between 3 percent and 5 percent over inflation.

GUERNSEY: I'd probably say around 2 percent. But then, we're a trust company, and for our beneficiaries we need a lot more income available in value stocks to distribute than currently available with growth style equities.

BROWN: We're 2 percent to 3 percent on inflation. It depends on asset class too, though. Our primary clients are ultrahigh-net-worth clients, and so we tend to have normal equity exposure, and then look for interesting managers who are doing various strategies to get alpha, as we say, in the portfolio.

AVENUE: What are the risks associated with using social media for high-net-worth individuals?

BRUSCO: Everything online is discoverable. And unfortunately, high-net-worth individuals really need to understand that they can expose themselves and their families to a host of personal liability lawsuits based on their actions on social media. Families should also think about other people who have



Anna Brusco

access and who are posting about them or on their behalf. We need to create awareness and best practices around this.

AVENUE: What advice would you give to clients on how to avoid complicated estate and wealth transfer issues?

GUERNSEY: COMMUNICATION and TRAINING. The hardest challenge of a wealth manager is to determine the knowledge of the people who are inheriting the money. I've said many times in *AVENUE* roundtables: We spend so much time educating the client about how and what this money is going to grow to be, but few are spending the time to educate the client on how to accept it, to manage it. We always recommend that the grantor write a letter to each child with their own signature about that exact same issue: "This is why I left it to you this way." Because it's too hard to talk about when you're alive, but if you just read a two-page letter, it goes much better. The letter has great "family" value, but parenthetically, has no legal status in an estate.

LEE: Often, the questions and concerns we hear from clients are about children and how to talk to their children about money. They want guidance on how to educate children about finances generally and wealth more broadly. The other big shift we're seeing with the next generation is the way they want to think about investing and the things that they care about. They often raise questions of impact and values expression. We often spend time translating between generations, both on basic issues of financial wellness and awareness, but then also issues of how to invest.

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—Anna Brusco

AVENUE: Can we give readers an update on active and passive investing and when people should use each?

LEE: Yes. Both. That would be my answer. We believe that you need active and passive investments in your portfolio. So, my answer is "yes, and . . ." It's not an "either/or" question. There are asset classes where it makes a tremendous amount of sense to be passive, and there are asset classes where you shouldn't be passive because active investments make more sense from a risk and return perspective. There is always a cost to investing. Sometimes the cost is in the basis points of the investment, and sometimes is in the cost of being less than optimally invested.

Paul Buongiorno

BUONGIORNO: I think many people probably think that all ETFs are passive. But there are ETFs that are active because they're factor-based. A factor-based ETF is nothing more than a mechanical approach to what many of our managers that we allocate to are doing, except just on a systematic basis. If you're investing to be down the fairway domestically, ETFs are hard to beat from an after-fee, after-tax standpoint.

BROWN: Our philosophy has always been for Efficient asset classes like equities, we prefer low cost beta options like etfs or index funds. And then, when you look at inefficient markets, try to find the most skilled managers in those asset classes. Over time, you'll probably do a little bit better than the overall indexes. Look at what Schwab is doing now. They bought a robo-advisor and they've got their own artificial intelligences running models. So for independent advisors like myself, we can create a model and let them run the model. You can get as sophisticated as you want with some of these models through Schwab. I guarantee Fidelity will be out there in the first quarter of 2018. Same exact thing, just all ETF-based. Lowest cost possible. And it's all based on algorithms.

LEE: Fundamentally, the role of an advisor has shifted from solely discussing investments to many of the things we have discussed today. There are a range of concerns that families face today. That's why we still need human beings who can listen to clients across a range of issues and give them good advice. Despite many of the changes in our industry, that will always be a need. ✦