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Q&A WITH JEFF KNIGHT: INSIGHTS FROM AN ASSET ALLOCATION VETERAN

Jeff Knight
Global Head of Investment Solutions and Co-Head of Global Asset Allocation

Q: How long can the bull market last?
It has truly been a remarkable period of time for equity investors. We've studied the history of the U.S. stock market measured by the S&P 500 Index and looked at the periods of time between twenty percent corrections. What we've found is that those periods typically last about three years, and the market tends to roughly double in between the twenty percent declines.

In this case, we're about eight years into the bull market, and from the very lows of the bottom of the financial crisis — the S&P 500 has nearly quadrupled. It's worth understanding how unusual this is in a historical context, and it's important to think about strategies for diversification and portfolio stability on this chronological basis alone.

Q: What are political events revealing about the markets?
It's easy to look at the U.S. stock market in the last year and observe a kind of a stair-step pattern: the market is flat for a while, leaps higher, stays flat and then leaps higher again. The leaps correspond directly to political moments, whether it's Brexit, the U.S. presidential election or the French election.

The temptation is to explain the jumps in terms of the political outcome: "Well, Trump is good for markets, so that's why the market went up so much after the election." I think it's more accurate to view these political moments as episodes that reveal a trend, not cause a trend. Investors who would otherwise deploy their investments or take risks are waiting to make sure that these political moments do not deliver an unexpected negative catalyst. Once we pass these moments of political uncertainty, that's when we see the market jump.

Q: How should investors think about the historically low levels of volatility?
No matter how you look at it, volatility of financial markets today is very, very low. To a certain degree, low volatility makes perfect sense. There's not a lot of variability in the economic news, and this translates into less variability in financial market prices. However, some of it is disconcerting. It could reveal a kind of complacency among investors, with investments being deployed indiscriminately, in a regimented, index fashion. This complacency is bidding everything up and stabilizing markets to a level that is rarely seen. Investors need to be careful—it's easy to feel under-gratified by performance, particularly in times of low volatility.

When volatility is low, even correct investment ideas don't seem to pay off as much. As a result, there's a temptation to scale positions aggressively in this type of environment, which I think could be a mistake. Stick to your strategies. Stick to your normal strategic allocation and don't change your methodology for determining how much to allocate to a certain asset class. Don't try to force more risk into a portfolio just because we're in a low volatility environment.

Q: What does it mean when your asset allocation views are neutral? Does that mean you have conviction in nothing?
There are a lot of words we tend to fall back on in the investing business. It's easy to use words in a lazy way so that they end up meaning nothing. "Neutral" might be one of those words. It can be used as a shield to hide under-confidence or uncertainty.

We try not to use that word unless it carries a very specific meaning. When we build our portfolios, we do it in the context of a longer term view. We expect each component of a portfolio to deliver in terms of return, risk and its relationship to other assets. There's a lot of serious work that goes into determining a baseline strategy based on this market outlook.

I think of neutral as simply endorsing our work and confirming our conviction that long-term strategic allocations remain appropriate. When we conclude that we're neutral, it's because we don't see any reason to temporarily depart from longer term work.

Q: What's your outlook for the rest of 2017?
In the first half of the year, we kept repeating to ourselves, "Don't overthink it, don't overthink it." Markets have been pricing in an upward inflection point for both worldwide economic growth and inflation. Such a scenario tends to be really good for stocks and not so good for bonds. This has been the case for the first half of the year.

As we look forward, we no longer believe in "not overthinking it." Some of this year's performance seems to have been based on an expectation of material change in economic and tax policy, very little of which we've seen occur. The next half-year will be decided by whether we actually see these things delivered — ratifying current market prices — or whether they happen in a more watered-down fashion than investors expect. If the latter is the case, the second half of the year could underperform the first half in terms of return.

The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks. It is not possible to invest directly in an index.