Summer Newsletter

An Investment Strategy for the "New Normal"

To its credit, the PIMCO organization (fund management subsidiary of insurance giant Allianz) is a leader in publishing timely commentary on the secular outlook for stock market investing. Recently, having just completed its annual Secular Forum, PIMCO (in a commentary written by Mohamed El-Erian*) stimulated considerable discussion among market practitioners by describing a world that has changed in a manner that is unlikely to be reversed over the next few years and labeling this outlook as the "new normal". El-Erian and his colleagues envision an investment environment over the next 3 to 5 years characterized by subdued growth, high unemployment, increased risk premiums, high volatility and lower asset prices. Particularly troubling to the authors is the potential for the heavy hand of government to continue to be evident in several sectors of the economy. This "Re-Regulation" phenomenon evidenced by excessive regulation, higher taxation and frequent government intervention, when coupled with the growth muting effects of the "De-Leveraging" and "De-Globalizing" trends PIMCO also sees, is likely in their opinion to produce below what we have come to regard as normal growth in U.S. GDP in the foreseeable future (1-2%, rather than the 3+% we used to have).

So if PIMCO is right and the "new normal" turns out to be an accurate description of the investment environment going forward, what are the implications for developing an appropriate investment strategy?

In the "new normal", I believe that total return investing (investors looking for current income as well as capital appreciation) will gain renewed emphasis. High quality large market capitalization companies with a global reach, a time-tested and resilient business model and a history of increasing dividends will command a lot of attention in an environment where modest total returns, rather than outsized capital gains, become the desired objective.

The search for steady income-oriented ideas will increasingly lead investors to certain niches in the equity securities markets. One of these niches is Master Limited Partnerships or MLPS. MLPS are investment vehicles that own income producing assets and are organized to pay out the income in a tax efficient manner. Individual investors in MLPS receive tax-advantaged dividend payments. The MLPS that own oil and gas pipelines and other midstream energy-related assets could provide investors with a particularly attractive combination of high dividend yields, the prospect of consistent dividend growth and an opportunity for modest capital appreciation.

*PIMCO Secular Outlook "The New Normal" May 12, 2009

If the “new normal” is characterized by slow growth in the developed nations as market participants there struggle with a perceived loss of wealth, the need to repay debt and the heavy hand of government intervention, then investors will orient their portfolio towards a more global mix. This mix is likely to include investments in the developing economies of China, India, Latin America and Eastern Europe. The investment industry has responded to investor interest in the emerging markets by developing an increasing number of Exchange Traded Funds (ETFS), which provide investors with a vehicle for owning a portfolio of individual securities in those countries in a cost efficient manner.

One of the many issues raised in PIMCO’s discussion of the “new normal” is whether or not the massive amount of fiscal and monetary stimulus adopted by the U.S. authorities to ward off the current recession will erode confidence in the dollar as the world’s reserve currency. If it does, then I believe investors with exposure to vehicles that are negatively impacted by a weak U.S. dollar will suffer. The potential for a weaker dollar in the “new normal” scenario may re-emerge as an important factor in making portfolio decisions in the future.

The Obama Administration’s new rules for Wall Street will be another. The President has made it clear that he does not want to see the U.S. economy return to a scenario where 40% of corporate profits come from the financial sector. As a result, pay limits and regulation reform for the banking sector rank high on his agenda. Given the heavy hand of government intervention, investors will need to be cautious in selecting individual investments in the financial sector.

On the other hand, the Administration’s interest in new initiatives for education, health care reform and the development of alternative energy sources could offer opportunities for investors if they can uncover and invest in the individual companies that will be the beneficiaries of government spending in these areas. The PIMCO people call the strategy of investing in vehicles that will benefit from government initiatives “Shaking Hands with Uncle Sam”. Going forward, I will be spending a lot of my research time looking for investment ideas that “shake hands with Uncle Sam”. Talk to you soon.