

The attractive returns once associated with IPOs have shifted towards the private-equity markets.

Simmering geopolitical issues make it difficult for investors to develop short-term investments strategies that accurately discounts so much uncertainty.



The Colony Group

MARKET PERSPECTIVES

► QUARTER THREE 2019

Low and declining yields drove investment markets during the third quarter of 2019. The yield on the 10-year U.S. Treasury note plummeted to near-record lows in early September before recovering to finish the quarter at 1.68%, down from 2.00% at the end of the previous quarter. Yields are even lower outside the U.S. Approximately \$15 trillion worth of global sovereign debt has negative yields, meaning investors are paying governments for the privilege of holding their money because they believe rates might go even lower. Short-term bond yields declined as well, but, in many countries, these bonds carry higher yields than longer-maturity bonds, a condition called an inverted yield curve.

Stocks continued to exhibit strength, highlighted by the 20.6% return for the S&P 500 year to date. This quarter's 1.7% return, however, was more muted than the previous two quarters. Notably, the return from stocks is almost entirely being driven by valuation expansion rather than earnings growth, as the latter was de minimis for each of the first two quarters of this year.

Interest-rate-sensitive sectors have led the way this year, largely due to the decline in interest rates, with utilities and real estate occupying two of the top three leading sector spots.

In this quarter's *Perspectives* we look at why companies are finding reasons to stay private for longer and how this impacts the market for initial public offerings (IPOs). We also investigate the many uncertainties that permeate the investment landscape and share with you how we incorporate these factors into our portfolio management process. We hope that you find it informative.

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Private Market's Gains Causing the IPO Market's Pains

The growth in financial capital over the past decade has been staggering, buoyed by easy monetary policy and an expanding economy. The consequences of these policies have left a mark on global investment markets. As funds have flowed into the capital markets at an accelerating rate, they have caused yields to compress and valuations to rise across the spectrum of asset classes. In addition, the resulting increase in liquidity for some markets is causing changes to cross-market correlations and the way companies access capital.

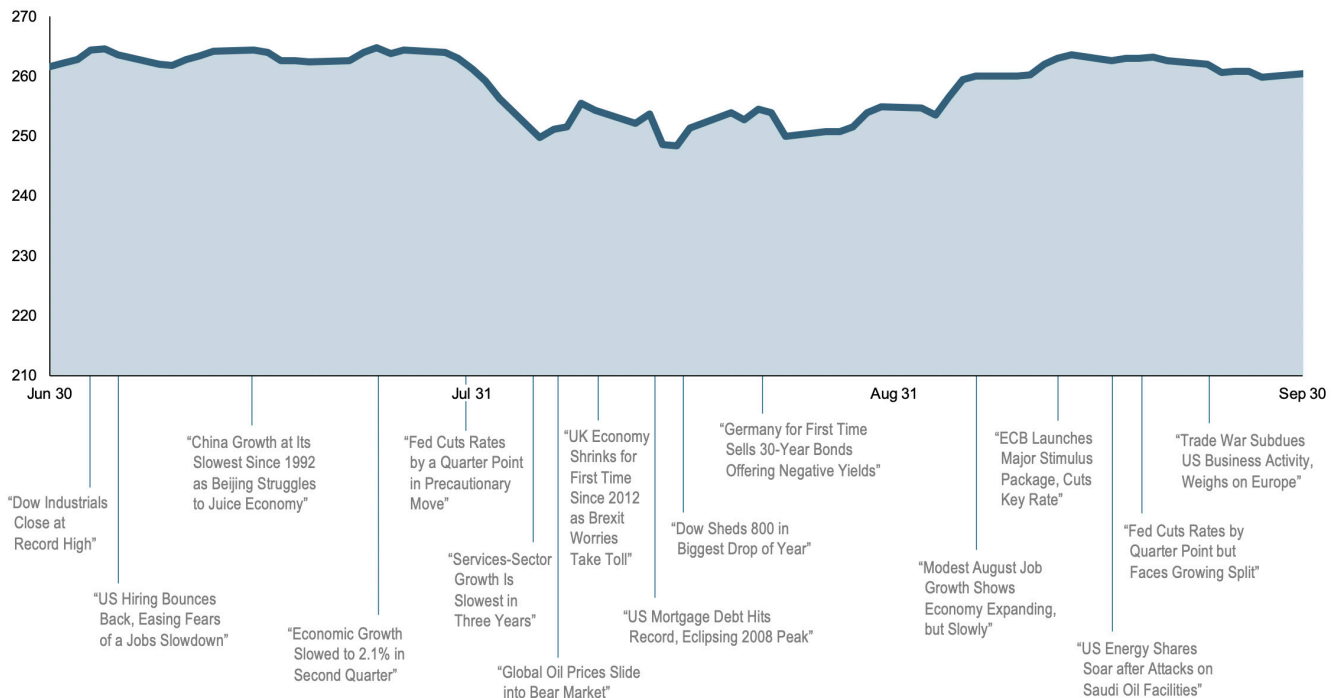
Global financial capital increased 53% to \$600 trillion between 2000 and 2010 and is expected to reach approximately \$900 trillion by 2020, according to data from the International Monetary Fund. Capital has not flowed into investment markets uniformly, however. Indeed, fund flows have increasingly gravitated towards the private markets, as highlighted by the \$5.8 trillion allocated to private equity since 2009, a growth rate of new capital that is twice the rate for the public equities market. At the same time, the number of U.S., exchange-listed, public companies has dropped precipitously despite a rise in the total number of companies. In 1996, there were 8,090 companies listed on U.S. stock exchanges, according to data from the World Bank. At the end of 2018, there were only 4,397, representing a decline of nearly 46%.

There are numerous reasons why companies have become more

averse to going public. Public markets are no longer the only place that offers the level of liquidity required for growing companies to cash out early investors at higher multiples. According to Bain & Company, today, valuation multiples are higher in the private markets than in the public markets, a rare occurrence that has happened only two other times: during the mid-1980s and just before the financial crisis. As a result, there is less of an incentive for private companies to go public. Why would an executive elect to take on the incremental costs associated with being public that come from higher compliance and reporting requirements? Moreover, many leadership teams despise the short-term focus demanded by stock market investors who often have a misplaced (in our opinion) focus on quarterly earnings. As a result, many companies are staying private for longer than ever before.

This phenomenon is most noticeable in the IPO market, which has been in steady decline since peaking in the late 1990s during the dot-com bubble. During that decade there were, on average, more than 650 IPOs per year. Over the past 10 years, the number has fallen to slightly more than 200 per year. In addition, many companies are waiting longer to go public. For example, the median age of technology companies going public during 1999 and 2000 was four to five years compared to 12 years in 2018.

MSCI ALL COUNTRY WORLD INDEX WITH SELECTED HEADLINES FROM Q3 2019



These headlines are not offered to explain marketplace returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

Graph Source: MSCIACWI Index [net div.]. MSCI data © MSCI 2019, all rights reserved.

It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. **Past performance is not a guarantee of future results.**

WHAT THIS MEANS

Companies increasingly are staying private longer. The number of private companies that have reached a valuation of \$1 billion or more, often referred to as unicorn status, has grown over the past ten years. The review of the list of these companies reveals many well-known names, including Uber, Facebook, Snap, Spotify, Wayfair, and Alibaba.

As a result, the attractive returns that were once associated with IPOs have shifted towards the private-equity market. Seemingly gone are the days when the privilege of receiving an allocation to a hot IPO could, over a short period of time, yield two, three, or even ten times your initial investment. Instead, these returns more often accrue to private-equity and venture-capital investors.

We have historically eschewed directly investing in the IPO market.

Our security-selection discipline has generally kept us away from the types of companies that enter the markets through a public offering. These companies typically exhibit rapid revenue growth but often are not profitable, are not generating positive cash flow, and are reliant on the capital markets to fund current and future growth. We generally consider these types of companies too speculative for all but our most aggressive clients.

The private-equity markets, on the other hand, have overall become a better place to source these types of opportunities, in our opinion. Through partnering with experienced and skilled sponsors, we believe it is possible to build a diversified portfolio of dynamically growing companies with above-average return potential. We have found, and will continue to seek, opportunities in this marketplace and share them with clients where suitable.

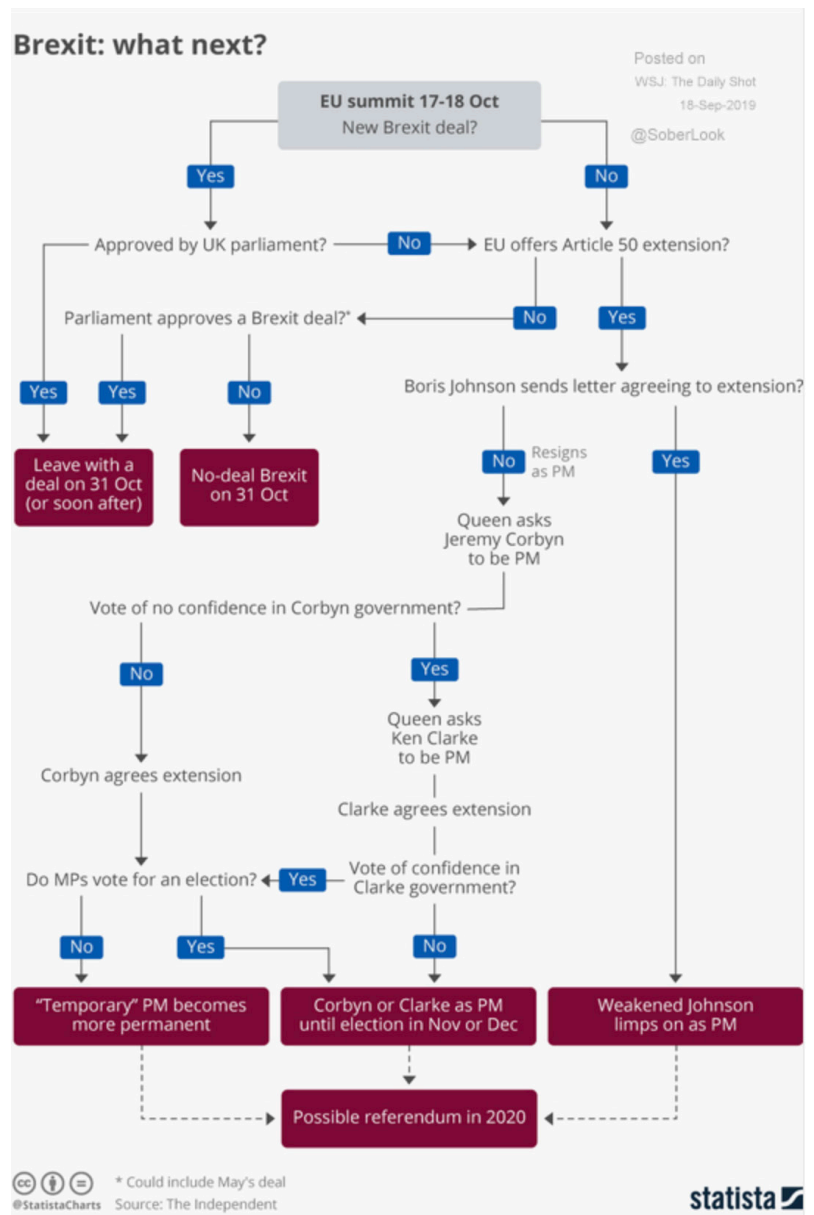
Known Unknowns

The trade war with China, recession, Brexit, impeachment, the U.S. presidential election, Iran, North Korea, and Hong Kong are just some of the significant uncertainties causing investors angst of late. Each new development involving these issues incites a market reaction that causes some of our clients' heads to spin. Navigating such an environment may seem like an impossible task to many investors.

The trade dispute between China and the U.S. seems to be the top concern for investors. The negotiations have settled into a pattern whereby the two sides commence discussions, report modest progress, reach a deadlock that scuttles the negotiations, downplay the two sides' differences, and then restart the process. In fact, as we write this, it appears the two countries may have reached an agreement on the framework of what the administration is referring to as the "phase one" trade deal. Nevertheless, pundits have a wide range of theories regarding how or when this will be resolved. In order to form an accurate prediction, these experts would need to understand both the Chinese and Trump administration's true objectives, handicap their tolerance to withstand economic pain, and decipher the trade war's potential impact on the November 2020 presidential election, to name just a few of the wide-ranging factors that influence the negotiations. We believe the likelihood of correctly evaluating all these factors is relatively low.

Brexit is another example that illustrates how difficult it is to forecast a resolution and highlights the diverse issues at play. There have been many twists and turns since Brexit negotiations started in March of 2017, following the submission of the withdrawal notice by the United Kingdom (UK) to the European Union (EU). Former UK Prime Minister Theresa May was unable to convince Parliament to support her deal with

Exhibit 1:



with the EU, ultimately costing May her job. May's replacement, Boris Johnson, seems committed to leaving the EU by the October 31st deadline with or without a deal, but his efforts to force the issue were recently handed a setback from the UK Supreme Court. The range of potential outcomes is illustrated through the decision tree on page 3 (Exhibit 1), which underscores the variability of results. In our opinion, investors cannot confidently develop a short-term investment strategy that accurately discounts this much uncertainty.

WHAT THIS MEANS

Markets are often described as a discounting mechanism because they relatively efficiently distill the many and often varying opinions of its participants about the future. Each trade that occurs within a market has two parties, a buyer and seller, with the two typically holding opposing beliefs regarding the future price of a particular security. This explains why markets are often called a zero-sum game in that one investor's success comes at the expense of another's.

We do not believe that investors can consistently make accurate

short-term forecasts. Therefore, we do not attempt to time the market. Instead, we take a more deliberate and measured approach to navigating uncertainties. Our investment team endeavors to identify the major risks and opportunities that might impact investment returns over time, carefully weighs the probabilities of one outcome versus another, and modestly tilts our client portfolios towards the opportunities and away from the risks. Importantly, we generally emphasize preserving wealth while still attempting to capture upside over time.

Conclusion

This quarter's *Perspectives* reminds us that markets are dynamic and constantly evolving. Our look into the changing nature of the private-equity and IPO markets and how difficult it has become to forecast the outcomes of certain short-term events are just two examples. We remain committed to analyzing the dynamic nature of the markets in order to position our clients' portfolios to generate strong risk-adjusted returns and thus help clients realize their financial and personal goals.

[See Colony Spotlight on page 5.](#)

COLONY SPOTLIGHT

► The Colony Group Named to Barron's Top 50 RIA firms in 2019

The Colony Group was once again named a Barron's Top RIA Firm in 2019, moving up to #15 in 2019 from #22 in 2018.

"I believe our recognition by Barron's and others is not only a reflection of the high standards we set for ourselves but also the deep and enduring relationships we have developed with our clients by being available whenever they need us and equipped with the knowledge and resources each situation requires," said Michael Nathanson, Chairman and CEO of The Colony Group. "This happens every day in every office as we help our clients find meaning and joy in their lives."

Michael Nathanson has also been included in the Barron's Hall of Fame, having been named to the Barron's Top 100 Independent Advisors list for 10 different years.



BARRON'S
Top 50 RIAs

Award Disclosures:

Barron's criteria: Barron's criteria: Top 50 RIA Firms (2019) and Top 40 RIA Firms (2018) - Barron's ranks independent advisory firms weighing dozens of qualitative and quantitative components, including assets managed, the size and experience of teams, and the regulatory records of the advisors and firms. The Barron's Top 100 Independent Advisors list included Michael Nathanson, Colony's CEO, for 2007 and 2009-2017, and as first among Massachusetts-based advisors in 2009, 2013, and 2016. The criteria included advisor's assets under management, contribution to the firm's revenues and profits, and quality of service.

► Colony Retreat

This year, our teams from 13 offices in six states traveled to Boston for our annual company retreat. Our colleagues cheered on the Boston Red Sox, volunteered to prepare backpacks for the Boys and Girls Club of Boston, and toured Harvard's campus with Colony's CEO, Michael Nathanson. Finally, Dan Jansen, former speed skating and Olympic gold medalist, made a surprise appearance and shared his compelling life story.

To view a video from our retreat, click on the image below.



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