Quarterly Insights

Is the Dollar's Global Status at Risk?

By Jared Kizer, CFA

We have seen an increase in questions about the future status of the U.S. dollar as the world's reserve currency, which simply means that it's the most widely used currency in global trade and finance. As one example, the U.S. dollar dominates foreign exchange transactions, estimated to be involved in approximately 90% of all currency trades as of 2022.[1] This, among many other data points, illustrates that the dollar is currently the only currency with serious claim to the reserve currency title. That said, recent news about China's yuan, also known as the renminbi, has led to some speculation: Is the dollar at risk of losing its status? And what might be the implications?

Is the U.S. dollar at risk of losing its reserve currency status?

In our opinion, the legitimate concerns facing the U.S. dollar's reserve currency status are:

1. The massive growth in U.S. federal government debt relative to the size of the U.S. economy.
2. Substantial national deficits year after year, with no end in sight.
3. Continued challenges connected to China.

The advantages the U.S. possesses relative to other countries are **the sheer size and dynamic nature of its economy** and a foundational respect for **property rights and the rule of law**. While there are other countries that could claim to possess one of these two strengths — or even claim superiority to the U.S. in one of the two areas — there is, in our opinion, no country (or bloc of countries) that credibly challenges the U.S. on both counts. One could argue that the closest challenger is the bloc of countries that use the euro. However, there is simply no evidence of a pronounced increase in the use of the euro in global trade and finance relative to the dollar. As for the use of China's yuan in global trade and finance, it barely registers when compared with either the dollar or euro.

What might be the implications for investors?

Our best guess is that if the dollar were to lose reserve currency status over the longer term, the impact on global markets would be slight. Although the dollar would depreciate relative to other currencies, there is no reason to assume that losing its status alone would have a catastrophic impact on global stock and bond markets. Within the last two centuries, global money has transitioned from gold to irredeemable fiat currencies to U.S. dollars redeemable for gold and to irredeemable U.S. dollars. Meanwhile, global stock markets have generally trended up. In other words, the last two centuries have certainly seen currency upheaval.

What should investors do if they are still worried?

Although an abrupt change in the dominant currency used could lead to market turmoil, a gradual change would be unlikely to disrupt markets. We continue to believe that the most effective protection against this risk — and all others — is broad, global diversification; a relatively short maturity portfolio of high-quality nominal and inflation-protected bonds; and, potentially, an allocation to alternative investments.

1 Source: J.P. Morgan, Michael Cembalest. Eye On The Market. April 26, 2023.

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Navigating Alternative Investment Strategies

By Daniel Campbell, CFA

For years, stocks and bonds have been the primary way investors could build their wealth. However, we've seen remarkable transformation in a third venue: alternative investments, loosely defined as any financial investment that does not fall under the traditional stock or bond categories.

While some alternative strategies have been around for decades, four areas we find intriguing for client portfolios include:

Real Estate

Private Lending

Reinsurance

Style Premia

Buckingham's Investment Policy Committee (IPC) has taken a measured and cautious approach to adding alternatives to our portfolios. Although we remain skeptical of most alternative strategies, we've found a few that may benefit a well-constructed portfolio. It's important for investors interested in alternatives to understand how the space has evolved, the framework the IPC employs when evaluating strategies, and the potential benefits and risks of investing in the various alternative asset classes.

Evolution of the space

Over the last 20 years, we've seen a few notable improvements in the investment landscape for alternatives.

- **Structure:** More alternative strategies are now available in publicly registered, SEC vehicles, so investors are no longer limited to the limited partnership (LP) space. This is good from a fee, transparency and liquidity point of view.
- **Fees:** Although the strategies are still more expensive than most stock and bond funds, increased competition has brought fees down to more reasonable levels.
- **Opportunity:** Finally, changes in market structures have opened new avenues for investors. Technological improvements have allowed for significantly faster underwriting for consumers and small business loans, and changes in legislation, such as the Dodd-Frank Act, have shifted incentives for large banks, opening new lending opportunities for private investors.

Evidence-driven criteria

We practice an evidence-driven approach to investing, which simply means that our recommendations are not based on my opinion or the opinion of any individual, but rather they're based on decades of academic and practitioner research. When evaluating alternative strategies, we look for certain characteristics across the funds and managers we recommend:

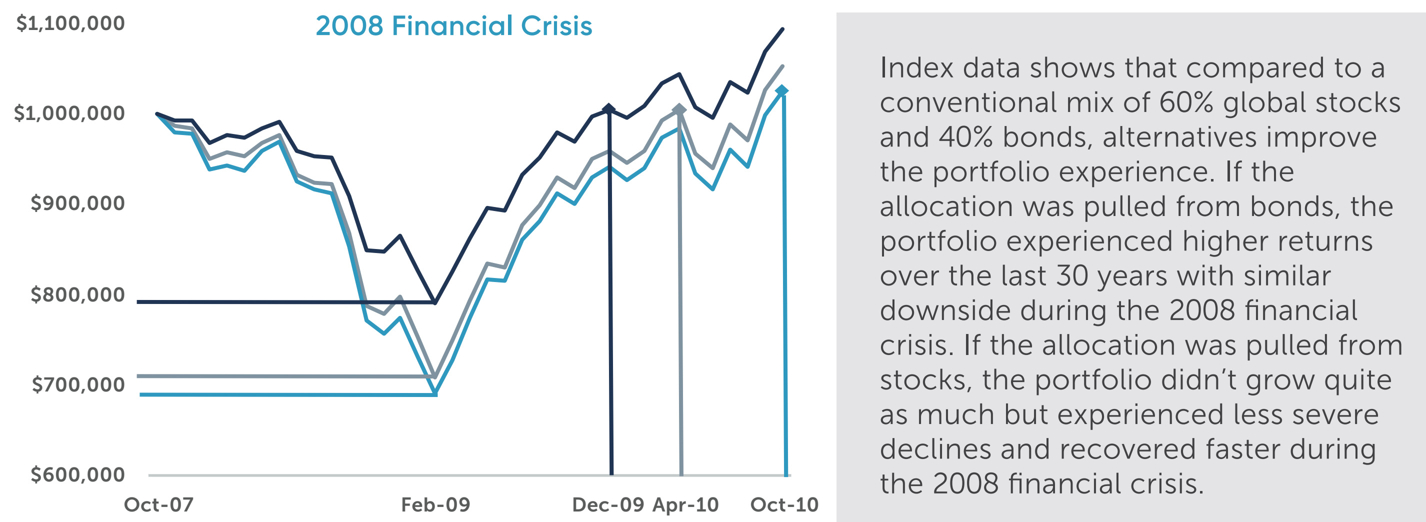
- We look for strategies that don't move in tandem with stock or bond markets. We look for investments that are exposed to a unique set of risk compared to stock markets.
- Although performance over shorter time frames will vary significantly, we expect investments to have better returns, on average and over time, than our high-quality bond portfolios.
- Finally, like everything else we invest in, we look for strategies that are systematic, transparent and repeatable. Our investment recommendations are backed by research that demonstrates economic or behavioral reasoning on why we should expect the premium to continue.

Those simple criteria create a high hurdle that most alternative strategies do not currently pass.

Impact of including

Ultimately, we know alternative investments are not right for everyone. Compared to the stock and bond funds we recommend, alternative funds are more complex, more expensive and can be less liquid, which means that investors are sometimes restricted to how much and how often they can withdraw their money. Finally, alternative investments can experience significant declines, and speaking from experience, the more complex the strategy, the harder the declines are to endure.

For those able and willing to stomach the risks, however, adding alternatives may cushion the portfolio from the unpredictable (and sometimes severe) declines in the stock market while offering a potentially greater chance for portfolio growth compared to high-quality bonds.



Index data shows that compared to a conventional mix of 60% global stocks and 40% bonds, alternatives improve the portfolio experience. If the allocation was pulled from bonds, the portfolio experienced higher returns over the last 30 years with similar downside during the 2008 financial crisis. If the allocation was pulled from stocks, the portfolio didn't grow quite as much but experienced less severe declines and recovered faster during the 2008 financial crisis.

Chart sources: Ken French Data Library, Morningstar Direct. For illustrative purposes only.The first chart illustrates the hypothetical growth of $1 million over the 30-year period ending in December 2022, and the second chart illustrates the hypothetical performance of $1 million invested at the October 2007 market peak and held through the Great Financial Crisis.

Index Composition information: 60% Global Stocks, 40% Bonds is composed of 36% U.S. Stocks, 18% International Stocks, 6% Emerging Market Stocks, and 40% Intermediate Government Bonds. 60% Global Stocks, 15% Alternatives, 25% Bonds is composed of 36% U.S. Stocks, 18% International Stocks, 6% Emerging Market Stocks, 15% Market Neutral, and 25% Intermediate Government Bonds. 45% Global Stocks, 15% Alternatives, 40% Bonds is composed of 27% U.S. Stocks, 13.5% International Stocks, 4.5% Emerging Market Stocks, 15% Market Neutral, and 40% Intermediate Government Bonds. U.S. Stock returns are represented by the total U.S. market return, from the Ken French Data Library. International Stocks are represented by the total developed international market, from the Ken French Data Library. Emerging Market Stock returns are represented by the total emerging market, from the Ken French Data Library. Market Neutral is represented by CISDM Equity Market Neutral Index, from Morningstar. Intermediate Government Bonds are represented by the Ibbotson Associates U.S. Intermediate Government Total Return Index from the Stocks, Bonds, Bills, and Inflation (SBBI) data, from Morningstar.

Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. The indices do not represent results of actual trading. Information from sources deemed reliable, but its accuracy cannot be guaranteed. Performance is historical and does not guarantee future results. Index total return includes reinvestment of dividends and capital gains.

Alternative investments may not be suitable for all clients. Individuals should speak with a qualified professional to review the risk characteristics of alternatives and determine their appropriateness based on each individual's circumstances. Alternatives have a unique set of risks including but not limited to limited ability to withdraw investment, higher complexity compared to traditional stock and bond investments, potential for significant equity-like losses, and higher expenses.

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The Big Challenge for Commercial Real Estate

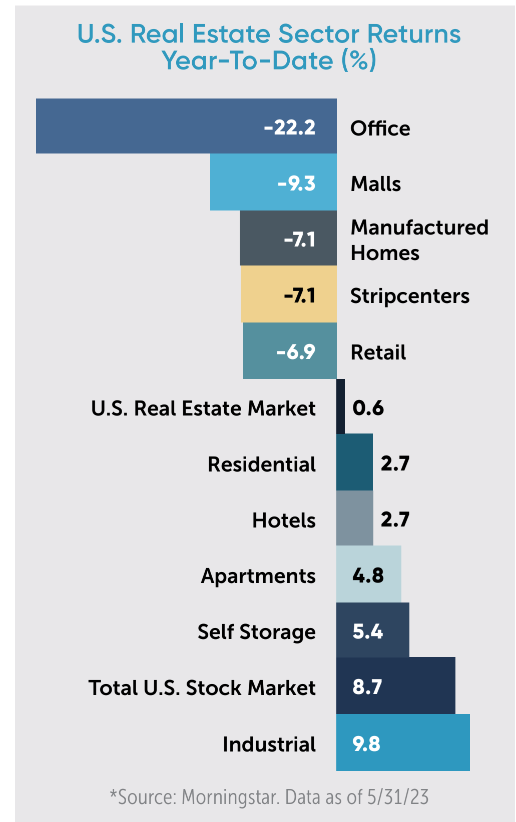
By Alex Kluesner, CFA

Given the uncertainties in both stock and bond markets this year and the increasing likelihood of a recession by year's end[1], it's not surprising to see headlines focused on the real estate sector and its lagging performance. Let's put context around these trends to evaluate the best course of action.

What is driving the poor performance in real estate markets?

Despite concerns, the overall real estate sector is slightly up for the year so far. That's because the sector tracks both residential real estate and many forms of commercial real estate. Of all the real estate sectors, office properties are taking the biggest hit this year.*

As many people are still choosing to work from home for all or part of the week, office buildings have sat half empty on average since the beginning of the pandemic.[2] This has forced building owners to lower rents and has raised their costs to attract new tenants, hurting profits. Financing costs for building ownership and maintenance have also skyrocketed as interest rates have gone up.



*Source: Morningstar. Data as of 5/31/23

What is the outlook for the office real estate sector?

The office sector faces significant headwinds in the short term. A record $270 billion in commercial mortgages will need to be refinanced this year, at much higher interest rates.[3] Property owners with floating-rate agreements have already felt the sting of higher rates and have been forced to sell their buildings at deep discounts. Fixed-rate payers who have yet to refinance may need to make similar decisions soon.

What happens over the longer term is uncertain. As the labor market gradually cools, employers might enforce stricter in-office attendance policies, which would be a boon for office real estate investments. It's possible that office owners find their way out of these troubled times as they did in the 2007-2009 Great Recession. Despite losing over 70% in value during those years, the sector went on to return 16.1% per year for the next decade. By comparison, the sector has lost nearly 54% of its value since the pandemic began through May 2023.

Do I need to make changes to my portfolio?

Although the headlines might urge investors to act, often the best strategy is to stick with your long-term plan. Public real estate constitutes only 3%-4% of the total U.S. stock market[4], and office buildings make up less than 5% of public real estate.[5] No matter the source of uncertainty, if you feel that the level of risk in your portfolio is too high, it's time to review your plan with your trusted advisor.

1 Source: Federal Reserve Bank of New York, The Yield Curve as a Leading Indicator
2 Source: Wall Street Journal, The Return to the Office Has Stalled, May 16, 2023.
3 Source: Wall Street Journal, Rise in Distressed Sales Signals New Chapter for Beleaguered Office Market, May 16, 2023.
4 Source: Morningstar, Russell 3000 index.
5 Source: National Association of Real Estate Investment Trusts, REITWatch, April 2023, page 27
The indexes utilized in the chart above are measured by Office (DJ US Select REIT Office Index), Malls (DJ US Select REIT Malls Index), Stripcenters (DJ US Select REIT Stripcenters Index), Retail (DJ US Select REIT Retail Index), Manufactured Homes (DJ US Select REIT Manufactured Homes Index), U.S. Real Estate Market (DJ US Select REIT Index), Residential (DJ US Select REIT Residential Index), Apartments (DJ US Select REIT Apartments Index), Hotels (DJ US Select REIT Hotels Index), Industrial (DJ US Select REIT Hotels Index), Self-Storage (DJ US Select Self Storage Index), and the Total U.S. Stock Market (Russell 3000 Index).

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