Strategy Thoughts

October 2014

Has a Turn been seen?

And an introduction to the Strategy Thoughts Allocation (STA) Model

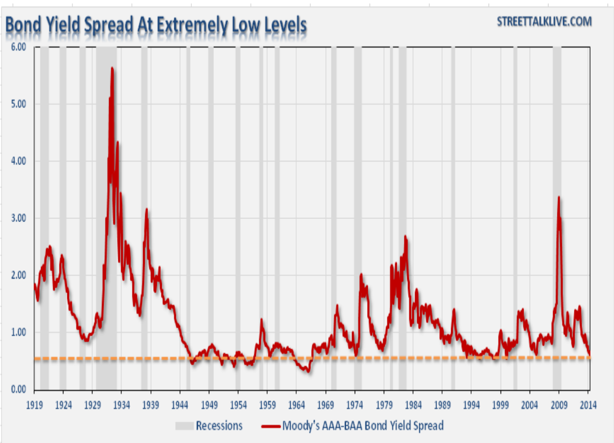
Introduction

Over the last month many of the forces that I have long feared have begun to manifest themselves across a broad array of markets. In this month's Strategy Thoughts I highlight some of the reversals, or turns, that have come about as a result of this and raise the possibility that what has been seen to date is only the beginning of what could well be a very damaging period for many investors. It should be clear that there have been no significant changes in my overall global investment outlook.

More importantly this month I will continue to share the very encouraging research that has now become something of an obsession for me. The pursuit of a disciplined rule based approach to investing. My thinking has moved on enormously since last month's Strategy Thoughts and the results have, to put it quite bluntly, simply blown me away. I have always believed that discipline was the single most important characteristic shared by all successful investors, and I have also always believed that overcoming our enormous psychological behavioural biases was the major challenge most investors faced. Over the last month the 'Rules' I outlined in the September edition have been modified, or developed, further and I have applied them to substantially more markets than last month. I have dropped the awkward SAA+TAA+Bonds moniker I had employed for the model and replaced it with the Strategy Thoughts Allocation (STA) model. I am confident that readers will be as impressed and surprised as I was by the results of the STA. I appreciated all the encouraging feedback last month and would certainly welcome more this month as I believe the STA goes a long way to providing the average investor with the potential for very healthy long term returns with substantially less volatility. Particularly when compared to traditional peer focussed, relative performance obsessed economic model driven fund management.

Turns

I have long been concerned that the bear market bottom in March of 2009 did not mark the end of the long term secular bear market that began in much of the developed world in 2000. With that in mind I have been surprised by the durability and magnitude of the 'bear market rallies' that have been enjoyed since that low point. Nonetheless, I continue to view the majority of reversals that have been seen and enjoyed since March 2000 as bear market, or sucker, rallies and have been looking for developed markets to roll over, yield spreads to widen, gold to resume its bear market and the US dollar to rally. The following collection of charts go some way to illustrating that a potentially significant reversal may have begun.



The chart to the left shows just how low bond yield spreads had got earlier this year. In June Fed chairman Janet Yellen was quoted:

"There is some evidence of reach for

yield behavior. This environment of low volatility is on my radar screen."

I have frequently commented that ‘more has been lost chasing yield than at the point of a gun’. This is a very old saying but it is remarkable how poorly we humans learn lessons. It is only six years since massive fortunes were lost through irresponsible yield chasing behaviour yet, as even Janet Yellen points out, investors have been at again, and in a very big way.

However, over the last couple of months some signs of a reversal are evident, as can be seen in the chart to the left of the Barclays ETF that mirrors the ‘High Yield’ (once known as Junk bonds) index.

More recently weakness has been seen in Emerging markets and across Europe.

Whilst the major indices in the US have held up reasonably well investors should be concerned that the smaller cap indices, like the Russell 2000 shown to the left below, have not. It is also apparent that

after consolidating for almost a year gold is resuming its bear market.

The turn in gold may not be as apparent as with the other currency and equity indices, however, over the last month it has become clear that gold is once again resuming its downtrend.

Finally, a significant turn (upward) in the US dollar has been seen recently. The chart left shows the performance of the ETF that mirrors the trade weighted dollar and the strength over the last couple of months is quite apparent. I continue to believe that the surprises going forward regarding the US dollar will be on the upside and that eventually it will be seen as a 'safe haven', just as it was through 2008.

The Strategy Thoughts Allocation (STA) Model

Last month I articulated five rules that I believed were essential in a disciplined investment model, over the last month I have fine-tuned that down to four:

- The approach **must be simple**; it must not rely on complex algorithms, ultra-high speed trading or proprietary and expensive pricing information.
- It must not be dependent upon, in fact **it must avoid**, the sometimes comforting (but not necessarily helpful) **forecasts and extrapolations of economists and analysts**.
- It must capture the very long term importance of **VALUE** and the persistence of **momentum** in markets.
- Any allocation changes **must be rule based** so as to ensure that the approach is totally insulated from the strong behavioural biases that conspire to undermine most investors over multiple time frames.

I concluded Strategy Thoughts last month with the following comments:

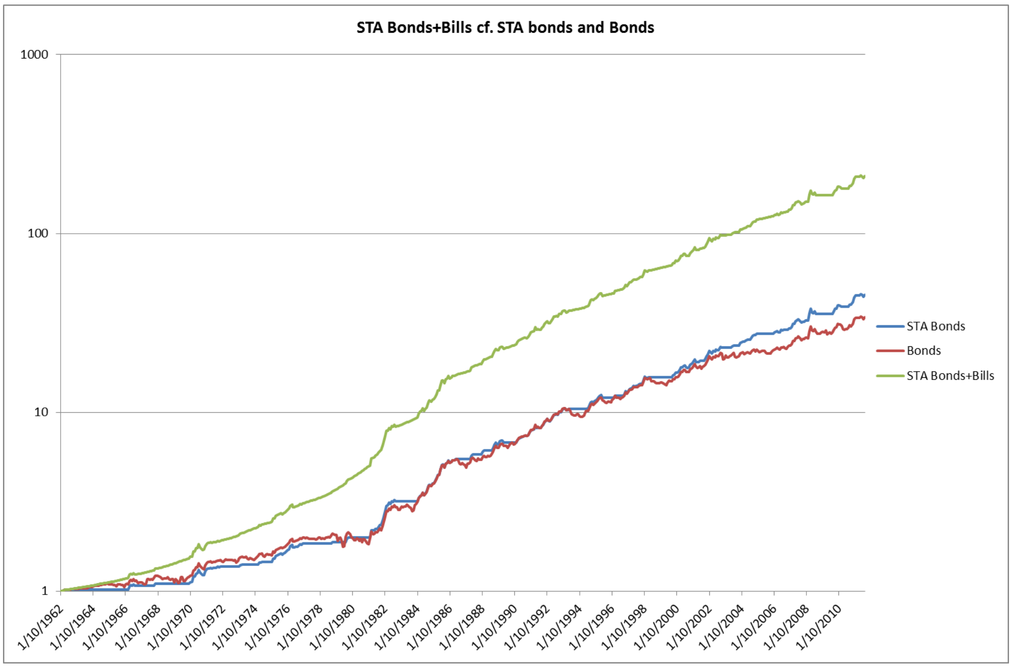
> Our next step will be to conduct similar research on other markets and asset classes with the aim of ultimately building a broader portfolio offering that can be made available to those investors looking for something more than the current relative performance obsessed and bias riddled offerings that dominate the investment landscape.

Over the last month a substantial amount of research and testing has been undertaken to further refine and expand the models that I presented.

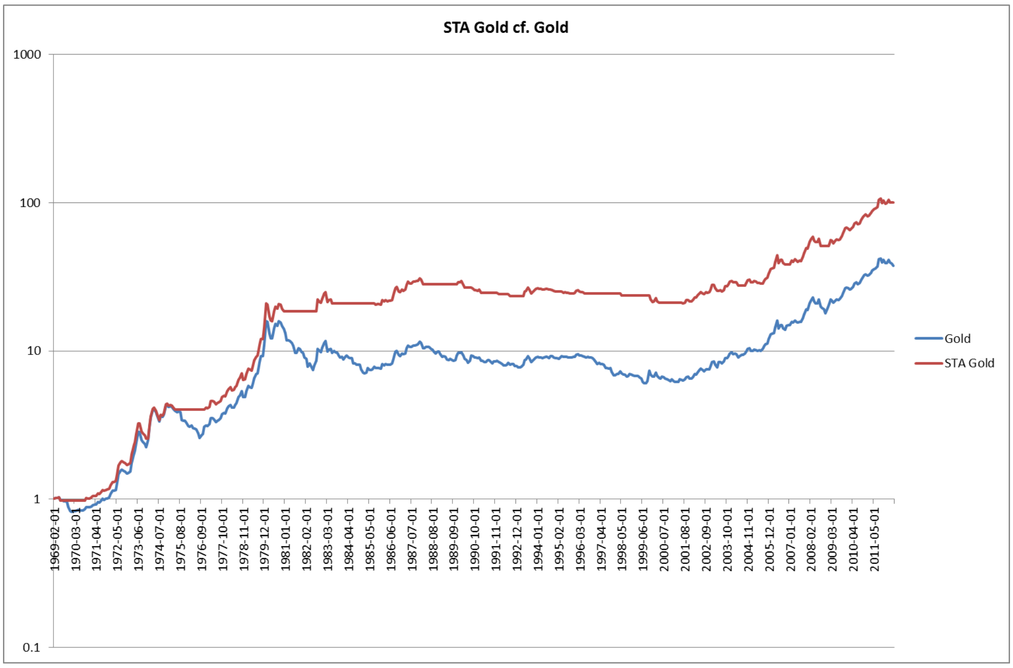
This research has been conducted utilising the longest and most thorough data available. In some cases this has stretched back into the nineteenth century, however, in others, particularly those simulations that have employed exchange traded funds (ETF's), the data understandably only extends back to the early 2000's. Nonetheless, even those relatively short histories have experienced enormous stress testing given the dramatic and historic swings markets the world over have experienced over that time.

The US

The chart below shows the long term total return of US ten year treasuries in red, the STA return resulting from being invested in the same bonds on average 47% of the time in blue, and then the STA return when the balance of the time is invested in bills. This strategy required an asset allocation shift on average every seven and a half months and delivered a compound annual growth rate (CAGR) of 11%

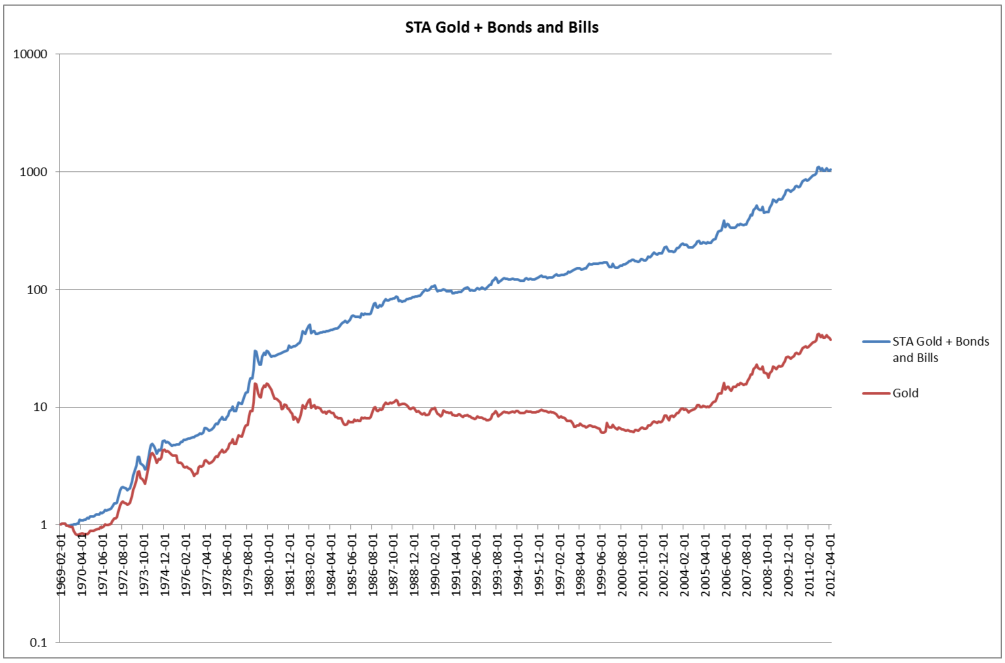


Exactly the same model can be applied to Gold:

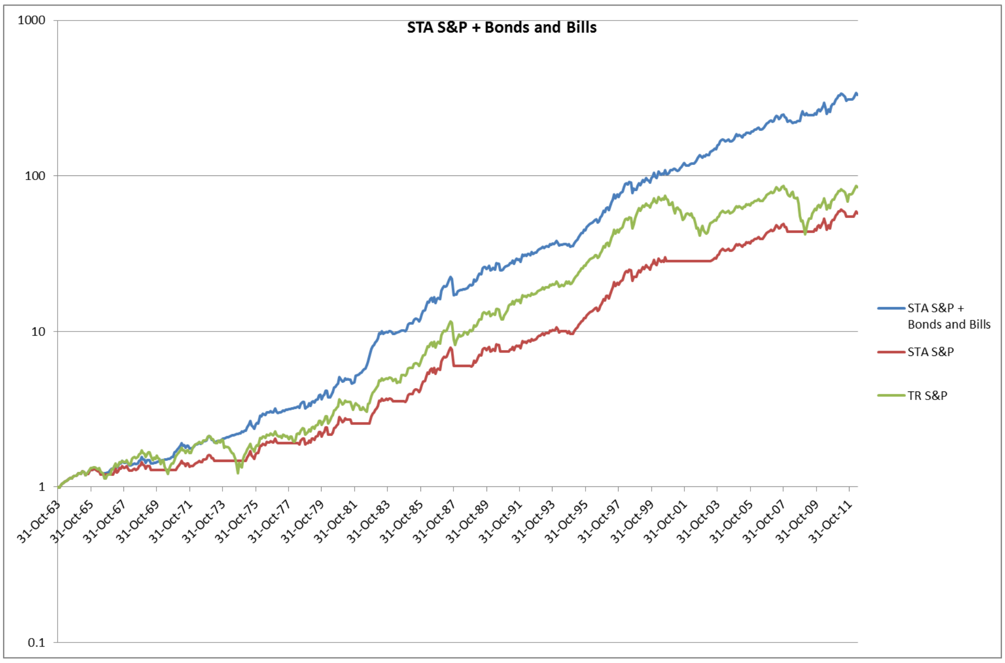


In the chart above the average exposure to gold in the STA model is 60% and there were allocation changes every eighteen months on average.

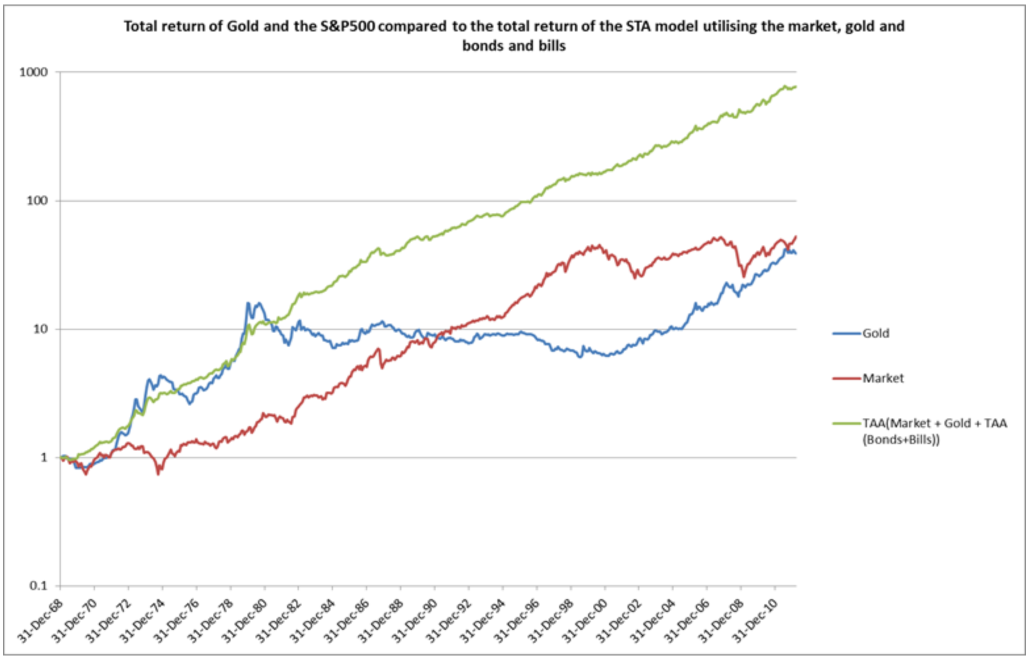
When the uninvested allocation in the STA gold model is invested in the STA Bonds and Bills model the returns improve dramatically yielding a CAGR of 17%



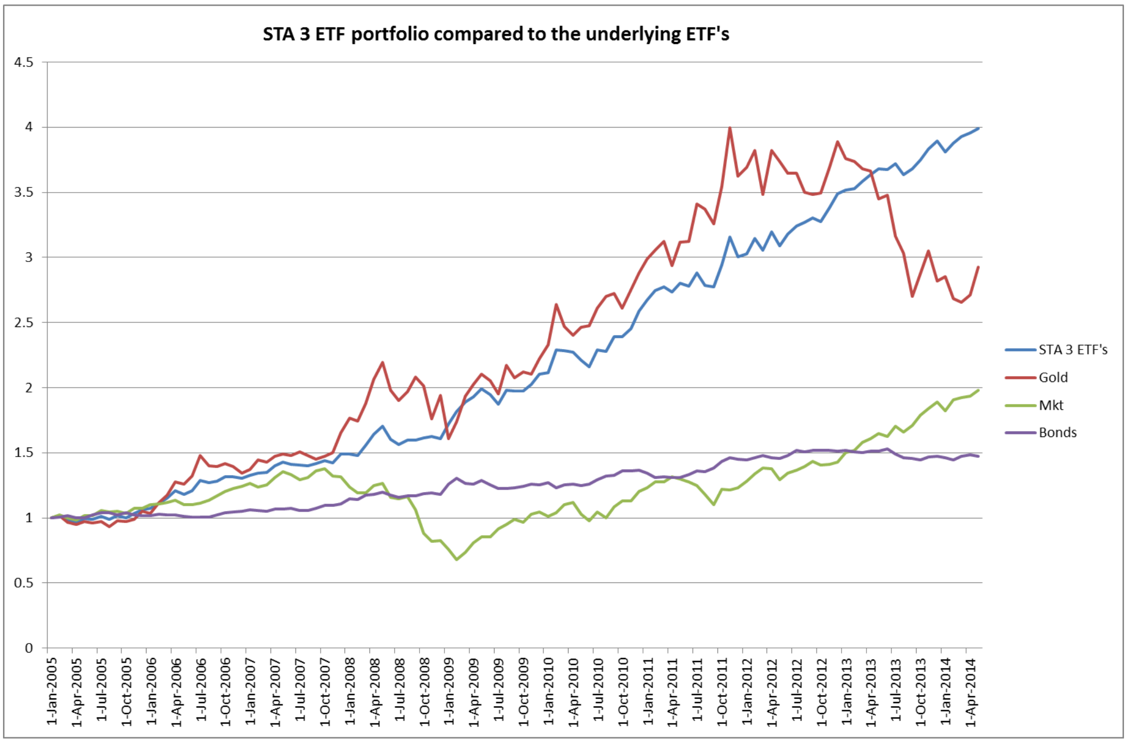
The same STA model can be applied to the total return of the S&P, in this case it is invested on average 70% of the time in the S&P and yields the result shown below in red. When the univested allocation is invested in bonds and bills the result is the blue line which delivered a CAGR of a little over 12%



Perhaps the most interesting results come when the three models, STA Bonds and Bills, STA Gold and STA S&P are combined in a three asset portfolio. It produces the 16.6% CAGR over a more than forty year period with minimal drawdowns shown below.

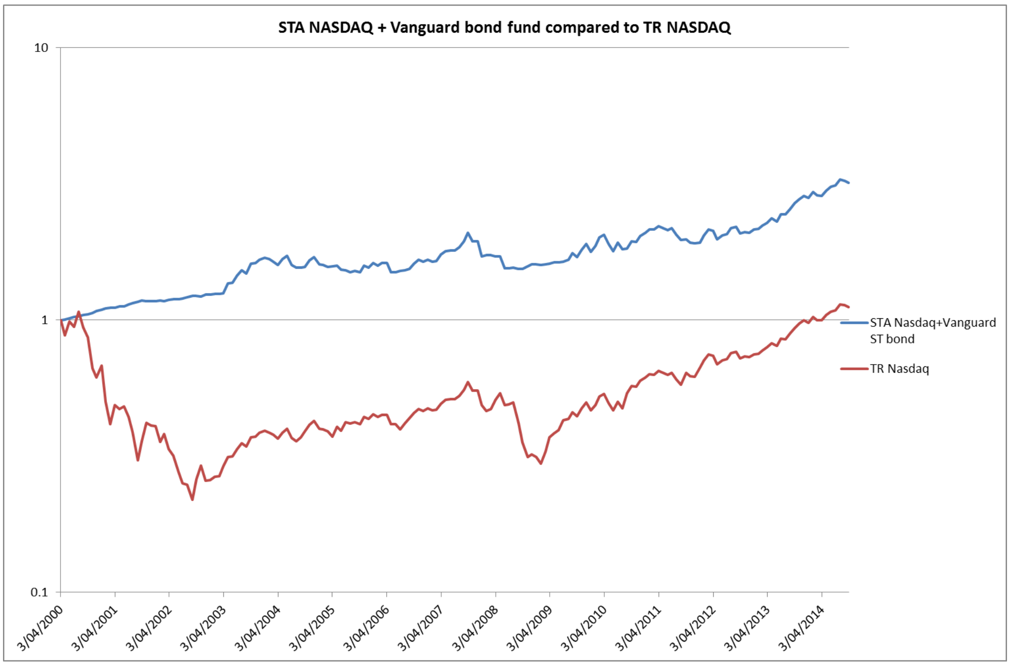


All the charts above were based upon long term data of total returns that unfortunately ended in 2012. A more current impression of the value of the STA approach can be seen when it is employed using actual exchange traded funds (ETF's) to reflect the underlying assets, especially as these have minimal management fees and can be easily and cheaply traded. The resulting three asset portfolio is shown below.



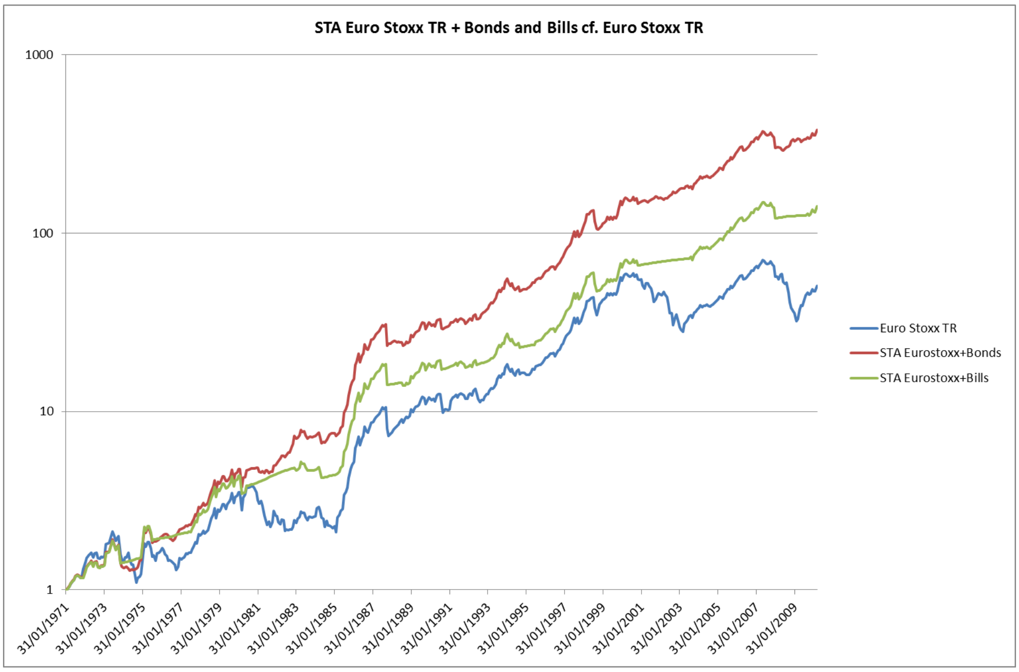
The CAGR for the STA portfolio shown above has been 16%, the worst decline was less than 6% over a four month period that was fully recouped the next month. Over the same period gold has suffered a 35% decline, the market a more than 50% decline and bonds have slipped a handful of percent on a couple of occasions.

A similar exercise can be done with the NASDAQ. Here I have used the entire data available for the QQQQ's, one of the earliest and most liquid ETF's. As no bond ETF has been available for this long I have used the Vanguard short term bond fund



The chart shows the total return of investing passively in the NASDAQ via QQQQ's compared to actively managing the NASDAQ exposure using the STA model and switching into the Vanguard bond fund when out of the QQQQ. On average the STA model is invested in the QQQQ 63% of the time and delivers a CAGR of 7.8% compared to a negligible return from the NASDAQ.

Europe

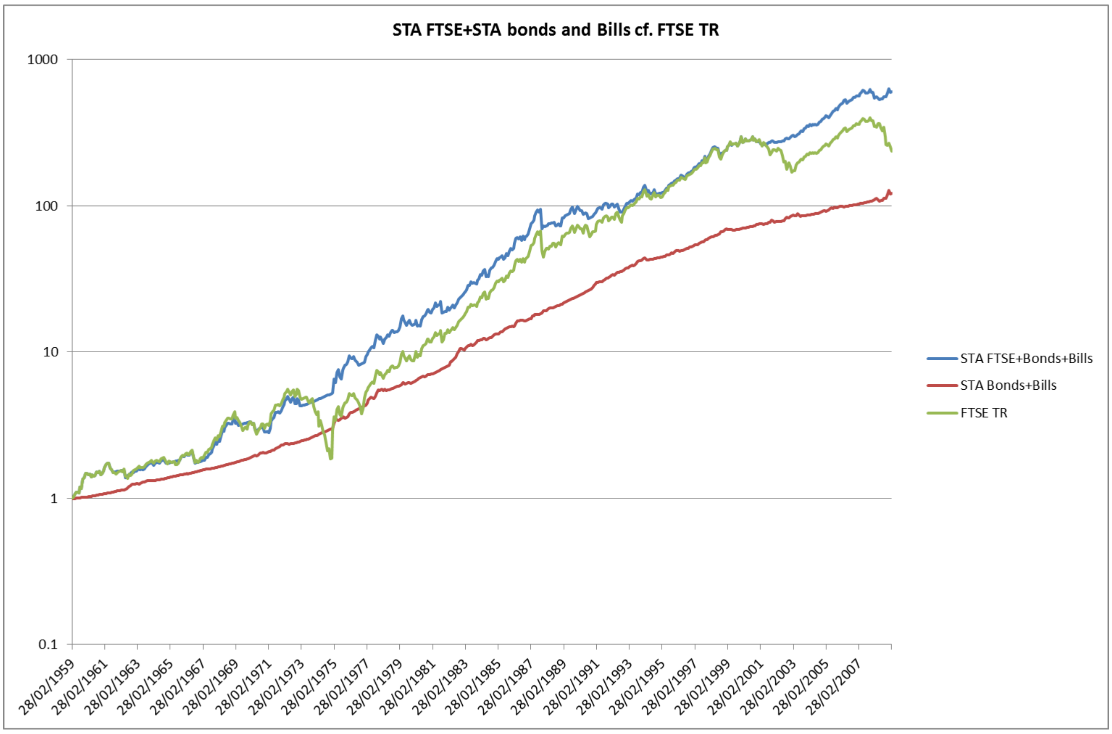


Unfortunately I do not have the data to be able to construct a STA bonds and bills return for Europe. Nonetheless, the combination of STA Euro Stoxx plus firstly bills and then bonds have both comfortably outperformed a passive holding of the index.

For a little over 39 years from early 1971 through to 2010 the STA model plus bonds in Europe produced a CAGR of 16.4% with a maximum drawdown of 22% on a couple of occasions. This compares to a maximum drawdown of more than 54% through a passive holding of the market.

The UK

In the UK the STA bonds and bill index can be constructed. The result for the fifty years from 1959 is shown below in the red line. The green line is the total return of a passive holding of the FTSE over the same period and the blue line is the combination of the two STA models. The result, once again, is very pleasing.

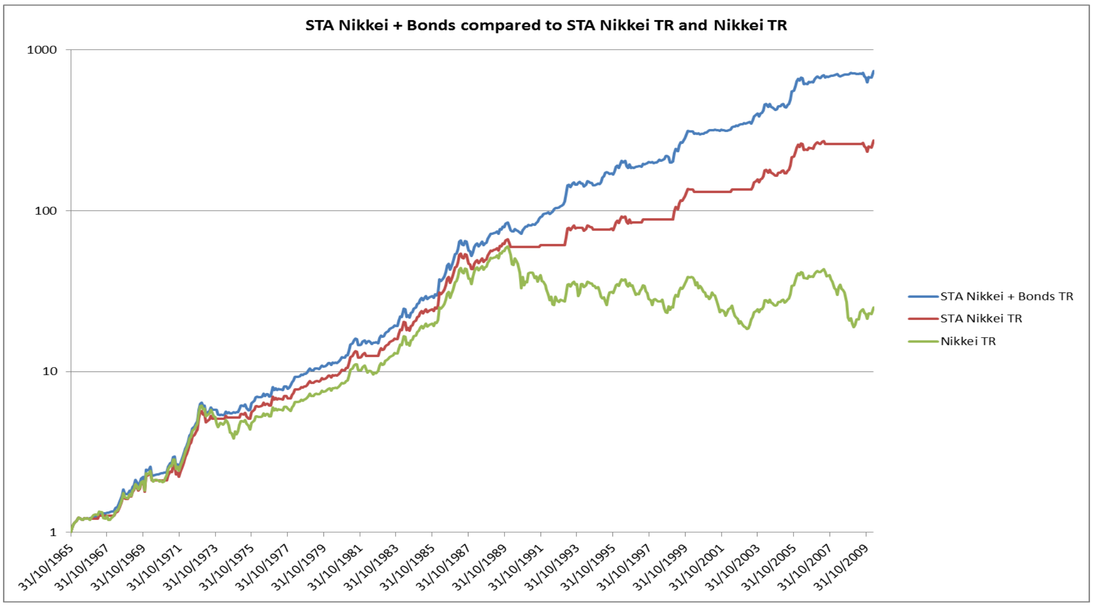


The STA model for bonds and bills in the UK, over the fifty years that history is available, yields a CAGR of 10.8% compared to 9% for bonds and 7.8% for bills. When this return is included in the STA FTSE model then the CAGR becomes 13.7%, this must be compared to the 11.6 a passive holding of the FTSE yields, would require an asset allocation change on average every seven months but would result in substantially reduced volatility.

Japan

Given the enormous secular bull market that Japan enjoyed up until the end of the eighties, and the historic and damaging secular bear market that it then fell into, this market provides a real test for the STA approach.

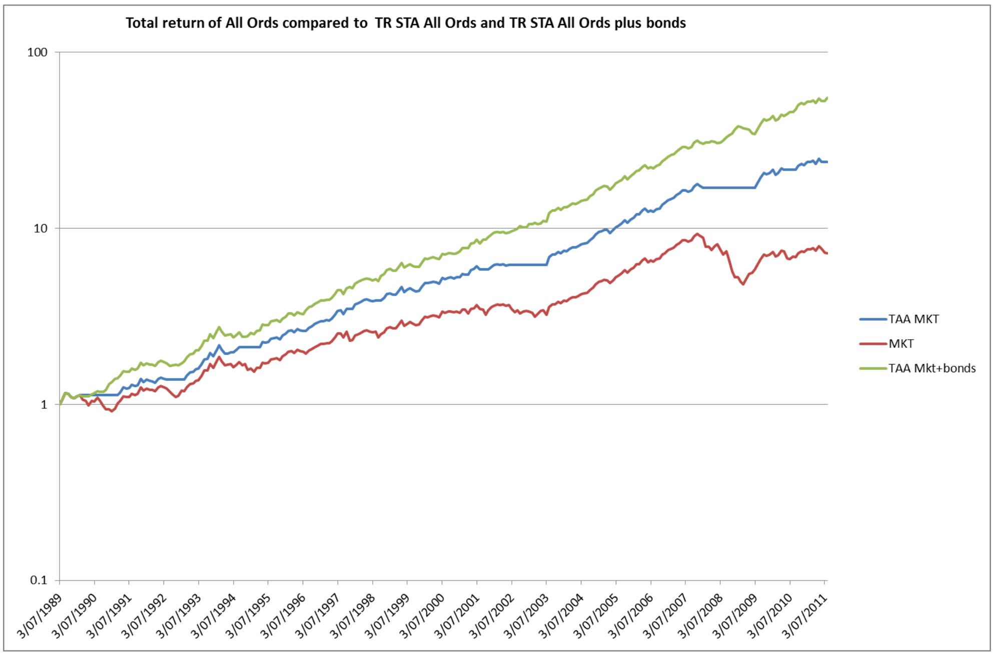
Like with Europe, I am unable to construct a STA bonds plus bills return series, nonetheless, the STA portfolio shown below shows that even without any bonds or bills the STA model handsomely outperformed the Nikkei in the four and a half decades shown. When the benefit of holding bonds is added in the results are even more rewarding.



The CAGR of STA Nikkei + Bonds over the forty four and a half years that data is available is 16%, excluding the bond holdings the return of the STA Nikkei has been 13.4%. The total return of the Nikkei over the same period has been just 7.5%. Perhaps most importantly the performance of the STA model has been very healthy since the peak of the Nikkei in late 1989 delivering a CAGR over the twenty and a quarter years shown of 11.3% compared to 7.2% when bond holdings were excluded and minus 4% for the market.

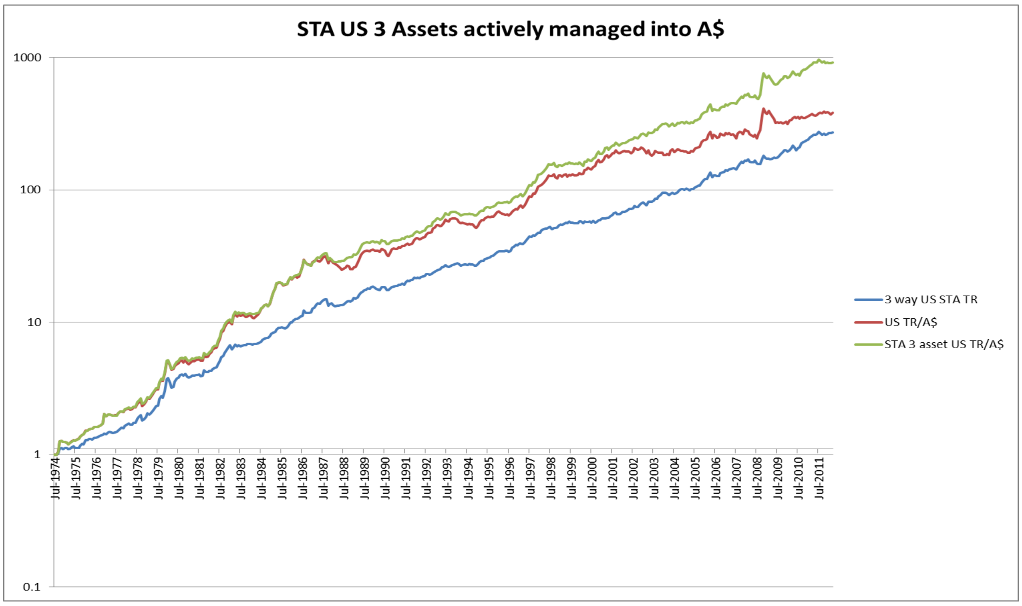
Australia

Total return data on all the various assets is harder to come by for Australia, but even with the limited history available a familiar picture, highlighting the value of the STA approach, emerges.

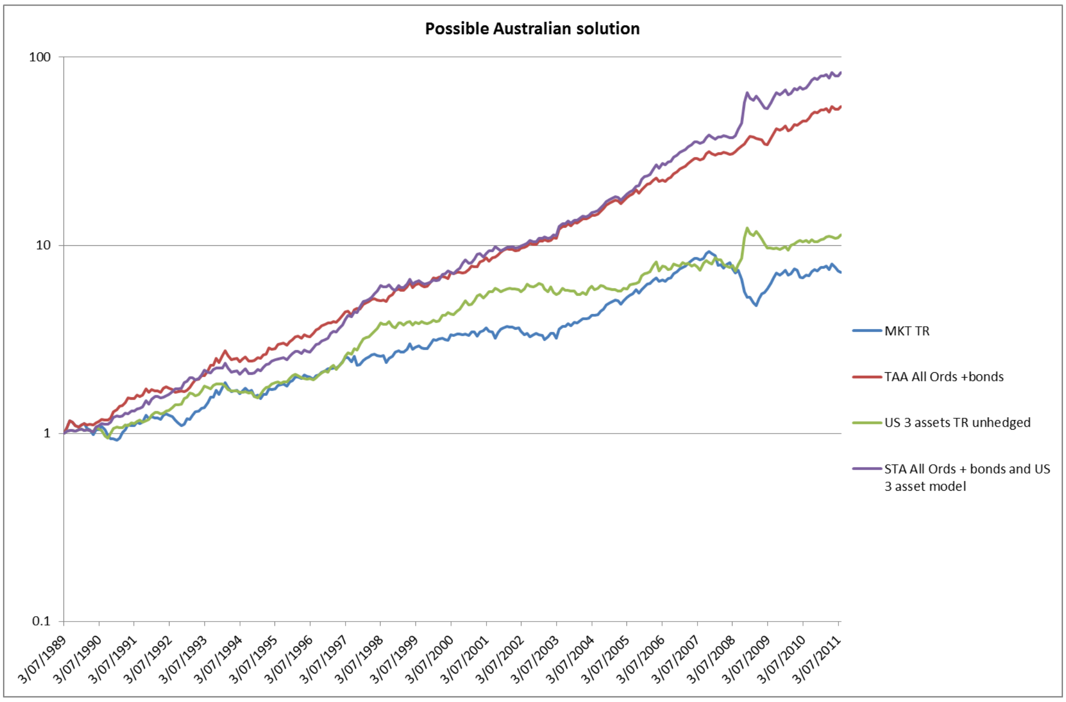


The chart above shows the total return of the All Ords for twenty two years from 1989 in the red line. Applying the STA approach to that index results in an investor holding an average exposure to the index of 72% and delivers comfortable outperformance, as shown in the blue line. When the uninvested portion is invested in the government bond market the CAGR jumps to 19.9% with a maximum drawdown of 13%, as shown in the green line.

Some research was conducted looking at the possibility of an Australian investor investing in the US three asset portfolio and having the currency exposure managed utilising the STA. The results were satisfactory, as shown below, however hedging an overseas exposure actively does add another layer of complication to what was always intended to be a simple approach.

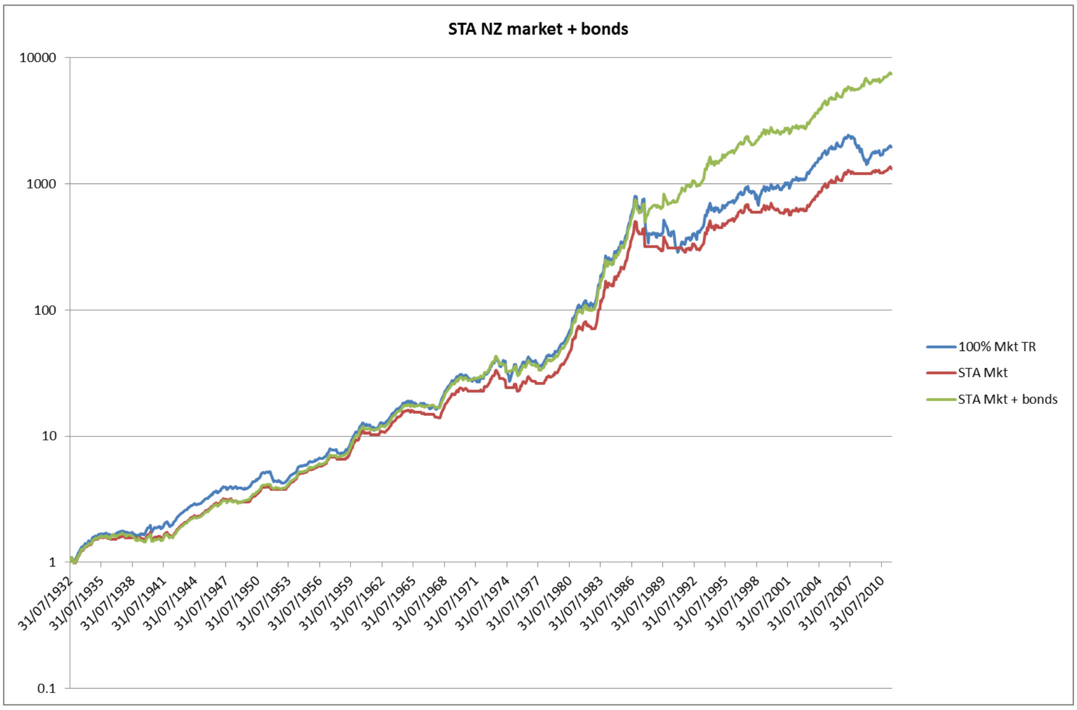


I then explored the possibility of an Australian switching between the US three asset portfolio, on an unhedged basis, and the All Ords plus bonds portfolio with the decision of which to own being delivered by the STA model on the exchange rate.



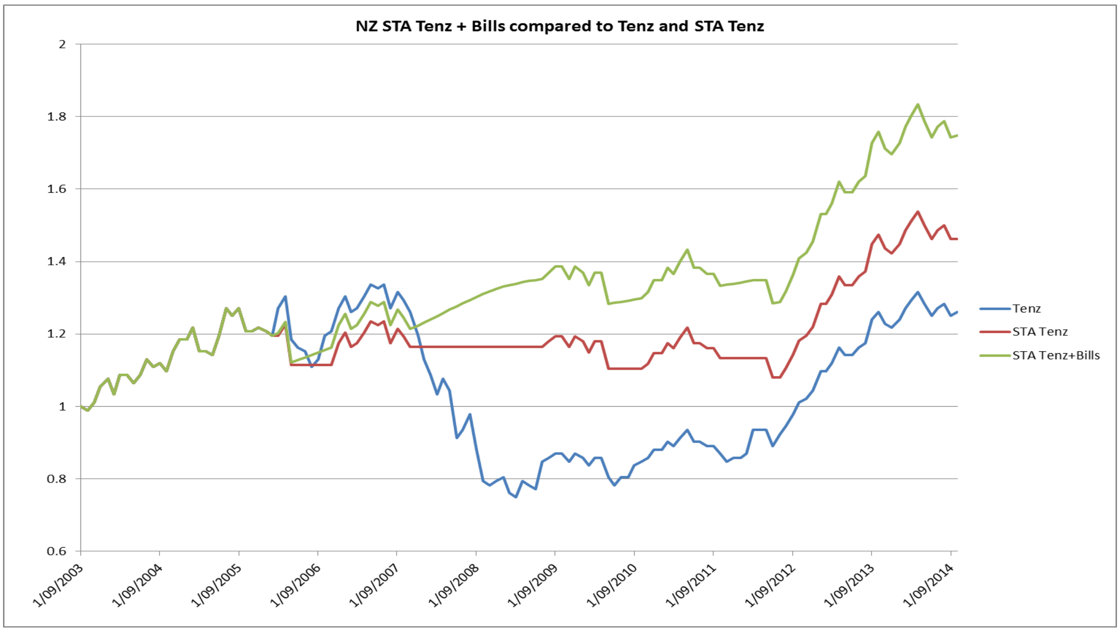
The resulting performance is shown above and the addition of the three assets portfolio slightly improves the performance of the All Ords plus bonds portfolio. It deliverd a CAGR of 22% and would have required an asset allocation switch every eight or nine months on average.

New Zealand



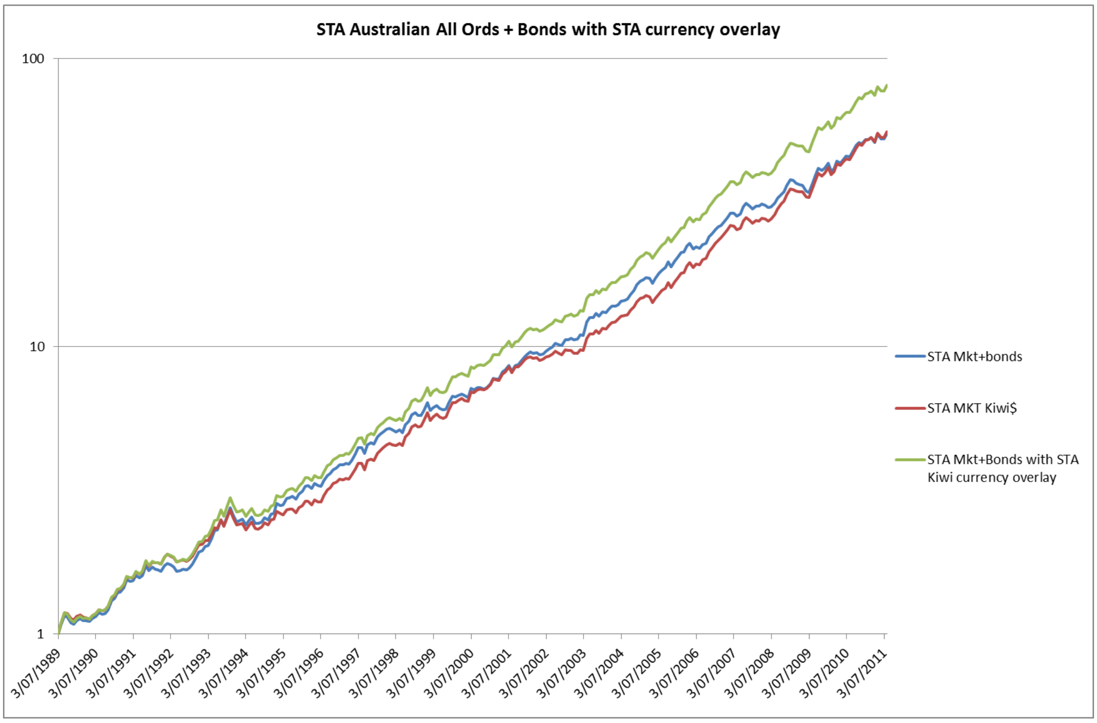
The seventy nine years of history available for the New Zealand market produces an STA market + bonds return comfortably ahead of the market alone, with substantially less volatility and a CAGR of 12%.

Over the shorter term it was interesting to test the STA using actual ETF's and bank bills

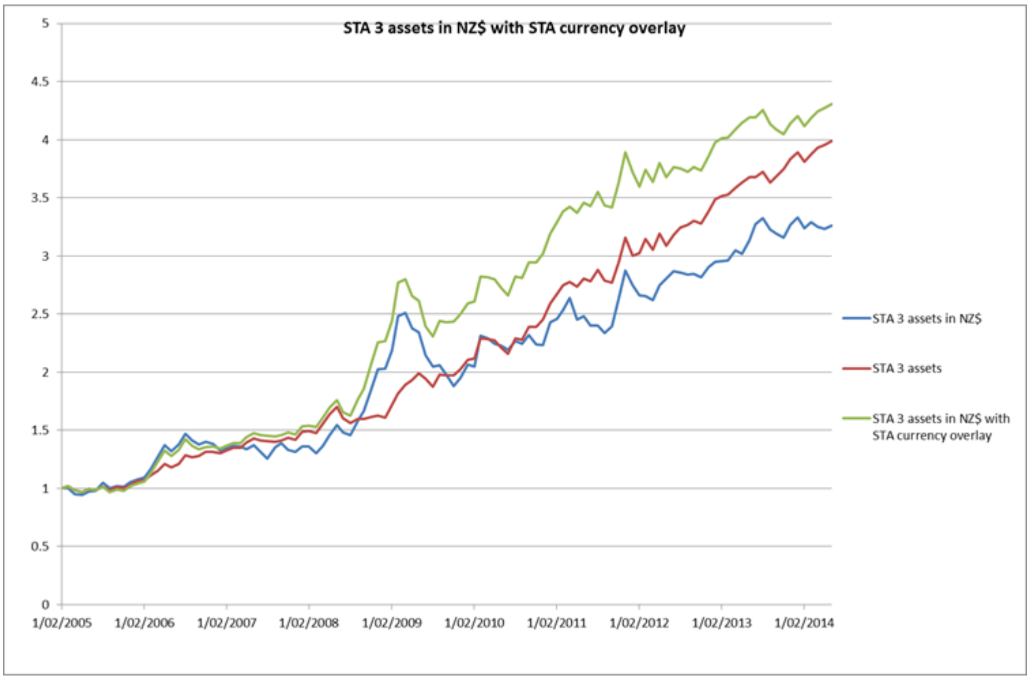


The STA Tenz plus bills return would have been 5.2% over the last eleven years, compared to 2.1% for a passive holding of Tenz.

If a New Zealander had invested in the STA Australian All Ords + Bonds portfolio and managed the currency exposure through an STA currency overlay he would have received a CAGR of 22%. Over that period thirty eight currency transactions would have been required, an average of only one per year.



Investing in actual ETF's on the US market, with an STA currency overlay, a New Zealand investor would have achieved 16.9% CAGR over the last nine years that suitable products have been available.

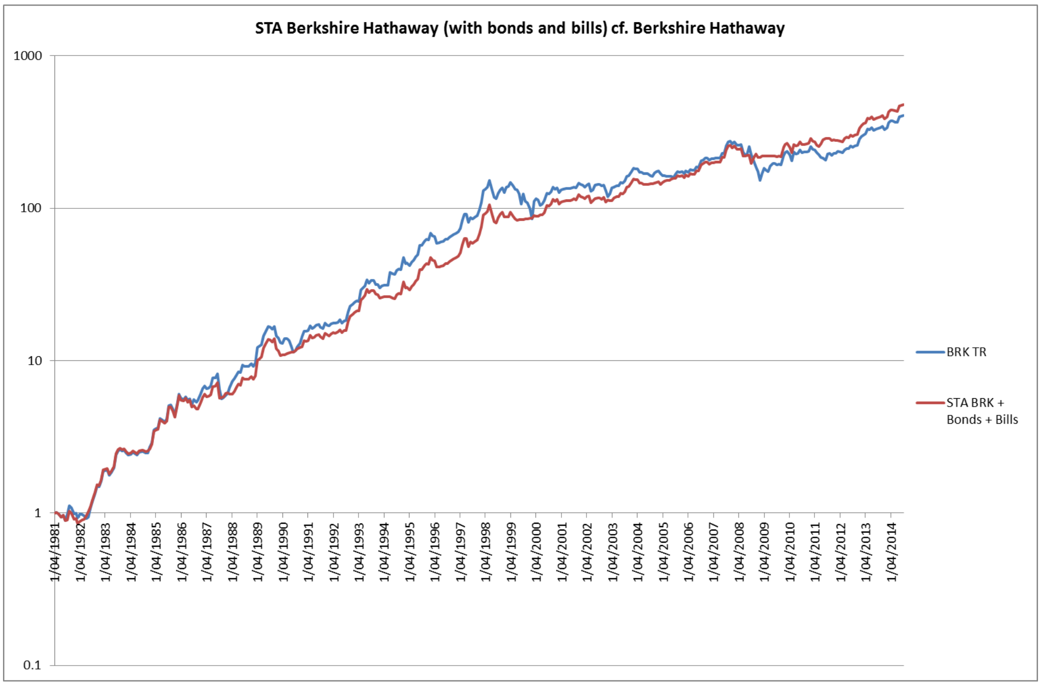


Utilising the same STA currency overlay, had a Kiwi based investor invested in the US three asset portfolio for the thirty eight years that data is available they would have received a CAGR of 21.8%.

STA compared to Warren Buffett

The STA model absolutely respects the long term value philosophy that is so fundamental to Warren Buffet's approach to investing. However, the STA model also overlays a very strong discipline that ensures investors do not succumb to the many powerful biases that unfortunately affect so many of our judgements at just the wrong time. These biases make us panic near long drawn out bottoms and get over excited, and prematurely extrapolating, near long term peaks. Warren Buffett has demonstrated throughout his career that his investing philosophy and execution are largely immune to such biases.

Given the above I wondered how an investor employing the STA approach would have fared investing in just Berkshire Hathaway stock, or, when out if it, the STA bonds and bills return. The results are shown below from 1981(the total extent of Yahoo's price history on BRK).



The STA approach has not always been ahead, although as of the beginning of October it was slightly ahead having missed a large part of the GFC associated decline. Throughout the thirty three and a half years shown the STA model has averaged a 79% exposure to BRK, with the balance invested in the STA bonds and bills return, yet has delivered similar returns but with significantly smaller drawdowns. Ahead of the dotcom peak in 2000 BRK fell 44% and took almost four years to recover back to its prior peak while over the same periods the STA model fell just 18% and was back at a new high nine months later. A similar picture was seen through the GFC. From December 2007 through to February 2009 BRK again fell 44% and took three years to recover to a new high. The STA model fell just 17% and was at a new high one year later.

None of this analysis is intended to undermine the investing prowess of Warren Buffett, rather it is intended to illustrate that similar results can be achieved through a highly disciplined investment approach that allows the average investor to avoid being swept away by the psychological biases we are so beset by.

Conclusions

The STA approach fulfils all of the rules outlined at the start. It avoids any dependence upon the sometimes comforting, and frequently extrapolating, forecasts of economists and analysts. It is relatively simple and it is certainly rules based, as a result the decisions that it drives are immune to the behavioural biases that plague most investors.

The research and back testing conducted over the last month certainly demonstrates that the STA approach has a place. It has delivered higher long term returns with less volatility than I expected and, given that some of that back testing stretched back to the early part of the last century, it seems reasonable to think that future long term returns will be similarly pleasing. Further supporting this assumption is that the more recent testing has included some of the most tumultuous market environments ever seen and employed actual products, rather than just index returns.

How the STA approach could be made more widely available is going to be explored over the coming weeks and months. I firmly believe that it has, and can offer, tremendous value.

Given the work that has gone in to developing the STA it is possible the nature of Strategy Thoughts may change. I will reflect upon this as I travel through Europe over much of the next month.

In the meantime a summary of the STA positions currently would be; totally out of most European markets, out of the Australian market, out of the small cap US market, out of gold and out of Hong Kong. The STA remains long the New Zealand market, the major US indices, Japan and US bonds over bills.

The STA has been gradually becoming more cautiously positioned over the last year; my expectation is that this trend will continue. Not that I am allowing my hopes or expectations drive my own investment decisions going forward. I will leave the last word this month to Stanley Druckenmiller who summed up many of my concerns brilliantly on CNBC in mid July, just as so many turns had already begun, or were about to begin.

> *"I am fearful that today* ***our obsession with what will happen to markets and the economy in the near term is causing us to misjudge the accumulation of much greater long-term risks*** *to our economy" – Druckenmiller CNBC*

Kevin Armstrong

8th October 2014