Strategy Thoughts

January 2017

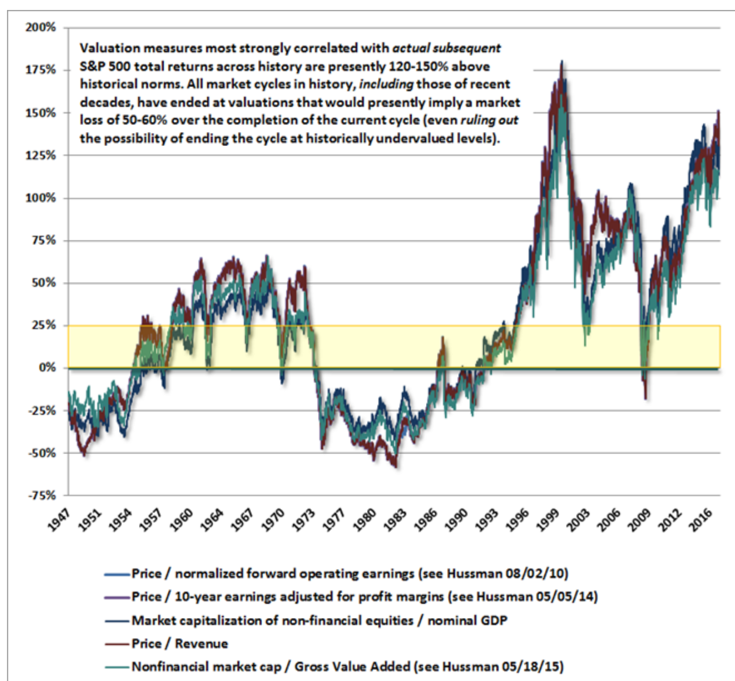
Does a New Year Change Anything?

Introduction

2017 ended amid much hype and expectation for the stock market, at least in the US, in the wake of the rally following Donald Trump's election victory. In late December a CNBC 'investment expert' forecast that the Dow would hit 20,000 in January and 30,000 in the next four or five years. More recently other commentators have come out with a selection of remarkably precise forecasts, one for 31,000 in two years, another for 38,820 as part of a 'super boom, and there has even been a forecast for Dow 50,000. The last time such numbers were so publicly discussed was in the second half of 1999 after books proclaiming Dow targets of 36,000, 40,000 and 100,000 were published. Perhaps this time it will happen, but almost certainly it won't. It is more likely that all these forecasts are just further expressions of the heightened level of expectations that are now priced into the US market. Unfortunately heightened expectations always result, eventually, in disappointment. This month's Strategy Thoughts looks at some measures of those expectations, question whether the rest of the world can withstand a US bear market through the lens of history, revisits the still rising US dollar and explores what it is that allows an STA approach to deliver the long term returns that most investors not only want, but need.

Some thoughts on Valuation

I have frequently criticised commentators who routinely employ a valuation measure as a justification for a relatively short term, six month or a year, outlook for a market. Valuation tells an investor absolutely nothing about where a market is likely to go over such short periods. However, over much longer periods valuation measures are useful, not because valuation in any way drives markets but because valuation measures, particularly when they are at historic extremes, are a key indication of the level of expectations on the part of investors. Anything only becomes historically cheap because 'everyone' knows that it is useless and never delivers a return, and conversely anything only becomes historically expensive because investors can't get enough of this asset that seems to inexorably rise in price. It is excessive expectations, either good or bad, and the inevitable disappointments and surprises that must follow, that drive markets and produce historic turning points.



John Hussman included the chart (above) of various long term valuation measures of the US market in his latest weekly commentary;

Given that long term valuation measures are an indication of investor expectations then it should be of grave concern to all investors that expectations now are more stretched than they were ahead of the Global Financial Crisis and more stretched than at any point in the last seventy years with the exception of the speculative peak associated with the tech boom of the late nineties. None of the previous peaks of historic long term valuations have ended well and, as Hussman notes in the chart, such extreme valuations have always resulted in a 50-60% bear market.

None of this means that the US market cannot continue higher, but even greater extreme valuations will be followed by an even more severe bear market. Hussman concluded his latest weekly commentary with the following;

> While we're seeing persistent signs of dispersion, particularly across interest-sensitive sectors, my sense is that investors are mistaking the market gain in 2016 as a repudiation of the idea that extreme valuations, dispersion across market internals, and overextended conditions are of real concern. My own expectation is that even if there is a longer life to this bull market, the 2016 gain will be erased rather soon, in a quite ordinary late-stage correction, much like those that emerged with increasing frequency approaching other major market peaks. Our outlook will change with conditions, particularly with respect to valuations, market internals, and the presence or absence of overextended syndromes. For now, the stock market is now much like Wile E. Coyote temporarily hovering just past the edge of a cliff. The moment of descent isn't clear, but I believe it would be a mistake to climb onto his shoulders.

I would summarise the first sentence of his conclusion as simply that the long term expectations of US investors are at an historic extreme.

Expectations

Before Christmas I noted that it was incredible how attitudes had shifted in the wake of the surprise outcome of the US election. Ahead of the election there was a very widespread belief that a Trump victory would plunge the world into chaos and depression, yet, after a hiatus of only a few hours on election night, markets have rocketed higher. The long term fear once associated with a Trump victory may actually turn out to be well founded but the eagerness with which attitudes shifted should be seen as a very major warning sign. New bull markets are greeted with great scepticism and doubt, they are not readily and eagerly embraced.

As 2015 ended strategists at major Wall Street firms had relatively subdued forecasts for the year ahead according to Business Insider, and even the most bullish forecaster twelve months ago underestimated how high the US market may rise. Now, in the wake of the Trump inspired rally, Business Insider is reporting that;

> For next year, **no strategist at a top Wall Street firm forecasts that the bull market will end**. Many expect America's largest companies to return to earnings growth and to see other benefits from Trump's promises to cut taxes and ease regulations. (emphasis added)

I have highlighted in the past that expectations through a bull market tend to be characterised as consistently underestimating how high it may ultimately go until close to the end when the consensus shifts to one of overestimation. Such a transition, in what is one of the longest running and rewarding bull markets in history, may now be occurring. This shift over the last twelve months can be seen in many sentiment indicators, including CNN Money's Fear and Greed monitor which twelve months

ago was signaling extreme fear, as it was ahead of the election. It has now been sitting at extreme greed or greed for several weeks.

How good has the last few years really been?

The success of the US market, along with the more recent strength in the US dollar, has somewhat masked how difficult the last ten years or more has been for most investors. I have long maintained that the true long term peak of the great secular bull market of the eighties and nineties in most developed markets was seen in early 2000. What has been endured since then has been a cyclical bear market into the 2002/3 lows, a cyclical bull market to the 2007 highs, a cyclical bear market down to the 2009 lows and finally a cyclical bull market that for much of the developed world ended a number of years ago but is still under way in the US and a few other markets. The result of this has been that a US dollar investor in the developed world outside of the US has received virtual zero return, even including dividends, since the 2007 peak and has endured a negative total return for the last two and a half years.

The US investor focussed solely on the US market has naturally fared much better with a total return of close to 100% since the 2007 peak and obviously much more since the 2009 low.

This success of the US market has understandably produced a heightened level of expectation on the part of investors as discussed earlier. However, this outperformance of the US versus most other markets of the world does raise an important question, how would other markets fare if the US did suffer the kind of bear market forecast by John Hussman?

What would a 50-60% US bear market mean for the rest of the world?

About fourteen years ago I produced the following chart which I used extensively in presentations and newspaper articles. It showed the enormous underperformance that the rest of the world had suffered compared to the US market over the decade of the nineties.

Back then I raised the possibility that the rest of the world may well outperform the US and that holding a ‘balanced’ international fund that, as a result of US outperformance was very overweight the US, may not be the smart move going forward. I described owning a capitalisation weighted

global fund as akin to investing by looking through the rear view mirror, one always owned the most of what had done well which is very different from owning what may do well next.

An updated version of that chart would show that from early 2002 through to late 2007 the rest of the world did markedly outperform the US. Both regions' markets obviously rose but the rest of the world delivered total returns of close to 70% more than those generated in the US. From that point on, however, the US market has delivered better total returns through both the cyclical bear market from 2007 to 2009 and the following cyclical bull market. As a result of all this, despite that period of dramatic outperformance in the mid 2000s the relative chart above would be right back down to the depressed levels for the rest of the world that were seen in the 1960s and 2000s. The same point, about the relative attraction of the rest of the world over the US, that I made fourteen years ago can easily be made now, and should be made given the remarkable level of valuation, and so expectation, discussed earlier. But this gets us back to the question raised at the end of the previous section which put another way could be, is it likely that the rest of the world will rise if the US falls by 50-60%.

History tells us that the answer to that question is NO.

Over the last eighty or more years, whenever the US market has suffered such a dramatic decline the world excluding the US has also fallen.

The total return of the US market from its 1929 peak to its 1932 trough was 80%, over the same miserable period the rest of the world excluding the US fell by 50%. Relatively speaking this was obviously a far better outcome, but still it was a 50% loss.

From the 1937 peak to 1938 trough the US' total return was negative 50%. Over that period the rest of the world fared far better but still delivered a negative 10% return.

From 1973 to 1974 the whole world suffered a similar decline in total return, For the US this was minus 41% and everywhere else minus 40%.

More recently the results for the rest of the world have been worse than that for the US. In the 2000 to 2002 bear market the US delivered a minus 44% total return while the rest of the world delivered minus 46% and during the GFC the US total return was minus 51% while for the rest of the world the comparable figure was minus 57%.

From the extreme position that the US market now finds itself, from both an absolute valuation (expectational) standpoint and on a relative return basis compared to the world excluding the US, it is highly likely that other markets will once again outperform the US, as they did in the 1970s and 1980s and for a while in the 2000s. However, it must be remembered that this performance is highly likely to be only relative in nature. Going down less than the US market is still going down. Aiming for capital preservation through the next US decline will be far more rewarding than hoping to find a market that not only falls less but that can totally buck the US trend.

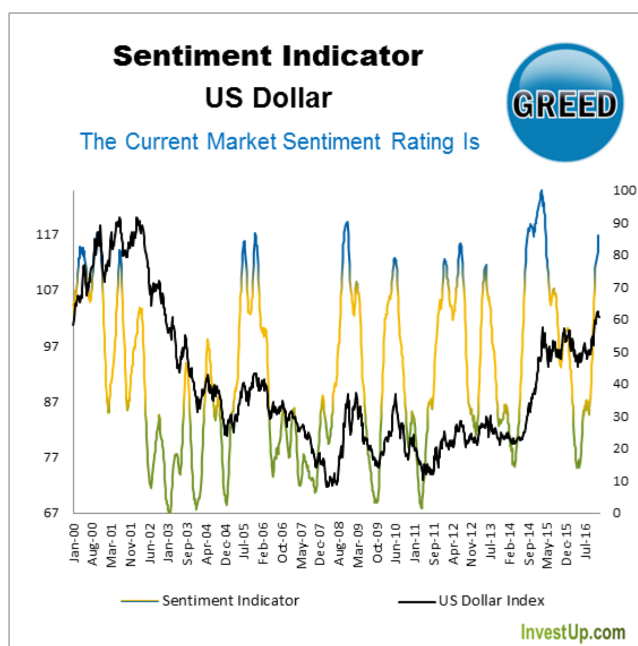
The US Dollar

Last month I commented upon expectations for the US dollar and the massive reversal that had been seen in attitudes to the dollar both over the prior six months and almost six years. I concluded that commentary with;

> Given this reversal I recently reduced my exposure to the US dollar by selling half my position in the ETF, UUP as it rallied to a new high.

I still believe that further strength in the US dollar is possible and weakness in the Kiwi is likely, however, my conviction is naturally reduced given the attitudinal shifts that have already been seen.

Since then, as can be seen in the chart (right), US dollar bullishness has only continued to grow as the currency has recorded even further new highs for the last decade. For the record I do still have my remaining half position in the ETF UUP, however, this is now more predicated on weakness from the Kiwi rather than further broad based strength on the part of the US dollar



Why does the STA Portfolio deliver long term performance?

Over the Christmas break I read a financial planning blog by Michael Kitces, "How Behavioral Biases Lead To Hard-To-Capture But Sustainable Alpha", it struck a real chord with me. It highlighted the irrationality so often present in investors' decisions and how a disciplined investor, one who was able to withstand the pressure that biases place upon us all, can generate superior returns. The most essential attribute that investors need if they are to be able to do this is discipline and it is that discipline that an approach such as the STA portfolio provides.

Behavioural Biases

Michael Kitces blog highlighted a number of the many biases that cause all of us to behave in a manner that could be seen as irrational, and is certainly a long way from being the cold calculating individual 'homo economicus' that forms the basis of so much of the 'theory' that supports and shields the investment industry. These biases include;

Exhibit a "recency bias", where we overweight what happened recently and extrapolate it into the future (e.g., since markets are rallying, they're going to continue to rally, and I should buy more!).

– Show an "availability bias", making us more willing to invest into stocks we can readily recall (e.g., since Apple products are popular, we presume Apple must be a good stock to invest in…even without ever actually look at the underlying investment fundamentals).

– Perceive less risk in something we have familiarity with (thus helping to explain why so many are so comfortable keeping concentrated positions in their employer – because it feels like a known quantity that is "safe", even if the employee has no actual access to special information that markets don't!)

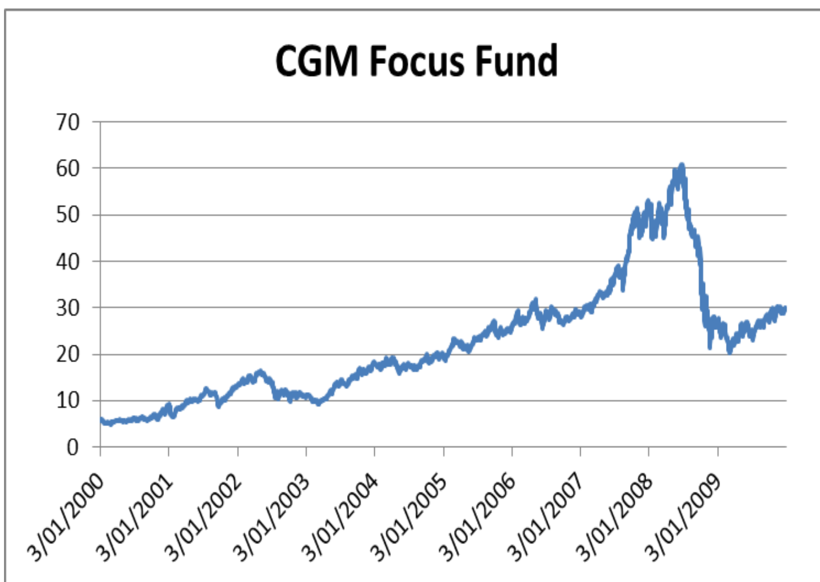
– Pursue gambles that have significant upside potential, despite their improbable outcome (which explains why we continue to buy lottery tickets with a highly negative expected value)

– Exhibit a significant aversion to losses and debt

– Move with the herd, showing a strong bias to do what everyone else is doing, and avoid the risk that comes with being singled out (especially if there's a bad outcome and someone needs to be blamed

All these biases result in markets trending, extending and then cracking. Capturing as much of the trend as possible and avoiding the pain of the crack must be the aim of any investor seeking long trem satisfactory returns.

Discipline, or why most investors lose!



As 2009 drew to a close the Wall Street Journal profiled some of the best mutual fund managers of the prior decade. The standout winner was the $3.7 billion CGM Focus Fund, run by Ken Heebner in Boston.

The fund had delivered an annual return of more than 18% a year over the decade, more than 3% more than its nearest rival, but that decade had been volatile, as the chart of the fund's total return shows:

The result of that extreme volatility was that the average investor in CGM got nothing like the high double digit return the fund actually produced. In fact according to Morningstar the average investor in CGM actually LOST 11% a year!

As the Wall Street Journal described;

Too bad investors weren't around to enjoy much of those gains. The typical CGM Focus shareholder lost 11% annually in the 10 years ending Nov. 30, according to investment research firm Morningstar Inc.

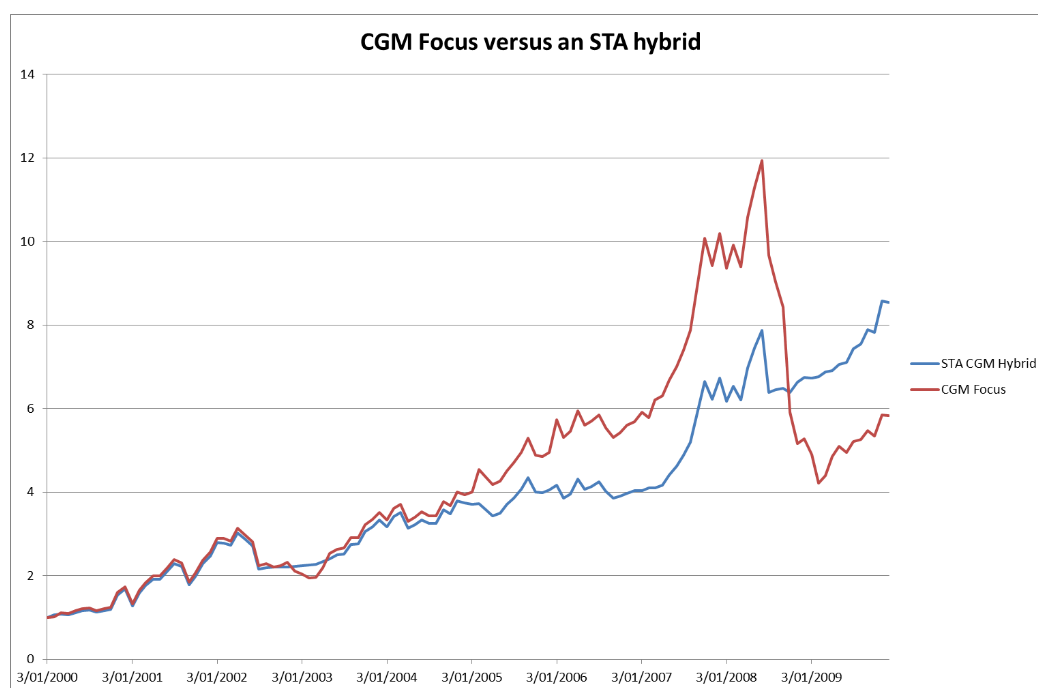
These investor returns, also known as dollar-weighted returns, incorporate the effect of cash flowing in and out of the fund as shareholders buy and sell. Investor returns can be lower than mutual-fund total returns because shareholders often buy a fund after it has had a strong run and sell as it hits bottom.

At the close of a dismal decade for stocks, the CGM Focus results show how even strategies that work well don't always pay off for investors. The fund, a highly concentrated portfolio typically holding fewer than 25 large-company stocks, offers "a really potent investment style, but it's really hard for investors to use well," says Christopher Davis, senior fund analyst at Morningstar.

The gap between CGM Focus's 10-year investor returns and total returns is among the worst of any fund tracked by Morningstar. The fund's hot-and-cold performance likely widened that gap. The fund surged 80% in 2007. Investors poured $2.6 billion into CGM Focus the following year, only to see the fund sink 48%. Investors then yanked more than $750 million from the fund in the first eleven months of 2009, though it is up about 11% for the year through Tuesday.

"A huge amount of money came in right when the performance of the fund was at a peak," says Mr. Heebner, the fund's manager since its 1997 launch. "I don't know what to say about that. We don't have any control over what investors do."

Ken Heebner is right, he had no control over what investors do, and it is a sad fact that the vast majority of investors chase, and want a piece of, whatever HAS been hot. This always leads to disappointment and clear stems from those behavioural biases outlined above. In order to overcome those biases all successful investors are disciplined, and importantly remain disciplined even when whatever discipline they utilise is producing lesser results than something else that is HOT. The STA approach that I outline in detail in **Investing: The Expectations Game** is just one form of discipline that any investor could easily factor into their approach. The chart below shows the effect of overlaying the STA approach on Mr Heebner's fund through the decade described by the Wall Street Journal.

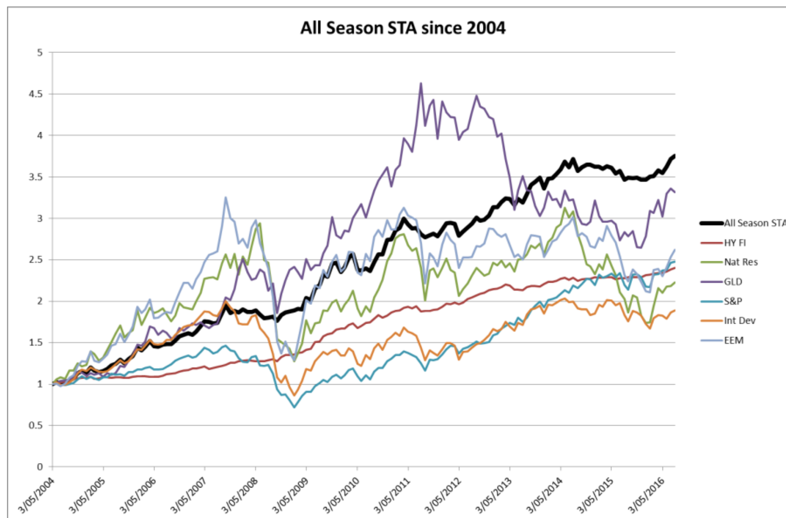


Utilising the STA approach an investor was invested in the CGM Focus fund two thirds of the time, the balnce of the time the investor would have been in the STA fixed income portfolio. Far from actively switching between the two funds the STA investor only made 16 switches over the decade, on average a trade every 7.5 months. Clearly over the decade the STA approach delivered superior and importantly less volatile returns but for much of the decade the STA approach lagged the fund itself. No approach is only going to give an investor all of the good but none of the bad, but a disciplined approach that avoids the worst of the drawdowns and captures much of the upside is clearly superior to the result achieved by most investors who only got involved when the fund got hot.

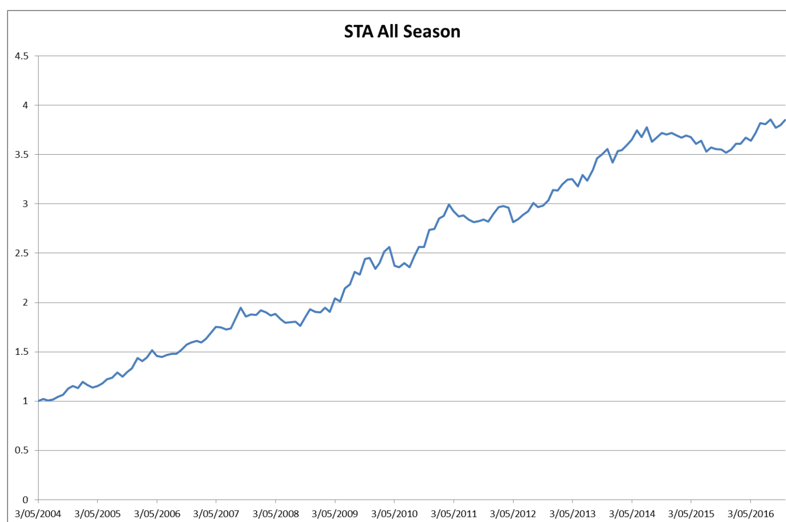
Update on the All Season STA

Last October I presented the 'All Season STA Portfolio' compared to its constituent parts as shown in the chart below. It is obvious that the majority of the underlying elements of the portfolio have been

far more volatile than the portfolio and that over the entire history available none of those elements has done better than the portfolio. From a behavioural perspective the STA approach forces an investor to do things that are by definition different to that which the majority are doing. This is obviously uncomfortable at times but comfort and success rarely go hand in hand when investing.



The performance of the STA All Season portfolio can now be updated, including the convertible bond fund in the fixed income calculation that I discussed last month.



The STA All Season Portfolio is currently 37% invested in fixed income which is equally split between converts and high yield, there is no exposure to intermediate treasuries currently. The portfolio has no exposure to either gold or emerging markets and is half weighted to international developed markets which it has been largely unexposed to for much of the last eighteen months. It has been back in natural resources for the last ten months and remains fully exposed to the S&P500, a position that has remained largely unchanged since 2011. Over the last twelve months the STA All Season Portfolio has returned 9.4%, over the last five years it has returned 36.5% and its compound annual growth rate since 2004 has been 11.3%

Conclusions

I concluded last month's Strategy Thoughts with the following;

> 2017 will likely be a very uncomfortable year for any investor currently seeking the comfort of the herd and relying upon things working out positively as so many now forecast. On the positive side it will likely be a year that presents some of the best investment opportunities of the last seven years for the disciplined investor who is currently prepared to sell the Trump driven rally, rather than buy any dip.

Over the holiday period of the last few weeks nothing has occurred to alter my outlook. In the US it may seem that further new highs and even greater rewards lie ahead for 2017 as the Trump honeymoon continues and that getting out now may be as dangerous as jumping off a moving train. However, getting out now is likely to be substantially less painful than staying on board and suffering the 50-60% fall that John Hussman described when the current 'runaway train' finally derails.

Kevin Armstrong

13th January 2017

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