Strategy Thoughts

October / November 2016

"I HAVE BEEN CONCERNED FOR A FEW YEARS"

Carl Ichan on CNBC 17/10/16

Introduction

When I read billionaire investor Carl Ichan's comments they certainly struck a chord with me, he went on to imply that the more time passed the more concerned he became. This is the sensible and logical conclusion to come to; however, it is not the path that most investors follow. Unfortunately one of the many behavioural biases that best most humans is recency bias. This bias tends to result in the extrapolation of recent trends way into the future and to ignore the much longer term framework. The longer that trend continues the more convinced we become that the trend is valid and long lasting. In markets this results in investors becoming more confident that nothing bad will happen the longer that nothing bad has happened for. This then builds complacency and history has repeatedly shown that markets peak amid such complacency and that something bad tends to happen when the majority least expect it and are least prepared.

This month I examine how long it has been since anything really bad happened, I outline a number of the reasons why, like Carl Ichan, my levels of concern have continued to rise, and finally I provide an update to the All Season STA portfolio that I introduced last month and has attracted a lot of interest, and questions, since then.

I too have been concerned for a few years

Generally levels of concern on the part of most investors do not appear to be overly elevated and there continues to be a high level of confidence in the ability of central banks to do 'whatever it takes' to prevent anything bad happening. This is particularly interesting, and amusing, to me. The faith in 'the authorities' or central bankers, as I outline at length in Investing: The Expectations Game, really came about in the wake of the 1987 crash and then again in Japan in the later eighties when it was believed that 'they'(whoever they were) would do whatever was necessary to keep the bull market going. It really is amazing that so many still believe in the ability of some powerful body to control the markets and the economy. Firstly, a casual review of what happened in Japan through the nineties should be enough to disabuse even the most optimistic of investors of the idea that 'the authorities' could drive growth and prevent anything bad happening in markets. Secondly, the results in the US have been no better, the 'Committee to Save the World', as Time magazine named them in 1999, Alan Greenspan, Robert Rubin and Larry Summers, didn't exactly prevent anything bad happening. Within a year of them being hailed so publicly by Time the US market peaked and began its worst bear market since the seventies and the high flying NASDAQ lost eighty percent of its value. Seven years later, ahead of the GFC, there was once again a widely held comfort that nothing too bad would be 'allowed' to happen, and then the world suffered the most dramatic and painful stock market and economic collapse since the 1930's. What is truly remarkable is that the misplaced faith in 'the authorities' persists and investors continue to take comfort in the idea that nothing too bad will happen.

Four years ago I titled the September 2012 edition of Strategy Thoughts;

Don't Chase Yield! And don't believe in the 'Music Man'!

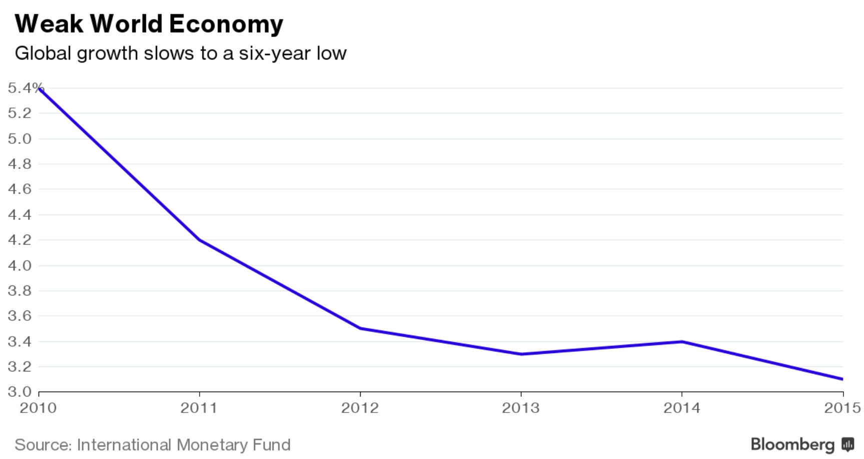
The message in that title continues to be just as valid, in fact probably more so, as it was four years ago. That edition contained an extract from a Wall Street Journal article

The Music Men

The illusion that central banks alone can conjure faster growth. WSJ 1st August 2012

> "As the financial world breathlessly awaits word this week from the Federal Reserve and European Central Bank, we can't help but think of "The Music Man." In that classic if now dated musical, the residents of an Iowa town are gulled by a huckster selling band equipment. They desperately want to believe in his power to solve their town's delinquency problems, until they discover Harold Hill can't play a note. Central bankers are today's music men, the maestros we desperately want to believe can rescue the world economy by playing one more monetary tune. Buy more bonds and lift the stock market! cry the boys at Pimco and Goldman. Pay less for bank reserves! shout the Princeton professors. Promise to keep rates at near-zero until 2015—or 2016 or 2017—beg the politicians. And so Mario Draghi and Ben Bernanke will try to sell us 76 more trombones. Sooner or later we'll discover that their money illusion can't save an economy from its more fundamental problems, and that they may even be interfering with the faster growth they want."

So now, four years later it is worthwhile checking in to see whether the 'Music Men's' efforts have achieved the desired results. The chart below should not be very encouraging.



And even the IMF are not impressed and have growing concerns.

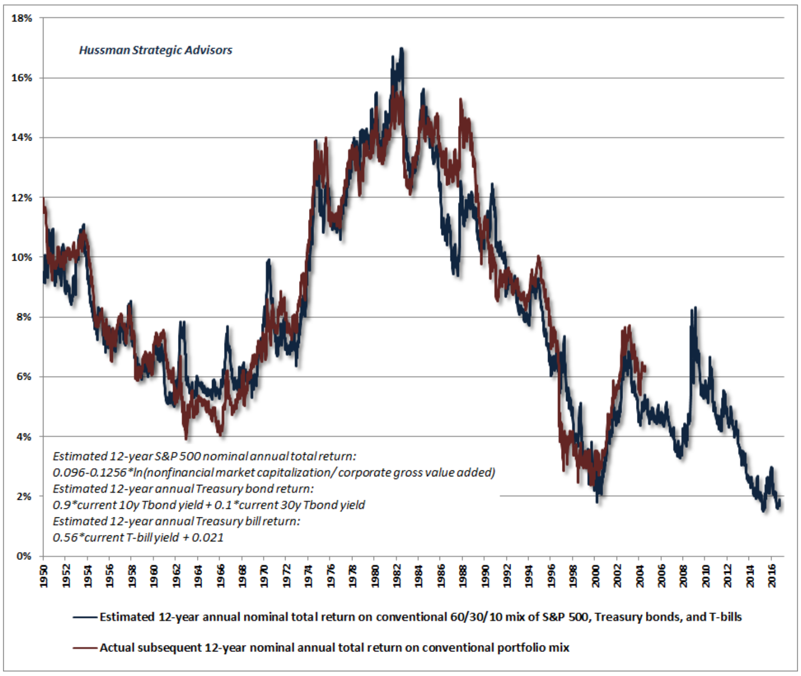
> Rising political tensions over globalization are threatening to derail a world recovery already seeking a reliable growth engine, the International Monetary Fund warned. Bloomberg 4/10/16

Even the most Panglossian of observer cannot be too impressed by 'the authorities' efforts to date since the GFC. It probably could be argued that the graph above would look even worse if 'they' hadn't done what they did, but there has certainly been a cost as highlighted by Bill Gross;

> **Bill Gross says global markets are one big casino created by central banks:** Bond guru Bill Gross says global markets have transformed into monolithic casinos fostered by the easy-money policies unfurled by the world's central bankers.

And whilst the efforts have not generated the growth so many expected and desired it may well have laid the groundwork for something bad to happen. Now is certainly not the time to be less concerned, especially if that reduction in concern is just because nothing truly bad on the scale of the GFC has happened yet.

Someone else who has been concerned for some time is John Hussman of Hussman Funds. I have been reading his weekly missive for many years now and have a deep respect for the detailed analysis he conducts and particularly for the disciplined approach he takes that allows him to take what at important peaks and troughs has appeared to be deeply controversial and contrary positions. This week he included the following chart in his letter. The blue line shows the twelve year return that he calculates a balanced portfolio will achieve and the red line shows what the twelve year return actually ended up being. The two lines have followed each other remarkably closely, which should be alarming for any long term investor who is currently taking comfort from 'the authorities' assurances. The projected twelve year return is currently the lowest that has ever been projected in the entire nearly seventy years of history shown. It is lower than the projected return in 2000 and in 2007.



John Hussman concluded his latest weekly letter 'Calm before the Storm' with the following

> I believe that I've been sufficiently clear about the evidence that drives our concerns, and that I've appropriately recognized and adapted to our own challenges during the speculative half-cycle since 2009. Still, in more than three decades as a professional investor, I've found that there's nothing like the completion of a market cycle to drive home the point that a disciplined focus on the market return/risk profile is essential, and that "this time" is never as "different" as Wall Street encourages investors to imagine. As a fully-leveraged "lonely raging bull" in the early 1990's, I found it nearly impossible to convince investors that market prospects were positive, as they imagined that the "Bush recession" would never end. In 2000 and again in 2007, it was nearly impossible to convince investors of the speculative extremes and downside risks of markets where the "old rules" didn't seem to apply. Once a market cycle is completed, everything seems obvious in hindsight. Soon enough, investors will wonder why they didn't consider the extreme risks of the current environment to be just as obvious.

The completion of this current market cycle, unlikely as it may currently seem in the US equity market and other buoyant regions like New Zealand, will not be something that most investors would want to ride through. But then most didn't choose to ride through 2007-9 or 2000-3. They were just caught there and then trapped. In the early stages they were caught by being comforted that whatever was happening was just a healthy correction and then through the middle and later stages became trapped, hardly daring to look at how bad things had become. Ultimately, as the general commentary grew gloomier and gloomier many unfortunately bit the bullet and threw in the towel at the point of maximum pain and invariably just at the wrong time. It was actually the point of maximum opportunity.

Perhaps what is most surprising is that investors have remained and possibly become more comfortable with markets even though, despite nothing truly bad having happened, things have not been that rewarding either, the 'calm before the storm' analogy of John Hussman may be quite appropriate.

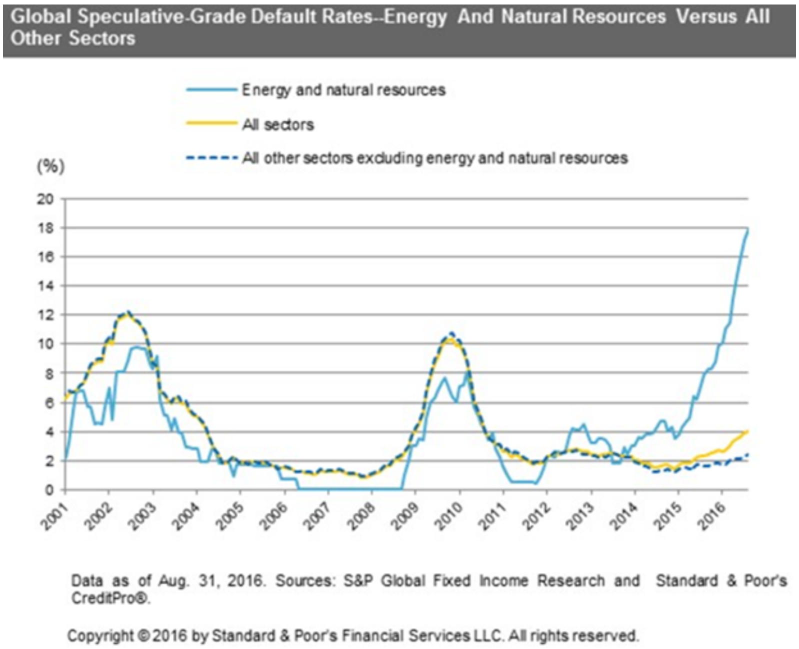
A quick but far from totally extensive review of global equity markets reveals that for most countries and regions little if any progress has been made for years. The Singapore and Korean markets are flat over the last five years or more, Malaysia is flat over the last four years, Hong Kong, Europe and Australia are flat over the last three years, Japan, China, Taiwan and the Dow Jones Industrial Average over the last two years and India and the NASDAQ over the last year. Stand out performances have been seen in Argentina and New Zealand, but even the NZX50 has fallen 8% over the last month and a half. The Brazilian market has also delivered great gains recently, but these have only brought the index back to a level below where it was as long as four years ago and well below levels seen in 2010.

With equity markets broadly having marked time, despite the enormous stimulus efforts that have been enacted globally it should also be of concern that longer term government bond yields have begun to rise. Bonds, until the middle of this year have been very rewarding for investors, with yields falling to record low after record low. However, yields have started to reverse, and contrary to the majority's expectations even longer dated Treasury bond yields have been rising as I have noted over the last few months. The ten year US Treasury bond yield has now risen to 1.8% from a low of just 1.34% a little over three months ago.

Over the same time period German ten year bond yields have also risen from -0.2% to a slightly positive number, Japanese yields have risen from almost -0.3% to close to zero and Australian ten year yields have jumped from 1.8% to 2.3%.

These may not be huge moves, but they are contrary to what may have been expected if it had been known that global growth would continue to disappoint the way it has and that it currently shows no real sign of surprising on the upside.

At the same time default rates on high yield bonds have also begun to rise.



It may be tempting to dismiss this rise in defaults to the challenges that the energy and natural resource sector has faced, as the chart above attempts to, however, defaults have now been rising in all other sectors for the last two years.

Financial stocks should also be raising investors' level of concern

Global financial stocks, US financial stocks and the value of US regional banks, all peaked in mid May 2007, four and a half months prior to the peak in the global and US stock market. This time around all these financial sectors peaked in June last year, more than fourteen months ahead of the peak to date in the US stock market.

In the last month Bloomberg reported;

> Goldman Sachs Group Inc. plans to cut about a quarter of its investment-banking jobs in Asia, excluding Japan, because of a slump in deal-making in the region, according to a person with knowledge of the matter.

CNBC reported;

> Bank of America set to cut about two dozen Asia investment banking jobs.

And that

> Bridgewater Associates, the world's largest hedge fund by assets, has announced a firm-wide "renovation" that will include employee layoffs, according to someone familiar with the matter.

In mid August Bloomberg reported;

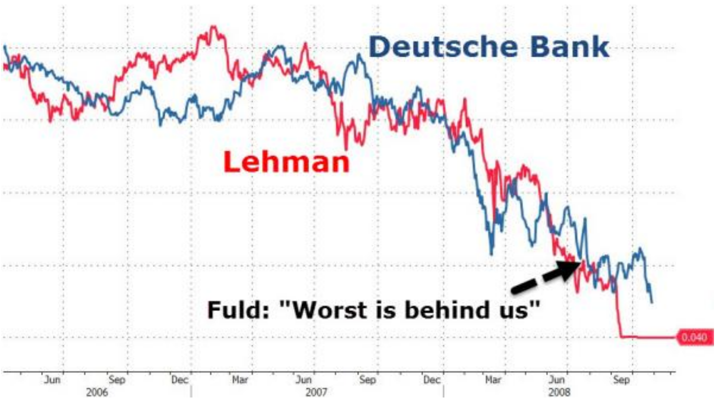
> Billionaire Paul Tudor Jones dismissed about 15 percent of the workforce in a shakeup at his hedge fund that's reeling from more than $2 billion in investor withdrawals this year.

Financial News reported;

> Investment banks could start another round of European lay-offs in the coming months as they struggle with a deal slowdown and placid markets, industry watchers said.

And the FT reported that Deutsche Bank would be looking to cut 9,000 jobs and exit up to ten countries. But then Deutsche Bank has a wider set of problems. The outlook for financial stocks looks challenging and the genral weakness they have been demonstrating should be anything but encouraging.

As an aside I thought the overlay that Zero Hedge published recently comparing Deutsche Bank now and Lehman Brothers in 2008 was an interesting, albeit a little contrived, comparison.

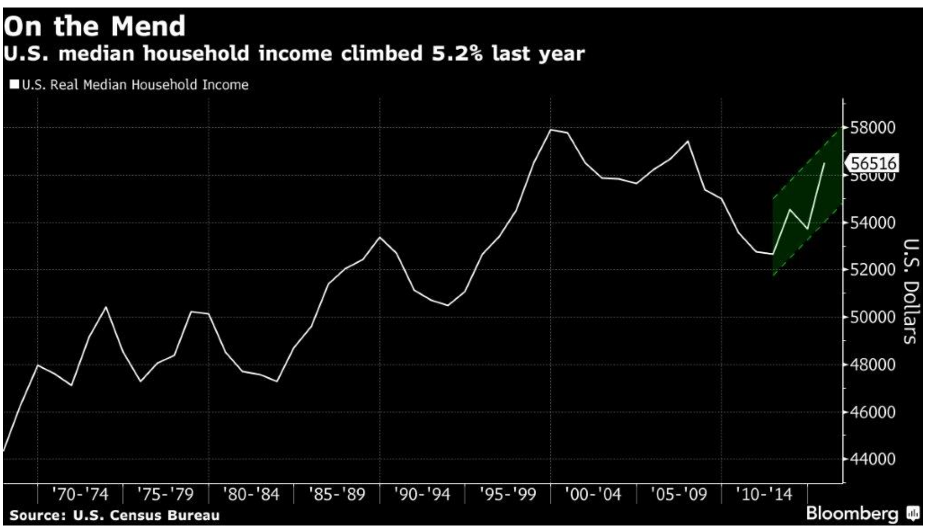


Whether or not Deutsche Bank will survive in its current form only time will tell but the broader poor performance of financial stocks, complacency in the face of deteriorating growth, rising defaults and longer term government bond yields and an increasingly obvious impotence on the part of central bankers to 'do whatever it takes' should all be reasons for growing levels of concern

Is it 2007 all over again?

The following headline and chart caught my attention.

U.S. Household Income Rises for the First Time Since 2007

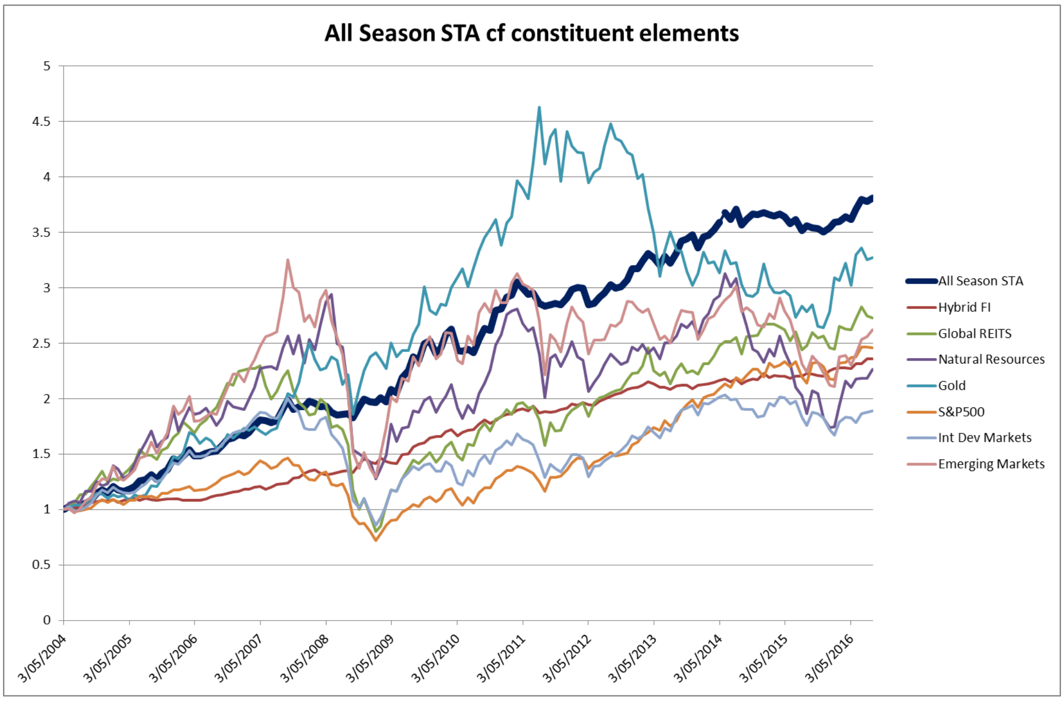


I am sure that it was meant to be an encouraging piece of news, household incomes are rising. But the question that an investor should be asking is does that mean they will continue to rise. The reason, apart from central bank stimulus, that the US market has been performing well on a relative basis globally is that things have been better there than in most other regions. The fact that household incomes have been rising for the first time since 2007 is why the market has risen, it tells us nothing about what may happen next. In fact an investor who survived and remembers the GFC should take no comfort from this news whatsoever, household incomes were rising, as the headline says, back in 2007, but that certainly did not mean anything good for the markets. In 2007 incomes did rise, but they never rose back to the levels seen at the previous peak in 1999, and this time around, even though they have risen they are still well below where they were eight years ago and even further below where they were sixteen years ago.

In some ways the chart above illustrates the secular nature of the unwinding that is still taking place in much of the developed world. The bull market of the eighties and nineties was a wonder to behold and be part of, but since then a secular bear market has been unfolding. When it finally ends it would not be surprising to see US household income levels below the recent low of a few years ago, although by the time those numbers have been seen and discussed in the media it will be highly probable that finally a new secular bull market in equities will have begun.

The All Season STA (update)

Over the last few weeks I have met and heard from many readers of Strategy Thoughts at various events promoting Investing: The Expectations Game and the most common question I have received has been “how can I invest alongside the STA portfolio?” My response has been that this rules based approach to investing continues to be a work in progress, however, a sensible, efficient and low cost solution may well be in sight. As I mentioned a couple of months ago, inspired by Ray Dalio’s ‘All Weather’ portfolio, I adapted the STA portfolio to become more of an ‘All Season’ portfolio that included high and low quality bonds, US stocks, global developed stocks, emerging market stocks, natural resource stocks and gold. To that mix I have now added global real estate stocks. The results are shown below.

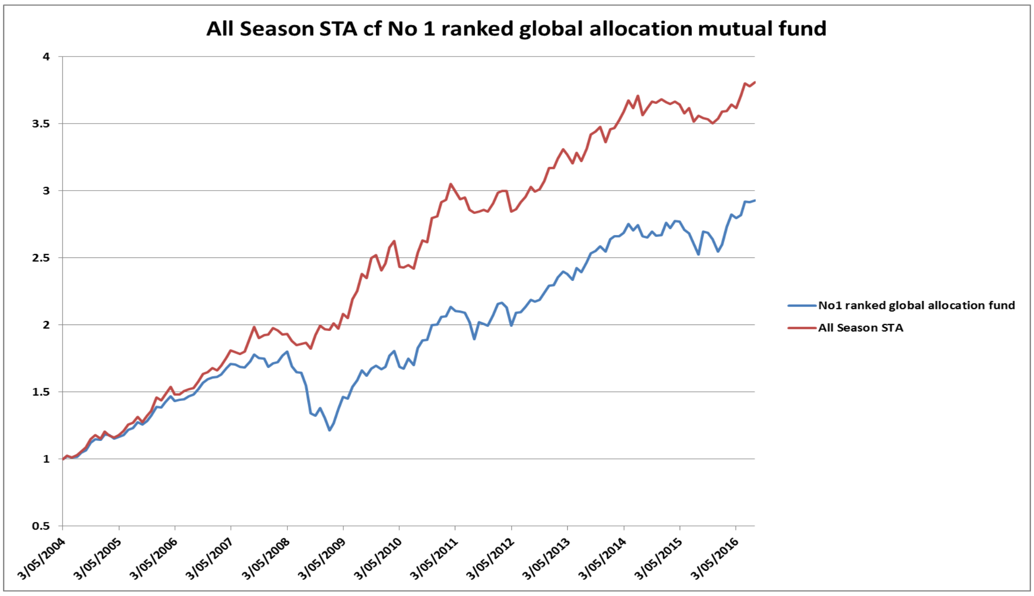


Over the twelve and a half years of history available for the STA All Season portfolio the average asset allocation has been 29% in the S&P500, 17% in intermediate US treasury bonds, 13% in high yield bonds, 8.5% in natural resource stocks, 8.5% in gold, and 8% each in emerging markets, international developed markets and international real estate.

It is clear from the chart above that the All Season STA has certainly not always been the best performing investment, however, it has avoided the severe drops that most other assets have suffered and only the hybrid fixed income portfolio has shown less volatility, but at the cost of lower returns of 7.26% p.a. Some details of the All Season STA portfolio include.

- The compound annual growth rate of the All Season STA has been 11.46%.
- The average rolling twelve month return has been 11.42%.
- The worst rolling twelve month return has been -8%.
- The best rolling twelve month return has been +33%.
- The standard deviation of rolling twelve month returns has been 9.3%

Over the last twelve years these would have been highly satisfactory returns for most investors, particularly given the extreme volatility, both good and bad, that most asset markets endured, so I sought some comparisons.



Comparing the All Season STA to the number one ranked global allocation fund reveals similar performance much of the time, however, most of the major decline through the GFC was avoided in the STA portfolio. The rules based STA approach continues to stack up well, particularly for the investor who's nerve may be severely challenged by another bear market. Avoiding the pain of a severe sell off is probably the most valuable attribute that the STA approach delivers as it ensures that an investor will stay the course rather than panicking at the point of maximum pain.

Buying what's hot revisited

In Investing: The Expectations Game I warn readers of the danger of buying whatever the hot new sector may be. Unfortunately the manufacturers of investment products do not launch the funds that they truly believe are going to deliver the best returns, the launch the funds that are easiest to sell. In Investing: The Expectations Game I wrote;

> It is important to remember that most fund management organisations are primarily focussed upon growing their assets under management. As a result the new funds they sell are by definition those that they think they can most easily sell the most of, not what they genuinely think will deliver returns. Sadly, when it comes to investing, the funds that are easiest to sell are those that would have given the best performance had they been available over the prior few years. But of course, before that performance occurred, very few would have invested at that time.

I was reminded of this when I began to look for a Global Real Estate fund to include in the All Season portfolio. As I scanned down the list of Global Real Estate funds, as ranked by US News.com, it was absolutely staggering; almost all of them were launched in 2006 or 2007, just at the crest of the real estate boom and just in time to capture the worst of the bust through the GFC. It wasn't until I got down to number 20 that I found a fund with sufficient history to be included.

This headline from Kiplinger in December 2006 reflected the mood of the time as fund after fund was being issued;

> **Investing in Foreign Real Estate Goes Mainstream**
>
> New international real estate funds with low minimums let you to take advantage of property growth overseas, and they provide portfolio diversification.

By the time such headlines were appearing the global real estate sector had delivered annual returns of close to 40%, and five year annualised returns of more than 35%. One year later, after the flood of new funds had hit the market, the one year return had fallen to -18%. Then through 2008 the one year figure collapsed to -40%. If an investor had been swept up by the enthusiasm outlined in such glowing headlines as above, and all the propaganda put out by fund managers gathering assets in possibly the hottest sector in the markets, they would certainly have been disappointed. Three years after that headline appeared the three year annualised return was a devastating -15% and by December 2011, five years after that headline appeared and the world was awash with real estate funds, the annualised return had plummeted to -3%.

So What's Hot Now?

The simple answer to this question continues to be YIELD. In what is largely a zero interest rate world with close to $12 trillion of bonds, mostly issued by governments, yielding negative returns it is understandable that investors have been seeking yield wherever they can find it. Understandable it may be but advisable it almost certainly is not.

I have frequently quoted the saying of Ray DeVoe that more money has been lost chasing yield than at the point of a gun, and I particularly strenuously employed that saying when investors were last aggressively chasing yield and finding it in CDO's and other exotic and higher yielding instruments eight and nine years ago. The danger of chasing yield was horribly brought home to many back then, but incredibly the lesson that was so painfully learnt has now been forgotten. Pressured by historically low and negative yields investors are once again chasing. The biggest inflows to mutual funds and ETF's are those boasting a current yield. In the year to date inflows into high yield bond funds in the US have totalled $11.1 billion. This compares with outflows at the same point last year totalling $2.8

billion. The message all investors need to remember is that just because a certain level of yield or return is required it does not have to be available, and if it is it may very well not be sustainable.

Conclusions

I concluded last month's Strategy Thoughts with;

> August may have been fairly quiet in global equity markets; unfortunately I fear that this is a sign of complacency rather than health. I continue to see an array of risks that are more likely to result in disappointments for investors, rather than positive surprises, and therefore continue to view preservation of capital as being what should be the primary goal of all investors.

Since then volatility as measured by the VIX index has spiked sharply higher, first in early September and then again in early October. I continue to believe that this increase in volatility is merely a prelude to what may be a more challenging period over the next six to twelve months.

As I wrote at the outset, I have been concerned for some time, and the lack of anything really bad having happened only makes me more concerned, certainly not less concerned.

Kevin Armstrong

19th October 2016