Strategy Thoughts

September 2016

A world of Uber Complacency

The problem with 'Other People's Money'

"Every cycle in human history has ultimately come to an end. Credit-enhanced cycles come to worse ends than the normal kind." Tad Rivelle, chief investment officer of fixed income at TCW Group

Introduction

Over the last month most equity markets have been fairly quiet, this may be seasonal or it may hint at a growing level of complacency. This month's Strategy Thoughts explores the world of 'Uber Complacency', a term coined by hedge fund manager Jeffrey Gundlach. It also looks at where expectations may currently be for an asset that hasn't been so quiet recently, oil, and raises the possibility that a disappointment may be approaching.

Finally in this month's edition I pick up on a topic I aimed to cover last month but ran out of time and space, 'The Problem with 'Other People's Money'. An outstanding book that touches on a number of issues that should concern anyone involved in or with the fund management and investment business, a group that I should imagine would include most readers in one form or another.

Complacency

In October 2007 the US stock market had just recovered from one of its worst sell offs of the prior four years, a close to 10% plunge in just a few weeks. At the time the overwhelming sense was that a bullet had been dodged and that things could get back to what the majority had become accustomed to accepting as 'normal', steadily rising and rewarding markets. This was despite there being clear evidence of a housing collapse, with home prices (which were supposed never to go down) having been falling for more than a year, the collapse of two Bear Stearns hedge funds, massive losses being announced by global investment banks, supposedly AAA rated CDO's losing half their value, commodity prices soaring and fewer and fewer markets joining the US market at new all time highs. I concluded the October 2007 edition of Strategy Thoughts with;

> History may not repeat but the rhymes of previous credit unwindings may be just as unpalatable as they have been in the past.

With the obvious benefit of hindsight it is now obvious that my comment was a massive understatement. Unpalatable is a very gentle term for what subsequently became known as the Global Financial Crisis and saw stock markets around the globe plunge between fifty and eighty percent. It is worth remembering that the vast majority of economists thought that a recession was a very low probability, the IMF raised their global growth outlook to the highest level they had ever published and the majority of stock market commentators viewed the recovery back into October 2007 as further evidence supporting the then conventional wisdom that dips were a gift that should be bought. The fact that the market was rallying in the face of all those concerns listed above was seen by some as evidence that the market was still climbing the 'Wall of Worry'. I have frequently employed the metaphor of 'The Wall of Worry' and the opposite metaphor of 'The Slope of Hope'. However, the presence of things to worry about does not automatically mean that the market will rise. The 'Wall of

Worry' metaphor is really intended to be used as a way to gauge the prevailing mood of the majority of market participants. There are always things that investors can choose to worry about, it's whether they do or not that really matters. When a market is hitting new highs and no one seems concerned about the litany of things that could be worried about, ironically that is when an investor should worry. It shows a high level of complacency and this approach certainly paid off nine years ago.

Now, nine years later, the US market is once again hitting new highs and out performing much of the rest of the world, all while there appear to be so many things that market participants could choose to worry about. Zero Hedge last month listed a few of them;

- First half US GDP growth disappoints.
- Donald Trump wins the Republican nomination.
- Oils rally from extreme lows falters.
- Gold ETF's attracting near record inflows.
- Britain votes to leave the EU.
- $13 trillion of sovereign debt sports negative yields.
- Global economic growth so sluggish that US 10 year treasury yields fall below 1.5%
- Federal Reserve guidance on future interest rate policy is ignored by the market.

All or any one of these things could be seen as reasons to be fearful, but with the US market hitting all time highs it is clear that many are choosing not to worry

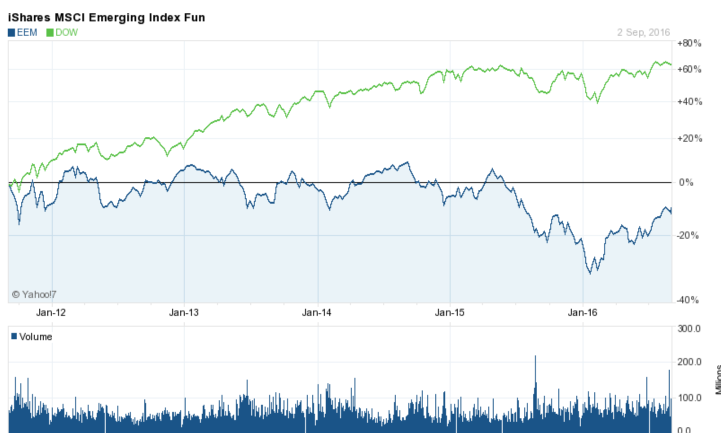
Expectations, and does low volatility mean anything?

Whilst the US market has performed well, despite all the above mentioned 'worries', the same cannot be said for the rest of the developed world. Year to date, through to the 2nd September, performance has been poor on a currency adjusted basis. The following are the returns for developed markets year to date in US dollars

- US +6.6%
- UK -0.3%
- Japan +0.1%
- France +0.9%
- Germany -0.3%
- Sweden -2.1%
- Switzerland -3.0%
- Italy -17.7%
- Spain -4.2%
- Singapore -0.4%
- South Korea +12.8%
- Australia +4.2%

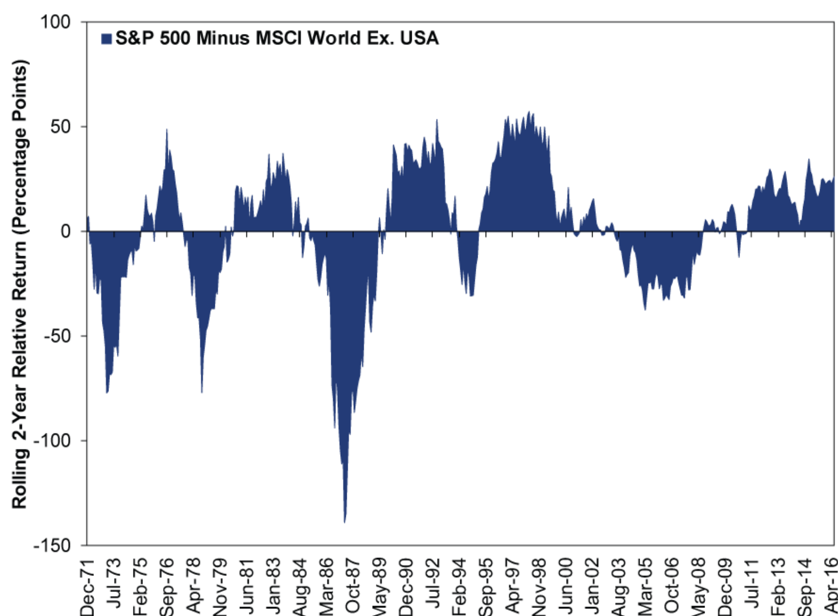
Over a longer term basis the performance of the US compared to the rest of the world can be seen in the following chart of the MSCI World ex US iShare compared to the Dow Jones Industrial Average.

Over the last five years the Dow has risen by more than 60% whereas the world ex the US has barely remained flat.



On a shorter term basis the emerging markets have delivered spectacular returns with the emerging markets iShare returning about two and a half times the return of the US market, however, over the last five years the story has been quite different.

In spite of all the reasons to be concerned the US has continued to rally and the hope seems to be that a stronger US economy will bring the rest of the world along, and with it their stock markets. Undoubtedly, eventually the relative out performance of the US versus the rest of the world will be undone, it always has;



Unfortunately, the unwinding of relative outperformance does not necessarily come through one region going up more than the other. The same unwinding can be achieved through one, in the case the US, going down more. My concern is that the complacency described in the US is not necessarily that unusual and that therefore the US market is set to roll over soon and in so doing it will join the many other markets and regions of the world that have already been suffering cyclical bear markets, in some cases for several years.

One thing that will likely change with this transition is that volatility will pick up.

And it should be a concern that a number investors who have been successful over the very long term have been publicly outspoken about the risk of such a transition. Jeffrey Gundlach, the chief executive of DoubleLine Capital, said recently that many asset classes 'look frothy', and that with the recent run-up in the benchmark Standard & Poor's 500 index while economic growth remains weak and corporate earnings are stagnant investors have entered a **"world of uber complacency."**

At the same time Gundlach announced that when ten year yields hit 1.32% in July his firm had gone 'maximum negative' on treasuries.

Long term bond yields

Long term US bond yields have continued to edge higher from the record low levels I highlighted last month, and yields in other parts of the world are beginning to show signs of reversing, this despite the continued pledge on the part of many central bankers to continue to do 'whatever it takes'.

The danger of this approach, and the continued expansion of central bank balance sheets, was brilliantly summed up by Tad Rivelle, chief investment officer of fixed income at TCW. In a

Bloomberg interview on the 27th August 2016 he warned that central bank intervention to keep rates low and prop up asset prices may worsen the impact of an inevitable end to the current credit cycle.

"Every cycle in human history has ultimately come to an end. Credit enhanced cycles come to worse ends than the normal kind"

The outlook for oil, and expectations

The price of oil has been remarkably volatile over the last few months having rallied substantially from its thirteen year low price at the beginning of the year. Given this strength the media have been understandably asking question along the lines of the following seen in one personal finance website, thebalance.com, in early August;

> Oil Prices Rebound 40% After 13-Year Low. What's Next?

Such questions are understandable, but what is less understandable, given their respective historic track records in forecasting oil prices, is that in looking for answers most went to the World Bank or the EIA. One media account quoted EIA forecasts

> The EIA forecasts that WTI and Brent will average $52/b in 2017. Three months ago, it predicted $40/b for 2016 and $50/b for 2017. **Its forecasts have not been able to keep up** with the unpredictability of supply and demand. That's because the oil industry is changing in fundamental ways. (emphasis added)

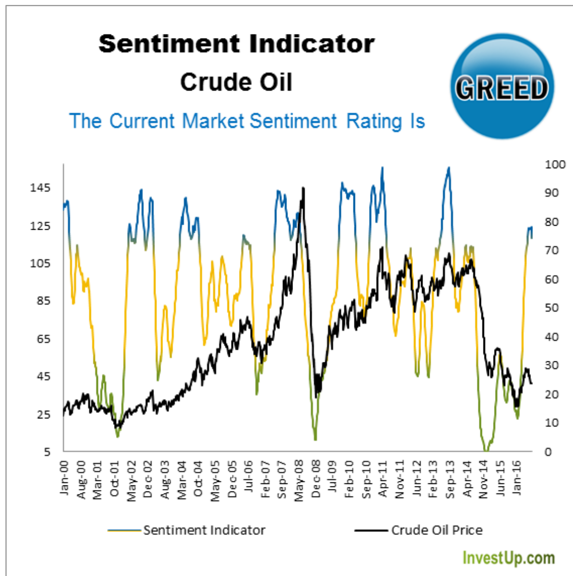
In mid January of this year, admittedly prior to oil's surge and with prices depressed the EIA released their outlook for oil prices under the headline;

> **Crude oil prices to remain low through 2016 and 2017**

This was understandable, given the rout that had been seen in oil prices over the previous eighteen months, but it wasn't especially useful given that it almost perfectly coincided with the beginning of a close to doubling in oil prices over the next five months.

It is worth looking back to mid 2014 to see what the EIA were forecasting for oil prices then. In the first half of 2014 the agency commented at length on the remarkable stability that had been seen in oil prices over the prior couple of years and with that backdrop they raised their forecast for 2015 to $105, just ahead of a plunge in oil prices in an almost vertical fashion from $115 to $45 in 2015 and $27 in early 2016. This forecast had been a remarkable extrapolation of the stability that had been enjoyed up until then but was far from useful. And it is not just the EIA that are forecasting higher prices now, the World Bank, in their July 2016 Commodity Markets Outlook, raised their expected average price for crude oil in 2016 and forecast moderately higher prices, on the back of their supply demand extrapolations, through 2017.

So now it seems that expectations have been raised amid a growing belief that that an important low was seen in January of this year and that prices can continue a comfortable steady rise from here. These expectations can be seen in the accompanying chart of sentiment towards crude oil from Investup.com.



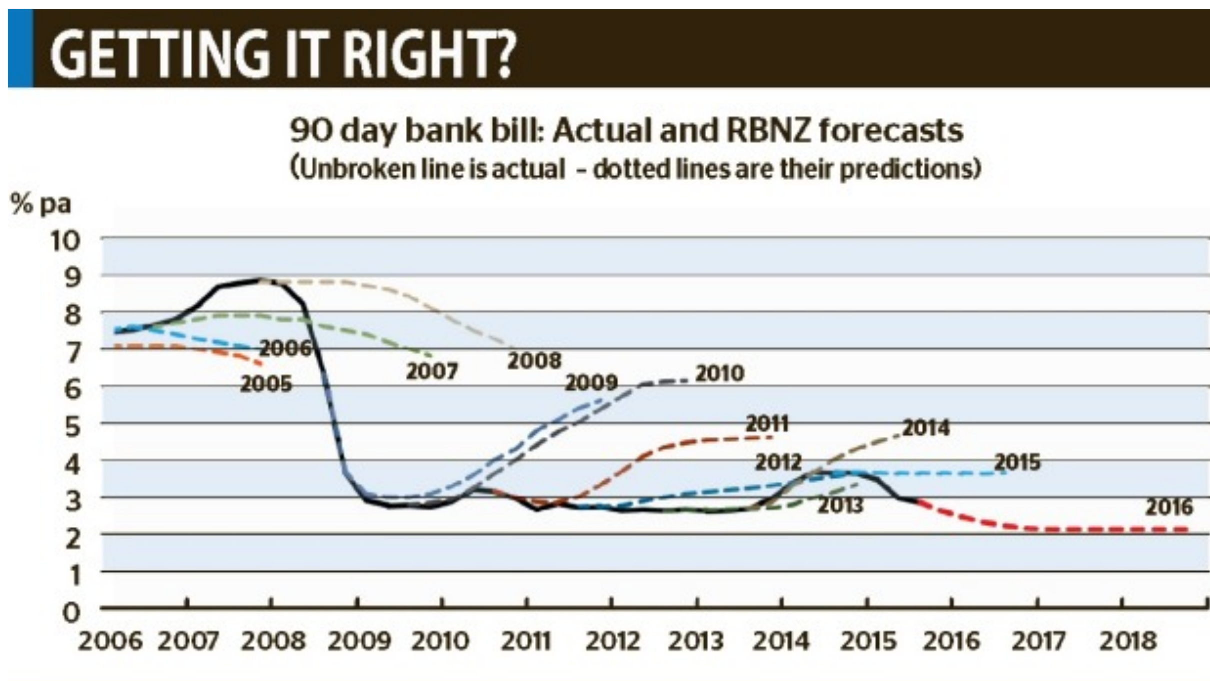
The recent rally has produced an enormous change in sentiment so that now the probability of disappointment seems far greater than that of a positive surprise that could sustain further rally.

Economist Forecasts

Long term readers will be very familiar with my views on the usefulness, or otherwise, of economist' forecasts so I won't go into chapter and verse on this subject again this month, although the 'extrapolations' mentioned above clearly illustrate the risk in these forecasts, nonetheless, I couldn't resist sharing this headline and chart that appeared a month ago in the 7th August edition of The NZ Business Day;

Don't rely on economists' predictions, Kiwis told

The article included the following chart of RBNZ forecasts for the 90 day bill rate



Even a cursory glance at the chart reveals that most of their forecasts have been extrapolations of the recent past and most have not been particularly insightful. This raises the question, where will the biggest surprise for the most people be regarding 90 day bill rates in NZ going forward? History

would strongly hint that they are unlikely to flatten out for three years at 2% as the RBNZ are currently forecasting. My guess is that they will either be a lot higher or a lot lower and probably both, but in what order I have no idea. The main message is that no one, particularly an investor, should take any comfort from an economic forecast, it will likely be wrong, and even if it is right the market's reaction will almost certainly not reflect the neat causality that may have been expected.

Other People's Money

Last month I mentioned a book that I had read while travelling through Europe a couple of months ago, 'Other People's Money' by John Kay. It had struck a real chord with me as elements of his message echoed some of my closing conclusions in 'Investing: The Expectations Game', particularly in relation to the global asset management industry, and it certainly is an industry. In mid 2015 The Boston Consulting Group reported that the profits for the industry had grown to $102 billion and Forbes recently listed the Investment Management Industry as the second most profitable industry in the world, behind only Generic Pharmaceutical Manufacturers, with a profit margin of 29.1%. These are remarkable figures when one considers how poorly the majority of investment managers perform over the long term. My closing paragraphs in 'Investing: The Expectations Game'are;

> The primary aim of the 'Expectations Game' for most investors should be a satisfactory real return on their invested capital. This does not mean that they have to be invested in the same asset allocation all the time and they should not be satisfied when they are told that they have done well because they outperformed a benchmark and only lost 20% or more of their capital. The permanent loss of capital is the single greatest risk all investors face
>
> This book began with the quote from Warren Buffett about investing being simple, just not easy. Taking the liberty to expand on this quote gets to the heart of the most important messages in this book;
>
> > **The act of investing is simple, it should always remain simple and complexity should be avoided at all costs. But being a successful investor is not easy. It is made difficult by the irrational behavioural biases that beset all of us as individual investors and the obsession of the investment industry to focus primarily upon their own reputational risk, rather than the very real risk of permanent loss of capital for their underlying investors. Their goal of increasing assets under management by selling whatever is easiest to sell, especially when that product is wrapped in a fee hiding complex structure, doesn't help the individual investor either.**
>
> These challenges can only be overcome by not taking as gospel whatever the media and other 'experts' tells you is driving the market, and by adopting a highly disciplined investment regime that will insulate you form your own and other providers irrationality.
>
> There is no scientific model that will at all times foretell where markets are going to go or what future returns may be. Those that are used are based upon the deeply flawed idea that markets are efficient and are often defended on the basis that there is no alternative, so efficient frontiers and the capital asset pricing model continue to be employed by the reputationaly focussed investment industry, as do Monte Carlo simulations that deliver a seemingly scientific probabilistic outcome. These approaches may work some of the time or even most of the time. The problem is that when they are working, when markets are moving in a fairly steady and orderly fashion, investors don't need a model. When they do need

something they can rely upon, when markets become volatile, highly charged with emotion, and on the brink of a dramatic reversal, they fail.

It is hard to think of any 'model', in any field of human endeavour as important as an individual's life savings, which is so heavily relied upon by such a large and profitable industry and yet is so deeply flawed. So deeply in fact that it has failed, and will likely continue to fail, just when it is most needed.

Rather than reviewing 'Other People's Money' I thought it worth sharing a particularly astute review of the book that appeared in the New York Times:

> In an 1814 letter, Thomas Jefferson complained that the financial sector of his day was populated by "adventurers . . . who burthen all the interchanges of property with their swindling profits, profits which are the price of no useful industry, of theirs." Almost exactly two centuries later, John Kay echoes the sentiment, noting that as "exchanging bits of paper cannot make profits for everyone," it is very likely that much of finance's profit "represents not the creation of new wealth but the sector's appropriation of wealth created elsewhere in the economy."
>
> The charge is an old one that has taken on new relevance in the wake of the 2008 crisis. Yet Kay is no angry Jeffersonian agrarian, but rather an academic economist with a weekly Financial Times column and a onetime financial consultant. He is more sanguine than the typical finance basher in that he acknowledges the sector's critical roles: as a payment system, a means of channeling savings to productive investments, an instrument to help manage personal finances across the life cycle and generations, and a marketplace for transferring and managing risk.
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> Nonetheless, Kay writes, a more recent process of "financialization" has created a hypertrophied sector, its activities ever more abstract and divorced from the real economy, successful mainly at multiplying the remuneration of its members. "The tip of the tongue that laps up the cream of the commerce of a continent" was how Oliver Wendell Holmes Sr. described the New York money center of his day; Kay might rather characterize it as a gobbling maw.
>
> Finance, Kay argues, has strayed dangerously from its core functions. And the functions themselves have been jumbled in dangerous ways (for example, with deposit-taking becoming the funding source for uncertain, long-term risk-taking). Within each function, activities have moved from the primary to the (literally and figuratively) derivative — less investing, more trading, fewer assets and more "asset-backed securities." Meanwhile, long-term relationships have been reduced to short-term transactions. The result: instability and crisis.
>
> While the gravamen of its complaint is old, "Other People's Money" is not merely another broadside content to denounce finance's dysfunction, but rather a masterly attempt to locate its various origins and connect them with analytical and theoretical rigor. Kay provides by way of context a panoptic overview of the history, evolution and structure of the financial system in the United States and Britain, one that is impressive in its ability to weave together a comprehensive range of material, from the mechanics of banking to the Gaussian copula, in elegant, jargon-free prose. He confidently employs many perspectives: economic, historical, legal and psychological. Call this technique a Lombard Street for the 21st century.

> The last third of the book insightfully addresses reform, which, refreshingly, Kay stresses is not the same as regulation. Some of finance's most abstruse and pernicious activity arises from regulatory arbitrage — restructuring transactions so that they move from a less favorable to a more favorable regulatory rubric. Moreover, financial regulation suffers from a faster-spinning revolving door compared with other industries, with the regulators themselves either coming from or looking forward to landing in the industry they are supposed to oversee. Kay writes like an anthropologist: The roots of finance's dysfunction, he says, are cultural. The ethos of an old-fashioned partnership of traders risking their own capital endured even as a move toward public shareholding transferred "both these risks and these rewards from the partners . . . to the shareholders. In reality, it had little effect on the financial expectations of those who worked in the firms." Reform has to mean changing the industry culture: inculcating an ethic of stewardship and faithful agency (living the rhetoric of "putting the client first") and changing industry structure where culture clash is insuperable.
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> It's a pity policy makers didn't have this book in 2007. In 2015, it can read like an indictment of a convict already sentenced. Post-crisis, banks are more heavily capitalized, trading less and earning lower return on equity. "Large financial conglomerates were run for the primary benefit of the people who manage them — and, in the main they still are," Kay says. But surely to a decreasing degree: At Goldman Sachs, the amount of total revenue that is set aside for employee compensation has gone from more than 50 percent before the crisis to about 37 percent in 2014. Still, this can feel like a change born of chastening rather than epiphany. Kay makes a strong case that change must be embraced rather than accepted grudgingly if it is to endure.

Finally it seems that the subject of the fees charged by active managers, and the growth in indexation, is beginning to attract an increasing amount of attention. One Wall Street firm likened passive index investing as worse than Marxism This may be a little extreme and somewhat self serving, however, Cliff Asness of AQR wrote an entertaining rebuttal of this view in an op-ed piece on Bloomberg, his closing comments included the following;

> *It's likely we've historically had too much active management at fees that were too high, delivering returns that -- net of fees -- effectively amounted to a big and unnecessary wealth transfer from investors to active managers.*

Passive indexation is not the whole answer and neither, clearly, is more active management at high fees, however, for most investors seeking a satisfactory return there is a solution as I outline at length in 'Investing: The Expectations Game'.

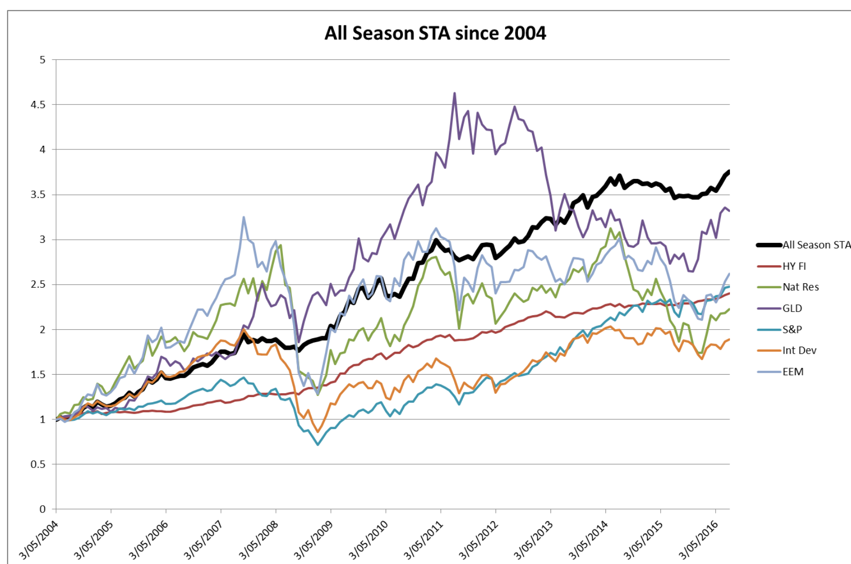
The All Season STA

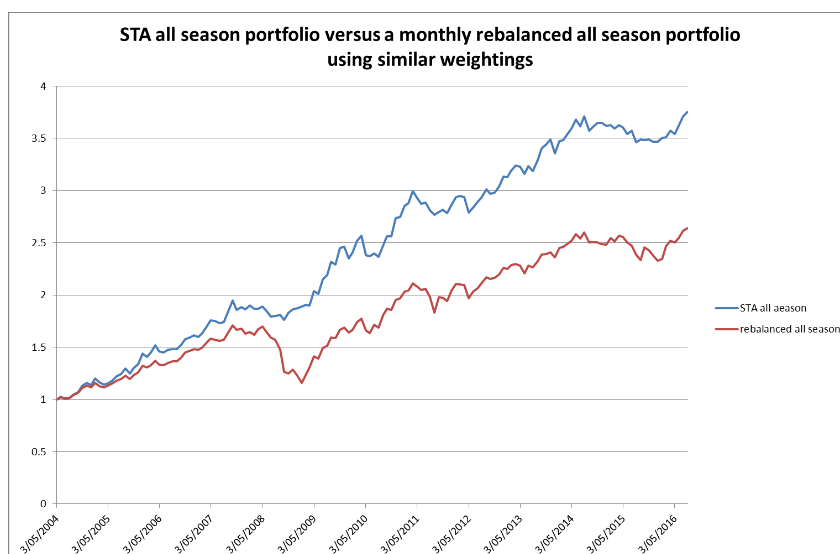
Legendary hedge fund manager Ray Dalio of Bridgwater Associates believes that the simplest and best portfolio for most investors over the long term would look like his 'All Weather Portfolio' that aims to minimise losses and diversify risk. Based upon his view that the four things that can drive asset prices are inflation, deflation, rising economic growth and declining economic growth he has constructed what he calls his 'All Weather Strategy'. This combines 30% stocks, 15% intermediate government bonds, 40% long term government bonds, 7.5% commodities and 7.5% gold and rebalances to these allocations on a regular basis.

Given that I totally respect and buy in to Dalio's long term perspective and approach I decided to adapt the STA portfolio that I have described at length over the last couple of years and outlined in

'Investing: The Expectations Game' to something along Dalio's lines. Unfortunately I cannot do the sort of back testing on the specific allocations that his team have done as liquid products that represent these assets have not been around long enough and real pricing would prove challenging. Nonetheless, I have constructed a portfolio with allocations to the iShares Emerging Markets ETF, the iShares North American Natural Resources ETF, SPDR Gold Shares ETF, the Vanguard Developed Markets (ex US) fund, the Vanguard 500 Index fund and the STA fixed income hybrid which is made up of allocations to the Vanguard Intermediate Treasury fund and the Vanguard High Yield fund.

The rules the STA All Season Portfolio follows are the same as previously outlined for the STA Portfolio. 13 month moving averages are the primary determinant as to whether an exposure is made to each asset and changes are only made once a month at month's end. The average allocation to each asset over the twelve years that data is available are 15% to high yield, 15% to intermediate treasuries, 30% to the S&P500 and 10% each to the other four assets.





The results of following the STA All Season approach are shown in the chart (left) compared to the performance of each of the constituent assets. The compound annual average growth rate of this portfolio has been 11.3%. This is superior to any of the underlying assets and drawdowns have been substantially less in all cases except for the fixed income hybrid. Obviously there are times when the allocation to each asset may be zero or substantially more than the average, it is therefore worthwhile comparing the return of the STA approach to what would have been achieved through monthly rebalancing to similar allocations.

The chart (left) shows this comparison. Not only is the average annual return more than 3% less with the regularly rebalanced portfolio the chance of a negative rolling twelve months is substantially higher at 21% versus 15% and the largest rolling twelve month loss is also substantially higher at 29% versus less than 10%

Anyone interested in exploring the STA approach further I would recommend reading the last three chapters of my new book **Investing: The Expectations Game** which I am delighted has been selected by Australian magazine Money as their book of the month for September. Visit http://moneymag.com.au/this-months-issue/ to read more.

Conclusions

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.

Kevin Armstrong

6th September 2016

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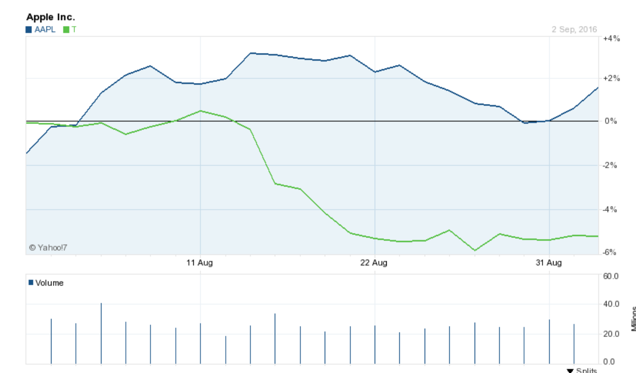
Apple / AT&T update

Last month I did say that I would not be tracking quite as closely the Apple AT&T relationship that I had been monitoring, and commenting on from an expectational standpoint, for almost eighteen months. However, given the miserable commentary that Apple has attracted recently over its Irish tax situation, which can only have dampened expectations, it is interesting to see how the two stocks have performed.



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Over the last month Apple has outperformed AT&T by 7%