Strategy Thoughts

December 2015

A lost twelve months?

or

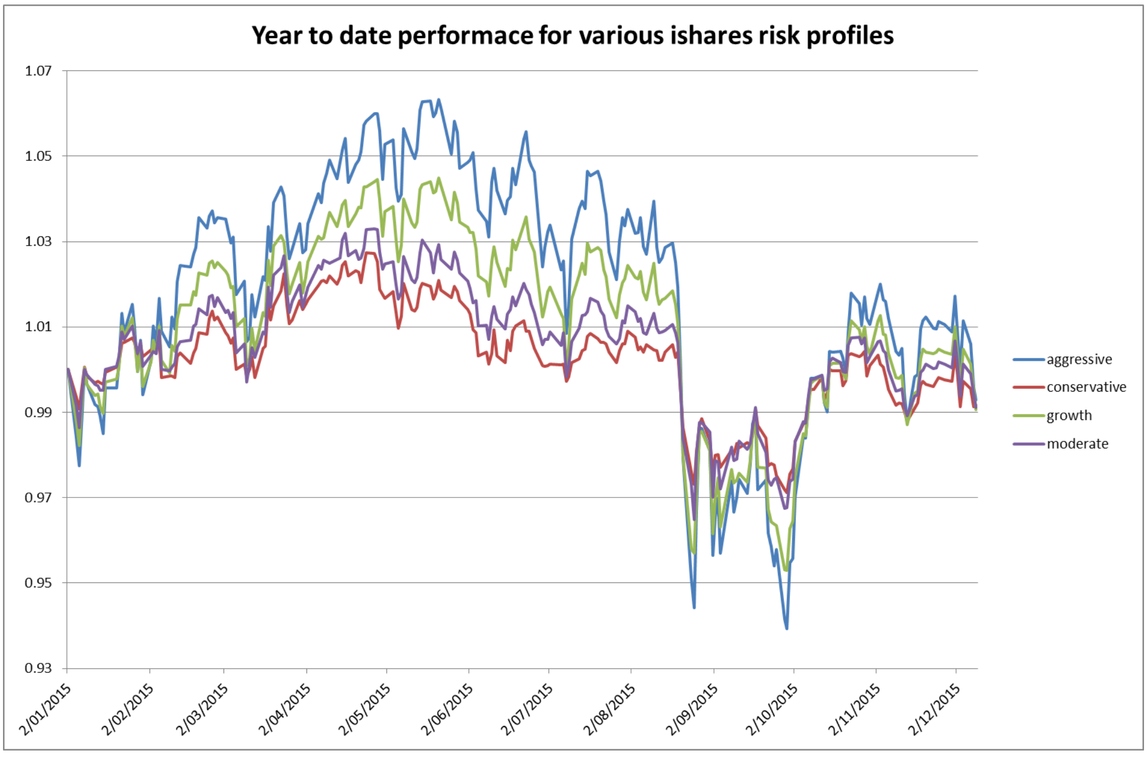
Risk Is Not a Knob

Introduction

This month's Strategy Thoughts spends no time discussing the subject that is currently dominating the investment media, the will the Fed or won't the Fed raise interest rates this week. I believe this to be an irrelevance that will have little bearing on how markets behave over the coming weeks and months. Of far greater importance is that investors realise; just how much risk they may currently be taking (and that greater risk in no way guarantees higher returns), how much deterioration has already occurred across global markets, the extent of the deflationary pressures that continue grow and that 'chasing yield' has already proved dangerous and is likely to become more so.

Risk is not a knob

To listen to the financial media, particularly in the US, over the last couple of months it would be easy to get the impression that 2015 to date has been another great year for equity investors and therefore that those investors who had adopted a higher risk profile would have received their expected higher return. In fact neither of those two impressions or assumptions is correct. The chart below shows the cumulative total return investors would have received in each of iShares core allocation exchange traded funds. The aggressive fund invests 80% in US and global equites and the balance in fixed income, the growth fund's split is 60% equities and 40% fixed income, the moderate has a 40/60 split and the conservative a 30/70 split.



Through the first five months of the year the outcome achieved would have been approximately in line with what the majority would have expected, the aggressive fund had returned about 6% while the conservative had delivered less than 2%. However, through the turmoil of August it really didn't matter too much which fund one owned as they all slipped into negative territory and cumulative returns converged. Understandably at the depths of the recent selloff the aggressive fund had fallen the most but with the recovery of the last couple of months total returns for all the funds have once again converged, resulting in a negative almost one percent return across all risk profiles that will have not pleased anyone.

It clearly hasn't been a good year and taking more risk has not, contrary to popular belief, delivered greater returns.

As I thought about this situation I remembered an essay that Ed Easterling of Crestmont Holdings had written in the early 2000's for John Mauldin's book 'Just One Thing'. The essay was titled 'Risk Is Not a Knob'. It went to some lengths to highlight many of the misconceptions investors have regarding the relationship between risk and return; it also alerted investors to the likelihood of periods, such as the last eleven months, when risk taking would not be rewarded.

The essay begins with a variation on Warren Buffet's first two rules of investing, (rule 1, don't lose money, rule 2, don't forget rule 1) "The first step toward making money is not losing it". Ultimately this, the permanent loss of capital, captures the true meaning of risk to most underlying investors (not professional money managers who seem to only care about relative performance). Easterling points out;

> Conventional wisdom about risk and long term returns promotes a false sense of security based on the erroneous belief that interim losses yield future gains. Some investors assume that higher risk means near term volatility rather than the possibility of permanent losses to their account.

The essay goes on to explore modern portfolio misunderstandings and highlights that many factors affect the prospective returns of riskier assets and that more risky assets certainly do not always deliver greater returns;

> Stocks are indeed riskier than bonds. History and the operation of rational markets have shown that stocks should return more than bonds over the long run, but the degree of risk in stocks varies greatly, depending on market valuations. Stocks are most risky when valuations, reflected in prices, are high. This is when risks of decline and loss are greatest. Higher risks can lead to higher losses unless addressed with the tools of risk management. To reiterate, **risk is not a knob to be turned for greater returns**. Turning the knob invites more risk; **it does not drive returns.**

Towards to end of the essay Easterling summarises one of his key messages;

> Estimating future returns is always a challenge, but too many investors rely on average historical returns rather than base likely future returns on existing valuations. Particularly when the environment is biased in the direction of below average returns, investors often underestimate the level of risk in their portfolios.

Whilst I don't necessarily agree with Easterling's use of valuations to determine future returns, (I see valuations as just one of many measures or manifestations of aggregate investor mood), I do agree that investors frequently underestimate the risk in their portfolios, particularly when risk is much higher after an extended bull market. Equally they overestimate the risk in their portfolios at the depths of bear markets.

The vast majority of investors in the US will likely now be experiencing varying degrees of disappointment and discomfort given the result displayed in the chart earlier, and yet the US has been amongst the best performing regions of the world. US investors who opted for more risk a year ago, presumably in the hope of greater returns, and perhaps invested in emerging markets or high yield debt have been even more rudely reminded that 'risk is not a knob', as I will illustrate later in the Deflation Update section of this edition of Strategy Thoughts.

This poor performance from riskier assets is yet another illustration of the problem I have been describing for several months, the deteriorating breadth of the overall investment universe.

Breadth

Breadth is a popular measure of the consistency of a market move, when all elements are rising together breadth is generally seen as being supportive, when markets continue to eke out further new highs but fewer and fewer elements are contributing to that move breadth is seen as having deteriorated and is generally an indication of a faltering market.

Last month I illustrated the deterioration in global breadth by showing the weakness of European markets compared to the US market and the weakness of the world index excluding the US compared to the US. These two charts (left) are updated and it is clear that the US market, even though it has failed to make meaningful headway over the last month, continues to outperform those other markets.

Even within the still relatively high flying US market there is a growing disconnect between those 'generals' that continue to advance, and the 'troops' that have been in retreat for some time.

The chart below shows the performance of the ten largest companies in the US as measured by market capitalisation compared to the overall market and the market excluding the contribution of these ten still high flying 'generals'.

The almost 20% difference in return is remarkable over just the last eleven months and is a clear indication of the underlying fragility of the overall market.

Apple versus AT&T

One of the top ten stocks that hasn't positively contributed to the situation described above is Apple. I last updated the relative performance between AT&T and its replacement in the Dow, Apple, in August in a section titled 'Apple update (or the value of what everyone already knows!)'. Then I wrote;

> On March 18th the largest company in the world by market capitalisation, Apple, replaced a tired old 'Ma Bell', AT&T. Over the last four months this switch has followed pretty much the pattern that has been seen throughout history, the new comer has struggled and the dumped stock has recovered. Since Apple replaced AT&T in the Dow Jones industrial Average, Apple has fallen 4% in value, AT&T has risen 2% and the Dow itself has fallen a little less than 2%.

As of the 11th December AT&T is unchanged since its inclusion in the Dow, the Dow itself is down a little over 4% and Apple is down more than 10%.

Deflation update

On the 3rd December Bloomberg reported;

> **Europe's Growth Pickup Fails to Counter Deflation Pressures**
>
> Accelerating economic growth in the 19-nation euro region hasn't yet left its mark on inflation.
>
> A survey of purchasing managers by Markit Economics showed deflationary pressures persisted in November, with output prices declining for a second month. While a composite gauge of manufacturing and services rose less than initially

reported, Markit's measures still signal economic growth of 0.4 percent in the fourth quarter, the London-based company said Thursday.

On the same day the Economic Times reported;

> # India's monetary policy doesn't reflect its current deflation
> December 3, 2015, 5:20 AM IST

A day earlier, on the 2nd December, UKmeatinfo.co.uk reported;

> **Further deflation for food prices**
>
> Food prices experienced yet more deflation in November. According to the BRC-Nielsen Shop Price Index for November 2015, the food category reported annual deflation of 0.3% in November from the 0.4% fall in October. This is slightly below the three-month average of 0.4%, but ahead of the six-month average of -0.2%.Overall shop prices reported deflation of 2.1% in November from a 1.8% decline in October, a joint record low.

Despite these worrying signs of growing deflationary pressure the President of the ECB attempted to allay any growing deflationary fears as CNBC reported on 4th December;

> The chance of deflation in Europe has subsided due to accommodative central bank policy, which could be adjusted "at any time" to meet goals, European Central Bank President Mario Draghi said Friday.
>
> "Thanks to our monetary policy actions, the risk of deflation in the euro area is firmly off the table," he said in prepared remarks at the Economic Club of New York.

Such a bold assertion on the part of a high ranking official may provide some comfort, unfortunately, as is so often the case in financial markets, that comfort is almost certainly misplaced. In April 2007 I illustrated the danger of similar remarks;

> "The managing director of the International Monetary Fund, Rodrigo Rato, said Friday that the global economy was strong and that volatility on financial markets was unlikely to last"
>
> "WASHINGTON (Reuters) - U.S. Treasury Secretary Henry Paulson on Sunday said he feels good about the U.S. economy and does not see the country slipping into recession."
>
> "The so-called fundamentals of the economy didn't change last week, with many economists still looking for slow, but not too slow, growth and waning inflation."
>
> "Volatility is a normal part of financial markets and the recent turmoil is not a symptom of major problems facing the economy, Treasury Secretary Henry Paulson said Friday"

With hindsight we now know that that this was just a handful of months before the onset of the worst bear market and global economic contraction in seven decades.

Mario Draghi's former counterpart in the US, Ben Bernanke made many similar misplaced remarks in the build up to and onset of the Global Financial Crisis;

- On February 15, 2006, Fed Chairman Bernanke said, "The housing market has been very strong for the past few years.... It seems to be the case, there are some straws in the wind, that housing markets are cooling a bit. Our expectation is that the decline in activity or the slowing in activity will be moderate, that house prices will probably continue to rise but not at the pace that they had been rising. So we expect the housing market to cool but not to change very sharply."
- On February 15, 2007, Fed Chairman Bernanke said, "The weakness in housing market activity and the slower appreciation of house prices do not seem to have spilled over to any significant extent to other sectors of the economy."
- On March 28, 2007, Fed Chairman Bernanke said, "The impact on the broader economy and financial markets of the problems in the subprime markets seems likely to be contained."
- On May 17, 2007, Fed Chairman Bernanke said, "We do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system."
- On February 27, 2008, Fed Chairman Bernanke said, "By later this year, housing will stop being such a big drag directly on GDP.... I am satisfied with the general approach that we're currently taking."

History tends to imply that Draghi's assertions may be prove to be hopeful rather than prophetic, but they certainly provide no comfort to the tens of thousands facing job losses due to the collapsing (deflationary) commodity markets. The BBC highlighted the plight of workers in mining giant Anglo American on the 8th December;

Anglo American to cut workforce by 85,000 in restructuring

Shares in mining firm Anglo American have fallen to a record low as the company said it would sell huge chunks of its business and shrink its workforce by nearly two-thirds.

The changes will see the workforce drop by 85,000, from 135,000 to 50,000.

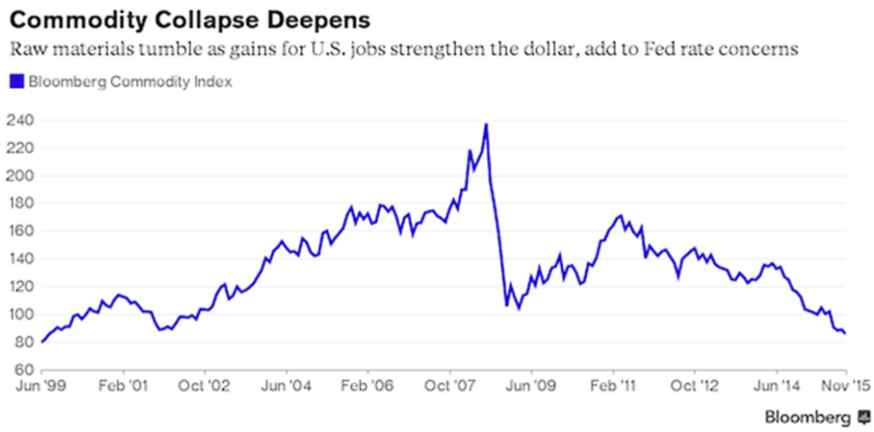
The group has been forced to restructure after the collapse of commodity prices slashed profits.

Anglo will also suspend dividend payments for a year, and consolidate from six to three businesses.

All the world's big mining companies have seen profits tumble along with plunging commodity prices as demand from China has slowed.

The price of oil is at seven-year lows, as is copper, and on Tuesday the price of iron ore tumbled to a 10-year low of $39.60 a tonne, after reaching a peak near $200 in 2011.

The enduring bear market of the last seven years in commodities can be seen in the Bloomberg chart below;



The effects of this deflationary commodity bear market have been far reaching and have proved particularly damaging to the emerging markets;

As can be seen on the chart above the recovery from the August selloff in global equities has been muted at best in the emerging markets, particularly when compared to large cap US indices, and that recovery stalled out some time ago. The effects have not been limited to equity markets in the region either.

On the 7th December Bloomberg reported that sales of emerging market debt had plunged;

Emerging Market Debt Sales Are Down 98%

The commodity-price slump and the slowdown in China's economy are crippling developing nations' ability to borrow abroad, even as international debt sales from advanced nations remain at a five-year high.

Issuance by emerging-market borrowers slumped to a net $1.5 billion in the third quarter, a drop of 98 percent from the second quarter, according to the Bank for

International Settlements. That was the biggest downtrend since the 2008 financial crisis and reduced global sales of securities by almost 80 percent, the BIS said in a report.

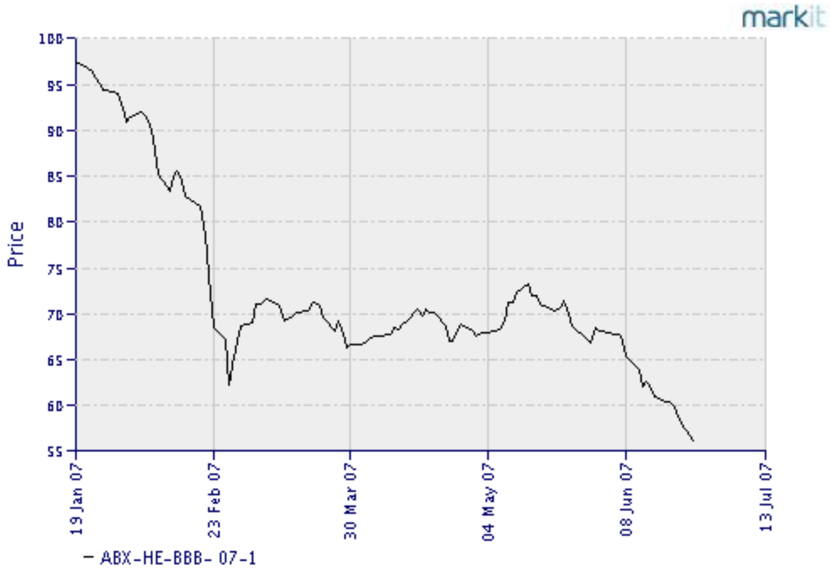
The situation described above for the emerging markets has also been seen in lower grade fixed income markets. I have long warned of the danger of 'chasing yield' and that danger is now becoming increasingly apparent. The chart below shows the price of the high yield bond ETF JNK. It bears a passing resemblance to the emerging market index but the post August recovery has been more than completely unwound.

This worrying trend can also be seen in the difference between high yield debt and investment grade debt where spreads have now grown to levels not seen since the GFC.

Another 'canary'?

In July 2007 I wrote the following in Strategy Thoughts;

> **Has anything changed yet?**
>
> The recent decline in many global equity markets, but particularly the US, has been largely attributed to the pain being suffered by two Bear Stearns hedge funds and relates to the continued unraveling of the US subprime mortgage market.



The unraveling of these subprime bonds is dramatically revealed in the chart above. It shows the value of bonds made up of a basket of subprime mortgages originated just last year. These bonds were trading at close to 100 in January, the big crack in late February is very clear but so too is the recent continuation of the decline. These bonds now trade at just 56!

History now shows that those two Bear Stearns hedge funds were among the first 'canaries in the coal mine'. They can now be looked back upon as highlighting the real danger that lay ahead. It also shows that their closure should probably not have proved to be the surprise that it was given how poorly the funds underlying bonds were performing.

Over the last week it is possible that another canary has provided a warning. On December 12th Bloomberg commented on the freezing of redemptions for a previously high flying high yield mutual fund;

Third Avenue Redemption Freeze Sends Chill Through Credit Market

Investors who piled into the riskiest corners of the credit markets during seven years of rock-bottom interest rates are getting a reminder of how hard it can be to cash out.

With outflows from U.S. high-yield bond funds running at the fastest pace in more than a year, Martin Whitman's Third Avenue Management took the rare step of freezing withdrawals from a $788 million credit mutual fund on Dec. 9. The firm's assessment that meeting redemptions would be impossible without resorting to fire sales has put a spotlight on the dangers for junk-bond investors as the Federal Reserve prepares to lift interest rates as soon as next week.

Interestingly, as with the Bear Stearns hedge funds eight years earlier, the freeze on redemptions in the high yield market should not have been a surprise, and obviously wasn't to those investors who had been dumping Third Avenue's fund for many months

It appears from the chart above that the market knew something long before the recent announcement of a freeze on redemptions. The fund has been plunging since the middle of last year! The real question this should raise for investors is whether or not this is merely an isolated incident or a sign of something more systemic flowing from the dangerous chase for yield that has been ongoing for several years in the face of global deflationary pressures. My real fear is for the latter rather than this being just an isolated incident.

Conclusions

Three months ago I concluded Strategy Thoughts with the following;

> In the meantime; ignore commentary expounding on the health of any economy and why that is good for markets, avoid risk and passive buying and holding, disregard commentary about capitulation points having been seen and do not chase yield.

Since then the danger of chasing yield has become extremely evident and the supposed capitulation point in August is now under question in many markets and asset classes. Despite this comforting words continue to be heard from central bankers around the world.

My real concern now is that the slow motion topping process, that has been unfolding for several years across asset classes and regions, will become a more homogeneous and damaging bear market. The paragraph I concluded last month's Strategy Thoughts continues to appropriately summarise my thoughts and outlook.

> As deflationary pressures continue to mount, and the impotence of 'the authorities' to do anything about it become more obvious markets are likely to become even more fragile and prone to bouts of extreme volatility. Through such an environment the depth and liquidity of the US dollar will become increasingly prized and I continue to believe that preservation of capital will be the most prudent, and rewarding, investment strategy. As I wrote last month,

eventually this will lead to a period of remarkable opportunity, albeit accompanied by remarkable discomfort, but we are not there currently. Now is not the time to chase yield or return, patience and discipline will be rewarded, firstly by avoiding exposure to increased volatility and downdraughts and secondly through preserving buying power for when true long term opportunities do eventually arrive.

Finally I would like to wish all my readers a happy and safe holiday period and urge them to keep a keen eye on risk and to avoid the temptation of chasing yields as 2015 draws to a close.

Kevin Armstrong

14th December 2015