Strategy Thoughts

June 2015

Time in, or Timing?

Introduction

Earlier this month I received some literature from a local investment organisation urging me it was 'time in not timing' that matters in investment. Whilst this did not totally surprise me I was once again reminded how frequently history repeats itself, especially in investment markets, due to our collective inability to remember lessons that have been previously painfully learnt. I have attempted to counter the obsession for 'time in' twice over the last decade and a half, firstly as the turn in the millennium approached and then in 2006/7. It is fascinating, and understandable, that the doctrine for 'time in' or 'buying and holding' gets stronger and stronger the longer a bull market lasts. To some extent it is merely stating what has by then become obvious to everyone. Unfortunately, as I discussed last month, by the time something is obvious to everyone it is of very little investment value. I fear that the 'time in' urge this time will be as poorly 'timed' as it was on the last two occasions.

Time or Timing?

The remarkably simplistic, but also alluring, catch phrase, that it is 'time in, not timing', that matters in stock market investments has a number of origins but at its heart is the desire on the part of asset managers to retain their funds under management. Understandably, as that is the basis upon which they are compensated.

Back in the mid 2000's, and the late nineties, the expression was frequently employed by fund management organisations eager to retain their clients assets. The argument usually went along the lines of;

> If you had attempted to time the market and just missed the best X days (weeks or months), then your return over some very long period would have been Y, a number substantially less than what would have been achieved simply by leaving your money in the market for the long term.

There is nothing incorrect in the analysis that these organisations show, but it does overlook the very powerful biases that drive human beings. The irony is that this kind of advertising and promotion only seems to appear as major tops are approaching, not at the depths of miserable bear markets when the majority do in fact give up on stocks. Not in an attempt to time, that opportunity is long gone, no, they give up just to take the uncertainty and pain away.

One of the core arguments behind time in vs timing is that no one knows the future and history has shown that over time stocks always outperform all other assets, therefore the prudent approach is to just keep buying stocks because over the very long term price doesn't matter.

It has not just been over recent history that such views have dominated.

The basis of the long term buy and hold philosophy is often claimed to be the book 'Security Analysis' by Benjamin Graham and David Dodd, originally published in 1934. It laid the foundation for what has become known as value investing and one of Graham's most famous, and successful students has been Warren Buffett, who famously states that his favourite time frame is 'forever' and that he wouldn't care if the stock market closed for a number of years as he was buying businesses.

Superficially this does appear to support 'time in' rather than 'timing'. However, the original edition of Security Analysis contains a section that was removed from later editions as it seems the editors did not want the book to date. This section directly related to the false and ultimately dangerous ideas that emerged through the boom of the 1920's and bear an uncanny resemblance to those proffered so eagerly late in bull markets by the 'time in' brigade.

A few quotes from this section of Security Analysis include;

- The notion that the desirability of a common stock was entirely independent of its price seems incredibly absurd. Yet the new era theory led directly to this thesis.
- An alluring corollary of this principle was that making money in the stock market was now the easiest thing in the world. It was only necessary to buy 'good' stocks, regardless of price, and then to let nature take her upward course. The results of such a doctrine could not fail to be tragic.

Then on the emergence of investment trusts Security Analysis commented;

- Under its canons investment had now become so beautifully simple that research was unnecessary and statistical data a mere incumberance. The investment process consisted merely of finding prominent companies with a rising trend of earnings, and then buying their shares regardless of price. Hence the sound policy was to buy only what everyone else was buying – a select list of highly popular and exceedingly expensive issues, appropriately known as the 'blue chips'.

The section concludes with;

- This example illustrates one of the paradoxes of financial history, *viz*., that at the very period when the increasing instability of individual companies had made the purchase of common stocks far more precarious than before, the gospel of common stocks as safe and satisfactory investments was preached to and avidly accepted by the American public.

It is clear that Graham and Dodd, having witnessed the lunacy of the twenties, could easily see that simply buying and holding for the long term was far from the sensible approach. Equally they could see the danger of the investment industry, at the time dominated by the newly emerged investment trusts, presenting the self-serving argument to unsuspecting investors of not worrying about price and just waiting, as they wrote in Security Analysis, for 'nature to take her upward course'!

Attitudes change

Sadly for most investors history has shown that the investment industry does not adhere to the 'time in' philosophy as aggressively as they urge their investors to. After a long a rewarding bull market it is easy to argue that buying and holding is the best approach, because clearly it has been over the prior upward move. However, as we all witnessed just six years ago, attitudes change;

On March 9th (the day of the bottom) Vectorvest.com described 'buy and hold' as **one of Wall Street's four biggest lies!**

On March 24th 2009 wallstreetoasis.com published an article under the banner headline;

BUY & HOLD ….. A SCAM

On the same day the Financial Times ran a story;

Is it back to the Fifties?

Highlighting how bonds had delivered the same return as equities in the US for the prior forty years, and in May 2009, very close to the bottom of the worst bear market in most investors experience one Australian fund manager published a paper 'deconstructing the 'Time in the market' mantra;

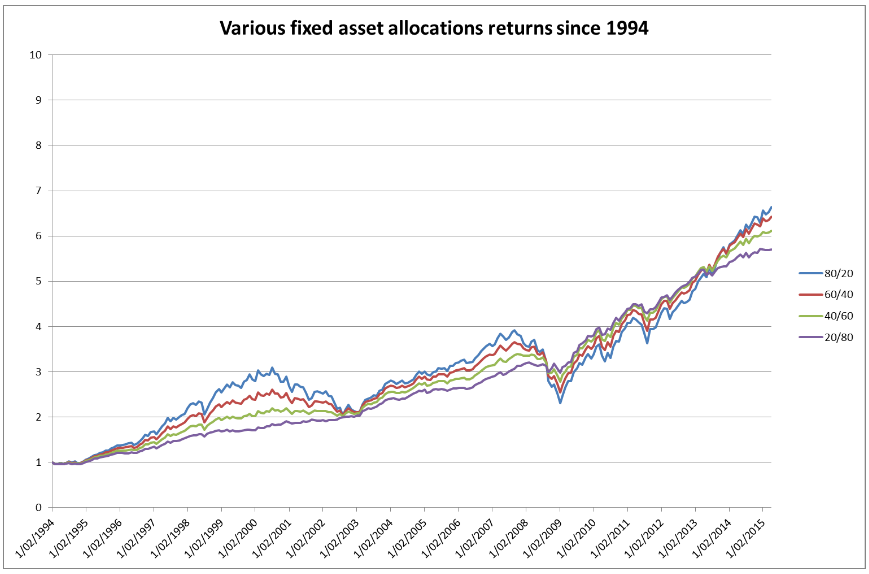
> Time in the market' used to be the rationale why investors should hang on to equities come hell or high water. However this mantra rings hollow to many investors who have seen the value of their equity portfolios halved over the last year. While investing is still about taking a long term view what's more important is the identification of the risks and possible rewards associated with the investments at any one time.

Now that the disingenuous 'time in not timing' is once again being heard more frequently, and perhaps not surprisingly after a six year bull market, investors should be careful not to complacently follow the herd and start to think that what has been enjoyed over the last six years is the new order of things.

Can asset allocation help?

Financial advisors will argue that diversification and a long term commitment to an investment plan is what most investors require if they are going to ride out and thrive through the roller coaster ride that investment markets invariably follow over the long term. There is a lot of sense in this but it is far from proprietary knowledge that needs to be paid for and it is an approach that will almost certainly leave investors most frustrated and questioning their long term plan at just the wrong time.

The chart below takes an admittedly over simplistic look at the type of results a US based investor would have experienced following a disciplined, regularly rebalanced, approach to US investing over the last twenty years. It takes the total return of the S&P500, the index that most managers benchmark themselves against (and as discussed at length last month invariably fail to match after fees) and the return of my STA fixed income fund, which combines intermediate treasuries and high yield bonds, and combines these two returns utilising various asset allocations, or risk profiles.



The most aggressive risk profile, with 80% in equities and 20% in fixed income, enjoys a wonderful rise through the mid and late nineties, but then from mid 2000 to mid 2002 the aggressive investor loses more than one third of his wealth and has fallen back to the same position he was in in mid 1997. At that point, having only achieved the same net return as a far more conservative investor (20/80), only with higher fees and far more heartache, it is understandable that the aggressive investor might question the sensibility of the long term plan he signed up for. A similar frustration and questioning, only to proportionately lesser extents, was experienced by the 60/40 investor and the 40/60 investor.

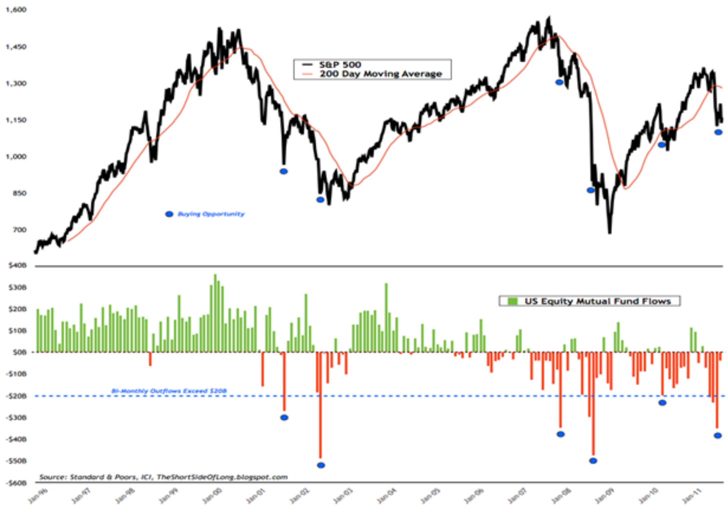
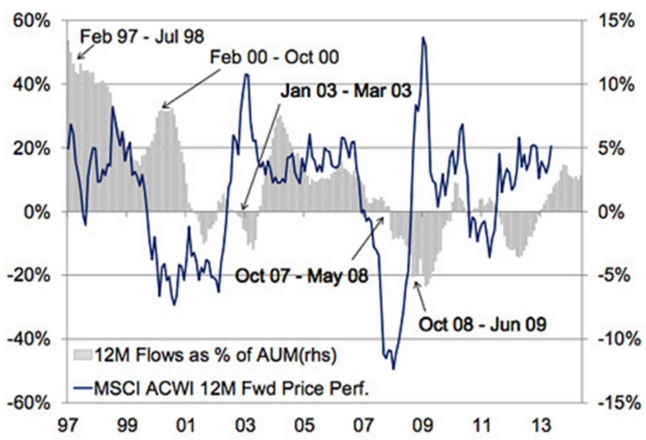


Figure 7. 12m Global Equity Fund Flows vs. next 12m Perf.



Source: Citi Research, EPFR from 2000, before ICI due to EPFR DM data availability.

Three years later, if the aggressive investor had stuck with his plan, he would have recouped those paper losses and be back in the position he had felt so good about five years earlier, and the new bull market had two more years to run. By late 2007 the aggressive investor would have been well ahead both of where he had been and the other risk profiles, but then the next, and more severe cyclical bear market hit. Over the next sixteen months the aggressive investor lost more than 40% of his wealth, and even the 40/60 investor fell back 20%. Again this would have severely tried their patience, confidence and discipline.

The charts to the left show that unfortunately, despite their best intentions during the good times, investors do tend to give up the most on volatile equity markets at just the wrong time.

The rise of Robo Advisors

Over the last couple of months there has been a substantial amount of media attention (Barron's, the Wall Street Journal and Forbes to name just three) on the growth of the so called 'Robo Advisors'. Wikipedia describes Robo Advisors as;

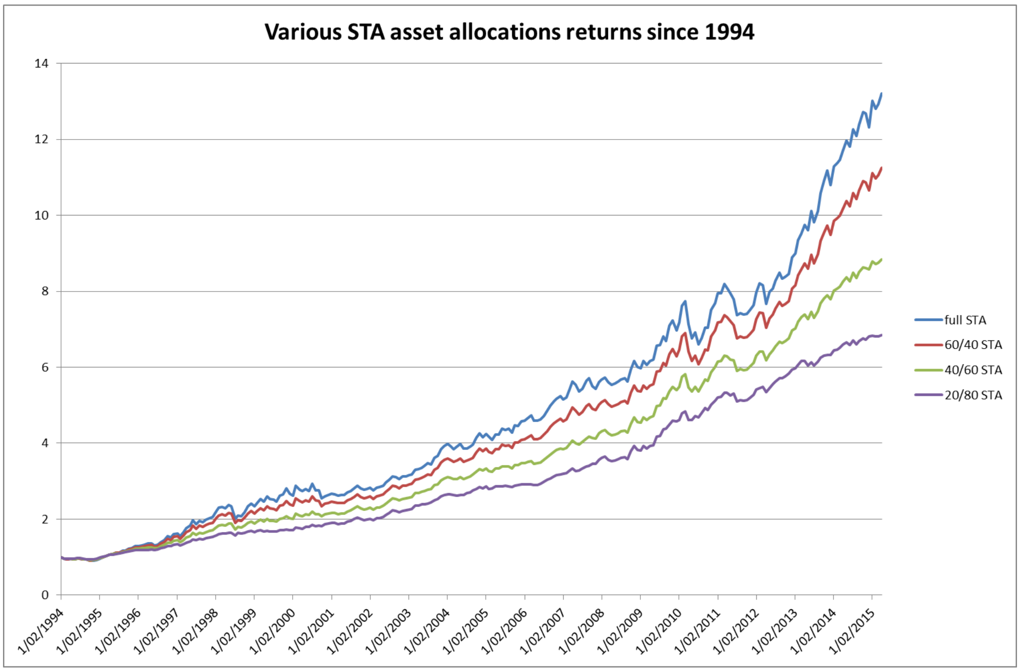
> **Robo-advisors** are a class of financial adviser that provides portfolio management online with minimal human intervention. While their recommendations may vary, they all employ algorithms such as Modern Portfolio Theory that originally served the traditional advisory community, which has relied on algorithmic templates to conduct portfolio management since at least 2005.

The main thrust of the Robo Advisor movement is to reduce cost, this should be applauded, and to automatically maintain the discipline agreed to at the outset by the client, again this should be applauded. However, their portfolios, as touched on by Wikipedia, are largely grounded in belief in the efficiency of markets and modern portfolio theory. As a result weightings to each asset class will be maintained, albeit in a very efficient, disciplined and low cost manner. The result of this approach will look a lot like those results shown in the chart above and so cyclical bear markets when they inevitably come along will still test the nerve and resolve of the underlying client.

I have long argued for disciplined portfolio construction and low costs, however, I have never believed that blindly following an asset allocation, that will inevitably result in periodic and very meaningful drawdowns and severely test an investor's resolve, could even be considered an optimal investment approach.

Over the last six months or more I have continued to refine my own proprietary low cost, highly disciplined, investment approach. An approach that doesn't attempt to beat any particular market, rather it aims to capture a reasonable amount of upside and to avoid large drawdowns.

For comparison sake I have produced a return chart below of what the same assets, the total return of the STA fixed income fund and the S&P500 total return, used in the large chart above would deliver had they been combined utilising the STA approach rather than fixed asset allocations. The four lines all have the same average asset allocations over time as those in the earlier chart, however the STA approach means that at times there may be zero exposure to equities.



The difference is obviously enormous, particularly when it comes to drawdowns.

- With fixed allocations, the most conservative 20/80 gave negative one year returns 3% of the time with a worst twelve month return of minus 6%.
- The most aggressive allocation, 80/20 gave a negative rolling twelve month return 20% of the time with a worst twelve month return of minus 35%.
- The most conservative STA portfolio gave a negative return only once (0.4% of the time) and then only minus 0.9%.
- The full STA portfolio gave negative one year returns 7% of the time with a worst twelve month return of minus 7.7%.

Twenty one year returns are also quite different as summarised in the table below;

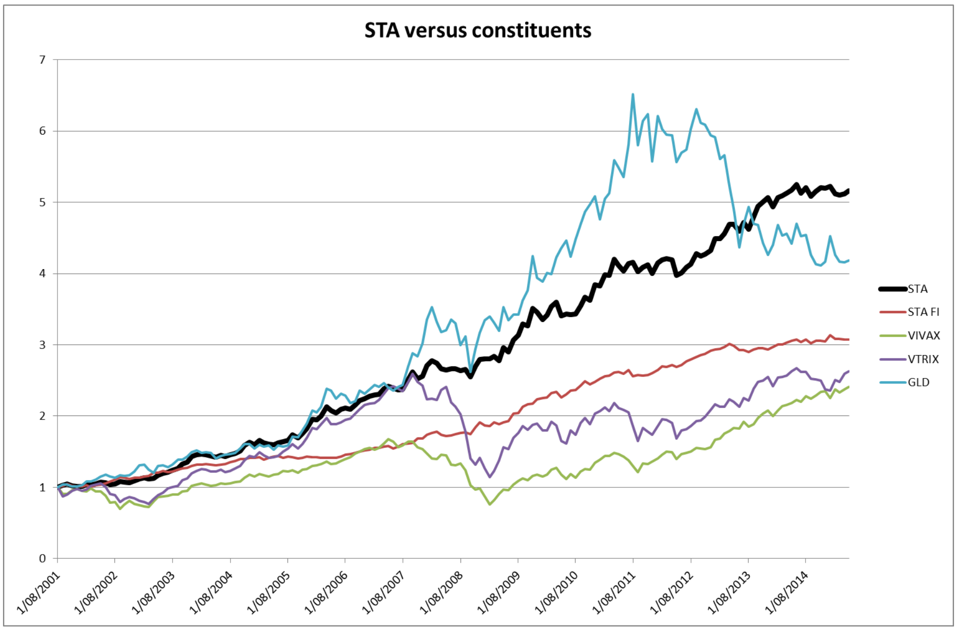
Fixed allocations	CAGR %	STA	CAGR %
80/20	9.3	Full	12.9
60/40	9.1	60/40	12
40/60	8.9	40/60	10.8
20/80	8.5	20/80	9.4

The most conservative STA portfolio actually delivers a better long term compound annual growth rate than the most aggressive fixed allocation portfolio but with virtually none of the volatility.

Naturally in investing there is no perfect investment however the STA approach results in far less stress being forced upon the investor during miserable bear markets, those periods when so many are apt to give up on their discipline. The price that is paid for this is that there will undoubtedly be periods where a fixed asset allocation out strips the STA approach, but not making as much during the good times is far easier for most to cope with than enduring ever mounting losses during the bad times.

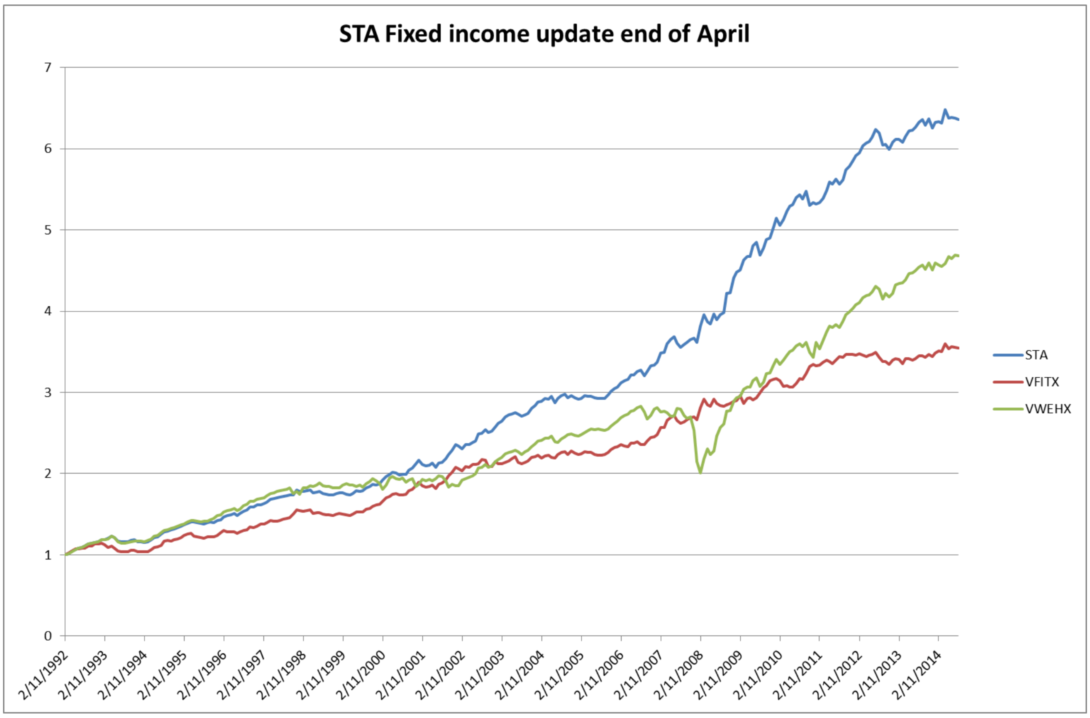
Updated STA Portfolio

What I consider to be the optimal STA portfolio has undergone a number of changes over the last couple of months. The gold ETF; GLD, continues to be a core constituent, as does the STA Fixed Income fund that is made up of two Vanguard fixed income funds, their high yield and intermediate treasury funds. What has changed is that the balance of the constituents are the Vanguard Global Value and Vanguard US Value funds. The result of these parts being combined using the STA approach over the last fourteen years are shown below.



The long term compound annual growth rate of this STA approach is a very satisfying 12.6% with fairly low volatility. It has delivered an annual average return of 13.6%, a negative rolling twelve month return only 5% of the time, a worst rolling twelve month return of just minus 3.4% and a best rolling twelve month return of 32%.

I firmly believe that the STA approach will consistently deliver superior long term returns and lower volatility than a fixed allocation approach, Robo or otherwise. However, I do have a major concern and in large part it stems from the fixed income element of the STA approach.



The chart above shows the results of combining the Vanguard High Yield Fund with the Vanguard Intermediate Treasury Fund going back as long as both have been available. Over the very long term returns from this approach have been better than the two constituents delivering a CAGR of 8.6%. However, over the last five and three years this has fallen to 5.9% and 4.1%, and over the last twelve months the fund has been flat. This has hampered the overall STA portfolio a little as gold has also struggled through much of this period but this has been made up for by the strength of the two value funds. My concern is that when equity markets roll over in a meaningful manner, and I continue to believe that this is a major risk, the STA fixed income fund will struggle to deliver the returns that it produced through prior equity bear markets.

A very long term concern

To some extent the concern that I have outlined above flies in the face of the principles upon which I set about constructing the STA approach. That is to have a rules based discipline that eliminates the risk of emotionally driven, and frequently hugely psychologically biased, investment decisions, but simple arithmetic does ultimately play a part in any calculation of potential future returns.

From an equity standpoint I have outlined both my secular and cyclical concerns many times and I currently take no comfort from those that argue that equities are fairly, or even in some extreme cases under, valued based upon the fact that interest rates are at such a low extreme. It is true that low interest rates may justify higher valuations but it is also the case that periods of very low interest rates have always ultimately been followed by periods of very poor equity market returns. So then I come back to what kind of returns fixed interest markets are likely to generate and it is hard to see a return to the longer term returns that the STA fixed interest model has generated any time soon without a meaningful set back in both treasuries and high yield spreads first. I do believe that the

STA approach will deliver superior returns than other traditional or even non traditional asset allocation approaches but unfortunately that may not a be a particularly high hurdle to beat. Again I come back to seeing the intermediate term future as one where capital preservation will be of utmost importance.

A similar sentiment, although arrived at from a slightly different direction was outlined by Bill Gross, now of Janus formely with Pimco, in his latest epistle. He concluded with the following gloomy outlook;

> As it is, in 2015, I merely have a sense of an ending, a secular bull market ending with a whimper, not a bang. But if so, like death, only the timing is in doubt. Because of this sense, however, I have unrest, increasingly a great unrest. **You should as well**. (emphasis added)

I have been fortunate to have spent my entire working life in an investment environment of very healthy returns across most asset classes. My fear is that despite the widespread need for those returns to continue, there is a high probability of a major hiatus in returns.

Baby boomers in the late nineties poured ever more money into higher risk equities because those were the assets that gave the return they needed to meet their retirement goals. On a probably smaller scale they learnt painfully that just because a certain return is needed it does not have to be available.

Currently the whole investment world seems to be looking for a return, the problem is it just may not be available.

The Danger of supposed Inevitability

Last month in Strategy Thoughts I discussed at some length the then dominant view that the Kiwi Dollar would inevitably hit parity with the Aussie dollar. The following headline and extract summed up the then conventional wisdom nicely as economists were all seemingly clambering over each other to raise their forecasts for the rising Kiwi.

NZ dollar could stay above Aussie dollar parity

NZ dollar could stay above Aussie dollar parity for 'at least a year', UBS says

April 17 (BusinessDesk) - The New Zealand dollar could achieve parity with the Australian dollar within weeks and stay above A$1 for at least a year, according to revised forecasts by economists for the New Zealand arm of the global financial services company, UBS.

At the time I commented that there was little value in forecasting a move that would only see the Kiwi rise another cent against its Aussie counterpart but still the certainty about parity grew. It is fascinating, and a little entertaining to see what has happened since.

I concluded those comments last month with the following;

> Whenever expectations become severely extended and conviction that the preceding trend is set to continue or even accelerate it is likely that the majority of believers are in for a disappointment.

To date there has certainly been some disappointment as the Kiwi almost immediately fell to just 92 cents after threatening the inevitable parity!

Apple versus AT&T

Two months ago in Strategy Thoughts I highlighted the danger of assuming that Apple's induction into the Dow Jones Industrial Average was in any way an indication that the stock should be bought. Since then the stock that Apple replaced, the widely unloved and overlooked AT&T has risen 3.3%, over the same period Apple has risen 3.1%

Conclusion

Very little has changed over the last month, the 'noise' over whether Greece can repay debt or when and if the Fed are going to begin the process of 'normalising' interest rates, does little to change my thinking. My primary concern is that the majority of investors are overpaying for advice that will not deliver what they hope for or need. The 'time in' mantra is just another symptom of what is now a very aged cyclical bull market and should be seen as a warning sign, not taken as a comfort.

Over the very long term healthy returns will once again be available; however, a period of severe discomfort is likely to be needed before such returns can be achieved. The irony is that once that 'discomfort' has occurred the majority will not believe that anything of the sort is possible.

This edition of Strategy Thoughts is a little early as we are heading to Europe for much of the next month and a half, as a result the next edition will not be out until late July, unless anything remarkable happens in the meantime!

Kevin Armstrong

26th May 2015