

## **Strategy Thoughts**

**March 2015**

### **Complacency!**

*"A feeling of contentment or self-satisfaction, especially when coupled with an unawareness of danger, trouble, or controversy."*

#### **Introduction**

This month's Strategy Thoughts was originally going to be titled 'European Complacency' as over the last month I have been amazed at how much has been published and broadcast that seems to totally dismiss there even being a problem in Europe, at least not one that should trouble investors. I then focussed my attention on what is undoubtedly a growing problem in Europe, deflation, but with the recent release of the January CPI number in the US it became apparent that the pernicious problem of deflation was spreading. But again, as with the broader problems facing the EU, the threat of a deflationary problem was broadly dismissed by the media. This was another very worrying sign of complacency. Finally, particularly in the US, with markets still battling higher, faith in behaviours such as 'buying and holding' and 'dollar cost averaging' have regained the pre-eminence that they held back in the mid 2000's along with a belief in the 'science' of modern portfolio theory and the efficiency of markets. The many shortcomings of all these beliefs and behaviours that were so profoundly and painfully exposed through the Global Financial Crisis have seemingly been forgotten given the relative calm of the last few years. This is yet another sign of deep and worrying complacency, and so I simply shortened this month's title to 'Complacency'.

#### **Economyths**

Four and half years ago I titled Strategy Thoughts 'Economyths', this was the title of a book by David Orrell that had just been published. It was a terrific and thoughtful book that I highly recommended and still do. Back then, less than eighteen months after the worst of the GFC, it got to the heart of the challenge that investors faced if they relied upon economics to make investment decisions. At the time the majority recognised that economics and its forecasts had some serious shortcomings given how poorly they had prepared anyone for the disaster that was about to hit in the form of the worst stock market and economic collapse in seven decades. The subtitle of the book was 'ten ways that economics gets it wrong'.

In chapter four Orrell illustrates the severe shortcomings of one of the myths, a myth that sadly after being so clearly exposed as such by the GFC is once again alive and well, the myth that financial risks can be quantified and measured based upon the idea that price movements follow a normal distribution.

Rather than summarise Orrell's points the following is an extract from chapter four;

Economists of the 1960s and 70s began devising complex formulae to measure and control risk. William F Sharpe's Capital asset Pricing Model computed the value of any financial asset, taking into account its risk. It was based on Harry Markowitz's Modern Portfolio Theory, which presented a technique for minimising risk by choosing asset classes that are uncorrelated with one another. Fischer Black and Myron Scholes came up with a clever method for calculating the prices of options – financial derivatives that give one the right to

buy or sell a security for a fixed price at some time in the future. The field of financial engineering was born. Several of its founders, including Sharpe, Markowitz and Black, were later awarded the economics version of the Nobel Prize.

These techniques all assumed the key economic myths; that investors are rational and independent; that markets are free and fair; that markets are stable and correctly reflect value and risk; and that, as a result of all this, price changes are random and follow a normal distribution.

He concluded this section of chapter four with;

In fact, orthodox risk-assessment techniques have **failed to realistically assess the risk of every financial crisis of the past few decades**, including the 1997 Asian crisis, the 2000 dot-com crisis, and of course the 2007-08 credit crunch. As a theory, **it appears to have no backing from observational data**. The reason is that, despite its obvious attractiveness and ease-of-use, the theory suffers from one major, overarching problem, which is that **price changes don't actually follow a normal distribution**. They're not normal. (Emphasis added)

For readers who would like to learn more about the shortcomings of the CAPM I strongly recommend that you read a paper by James Montier from early 2007, 'CAPM is CRAP'. It is freely available at; <http://initiativeming.blogspot.co.nz/2007/01/capm-is-crap-by-james-montier.html>

The Capital Asset Pricing Model doesn't work but it continues to be relied upon partly because it is, as Orrell wrote, easy to use and feels like it should work and partly because there is no other way to build a seemingly scientifically based portfolio. The cruel fact is that investing is not a science and any sense of comfort and security that such approaches deliver should be treated with the upmost caution.

Portfolios that are offered to individual investors generally have been through extensive 'optimisation', usually based upon all of the above, with the aim of providing a level of comfort that some 'scientific' method has been employed in the resulting portfolio's construction. Sadly the results of all this 'optimisation' has proven to do little to protect investors when they most need it.

A quick review of New Zealand's KiwiSaver balanced funds since April 2008 shows that the average balanced funds annual returns have varied between minus 12% and plus 18% over the last nearly seven years with an average after tax annual return of between five and six percent. This is a similar average return for the average KiwiSaver growth funds, only here the range of results (minus 18% to plus 22%) has been more dramatic.

The challenge investors face is that after a very negative year's return it is very difficult to maintain ones composure and continue to ride what at the time appears to be an ever sinking ship. At the depths of the 2007 to 2009 market plunge, in March 2009, many investors would have given up on equities. The outlook was bleak, there was a proliferation of academic studies showing that actually the widely held belief that equities outperform bonds over the long term was wrong and buying and holding clearly no longer worked and was being debunked.

## **Why a buy and hold strategy will not work**

### **BUY & HOLD ..... A SCAM**

## **Is Buy-and-Hold Investing Dead?**

Then when the rally, which has now turned into a six year bull market, did begin no one believed it as the headlines I included in Strategy Thoughts in May 2009 illustrated;

### **Rally, Yes; Bottom, No**

*Forbes.com* – 3/10/09

### **No Way You're Getting Me Back in This Market**

*Yahoo! Finance* – 4/8/09

### **Is this a sustainable bull market?**

The March run likely will lead to weakness

*MarketWatch* – 4/1/09

### **Warning: The bear isn't hibernating yet**

*CNNMoney.com* – 4/1/09

### **Goldilocks rally meets the bears**

March was good, but a downturn is inevitable

*MarketWatch* – 4/1/09

### **Don't Buy the Chirpy Forecasts**

The history of banking crises indicates  
this one may be far from over.

*Newsweek* – 3/30/09

### **Bear Rallies Turn Market Into a Circus**

*Wall Street Journal* – 3/23/09

### **Enjoy the Sucker's Rally, Says Merrill's Rosenburg**

*Yahoo! Finance* – 3/19/09

### **Roubini Says Rally is a "Dead Cat Bounce"**

*The Business Insider* – 3/16/09

### **Is This A Real Rally Or Dead Cat Bounce?**

*Investors Business Daily* – 3/16/09

Now, as I alluded to in this month's introduction, all this has been forgotten and investors once again complacently believe that equities are the secret for long term success and that the CAPM and Modern Portfolio theory will stand them in good stead!

## **Stock Market Outlook for 2015 and 2016 Remains Positive, Despite**

### **Declines in Oil** *Yahoo Feb 4<sup>th</sup>*

## **Where will the bull run take Wall Street to?**

*CNBC* 1<sup>st</sup> March

Rene Nourse, principal and managing director at Urban Wealth Management, expects the blue-chip Dow to hit 20,000 and the S&P 500 index to touch 2,300 by year-end.

It is amazing, but not entirely surprising, just how opinions and sentiment change as a market moves from the depths of the worst bear market in decades towards an important peak. Over a period of a handful of years the lessons that were so painfully learned at the bottom are totally forgotten and the investment beliefs that were so shockingly exposed as 'having no backing' are resurrected.

## **Complacency in Europe**

As I mentioned in the introduction European markets, and their associated complacency, were going to be the primary focus of this month's Strategy Thoughts, however, so much more complacency was apparent.

On the 20<sup>th</sup> January the Financial Times began highlighting the growing appetite within Europe for riskier low quality bonds

## **Eurozone junk bond sales rebound**

The European market for junk bonds has begun the year in robust fashion, bouncing back from subdued activity in recent months as investors seek higher returns from owning lower-quality debt.

By the middle of February the same story was attracting even wider coverage as the desire to chase low quality European yields grew;

The Seattle Times on reported on February 14th:

## **Junk bonds back in vogue**

Junk bonds are benefiting from demand for higher-yielding assets as the European Central Bank's new round of bond purchases pushes yields on more than \$1.7 trillion of debt worldwide below zero.

Then the next day Bloomberg ran the following story:

## **ECB Stimulus Fosters Greed and Eclipses Greece Risk**

The battle between fear and greed in Europe's credit markets is over as Mario Draghi's quantitative easing ensures that not even the threat of a Greek exit from the euro is endangering risk appetite.....

"The market is shrugging its shoulders," said Aengus McMahon, London-based head of European high-yield research at ING Bank NV. "ECB stimulus mutes concern over Greece because there's a lot of money coming in looking for yield."

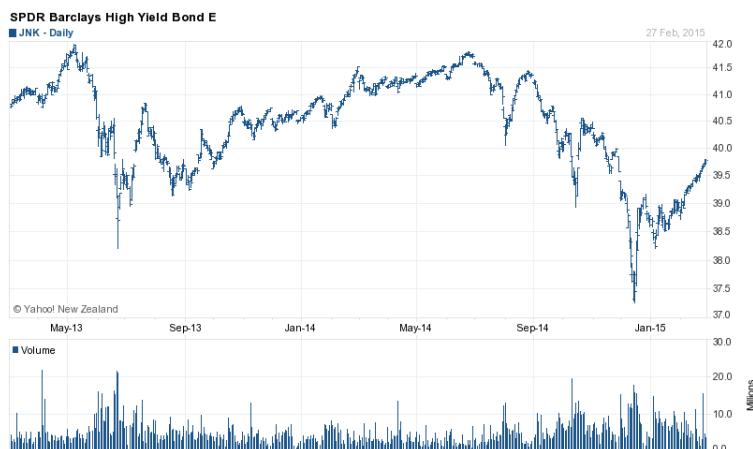
This increased appetite for risk has flown in the face of many things that at other times could have been a source of immense concern for European investors and has not surprisingly been accompanied by a rally in European equity markets. Some commentators have interpreted this action as being a positive, as being evidence of the 'wall of worry' continuing to be climbed, however, I think this shows some confusion on just what the old adage means. I have probably referred to the 'wall of worry' as many times as any other writer over the last decade and have in the past had to clarify just what this sentiment indication means and how it can be used. It is undoubtedly the case that all bull markets begin amid an atmosphere of fear and a predominance of things to worry about, from there the climb up the 'wall of worry' can begin. As the bull market unfolds so long as there are reasons for uncertainty and concern the bull market can continue, however, the peak, the top of the 'wall of worry' is not reached when there is nothing to worry about, there are always things that investors can choose to worry about. The peak comes when, despite there being things to worry about, the vast majority of investors choose not to worry, that is when it can be said that complacency has set in.

Given the rampant issuance and demand for the lowest quality debt in Europe it does seem reasonable to describe what is currently being seen as complacency and should be seen as a warning sign not a green light to get out and chase yield at any price.

Nonetheless, European markets have been strong, although this burst of strength needs to be kept in perspective. The recent strength has only brought broad European indices back to levels they were at ten years ago and 35% below where they were fifteen years ago. The secular bear market in Europe

certainly still appears to be in place and a cyclical bull market peak may be unfolding as risk appetites are expanding.

Late last year I commented on the weakness that was being seen in US junk bond markets and used the Barclays High Yield Bond ETF (left) to illustrate that weakness.



Throughout the first couple of months of this year, as junk bonds were flying off the shelves in Europe, that weakness has been partially, and quite dramatically, reversed. Another sign that fear is fading and the pursuit of yield is in full force, or put another way, it is yet another sign of complacency on the part of investors!

## Deflation

I have been concerned about the risk of deflation for many years and have written about this threat many times and have frequently recommended to readers the excellent book economist A Gary Shilling wrote four years ago ‘The Age of Deleveraging’.

The first hint that deflation may become a global problem came during the depths of the bear market in the wake of the dot com bust. The associated recession and fall in inflation certainly got the attention of central bankers as the fear that the US may slip into a deflationary spiral, similar to that of Japan, was very real. The next outbreak of deflationary fear came during the depths of the GFC when certain economies did actually experience brief bouts of deflation but again, as economies recovered, the fear of deflation faded.

What is of particular concern now is that deflation is actually being seen in many parts of the world.

**Deflation alarms ring louder as EU, Chinese factories struggle** Reuters 2<sup>nd</sup> Feb

**The Eight Unlucky Countries Facing Deflation This Year** Bloomberg 6<sup>th</sup> Feb

**Devaluation by China is the next great risk for a deflationary world**  
The Telegraph 4<sup>th</sup> Feb

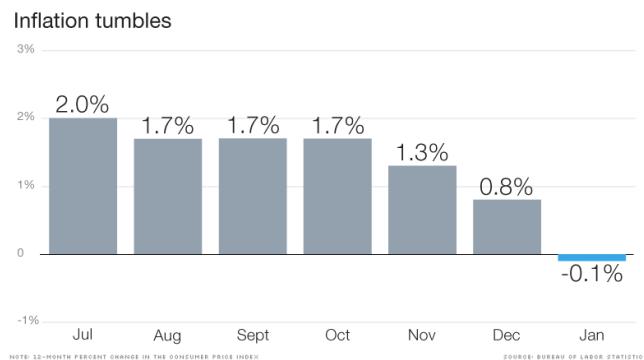
China is not alone in facing a dilemma as deflation spreads and beggar-thy-neighbour currency wars become the norm

**Bank of England says Britain set for deflation for the first time since 1960** The Independent 14<sup>th</sup> Feb

**Deflation fear as China prices plunge** Australian Feb 10th

And most recently in the US as CNN Money reported on the 26<sup>th</sup> February;

## Its official: America has deflation



This was after the US Labour Department reported that the CPI for January fell to minus zero point one percent, yet in the wake of that release complacency that it wasn't real deflation or that it wasn't going to get worse was rife;

"There is little danger that this temporary bout of falling energy prices will develop into a more insidious debt-deflation spiral," says Paul Ashworth, chief U.S. economist at Capital Economics.

In the UK Mark Carney, the Governor of the Bank of England appeared unconcerned as reported by the BBC;

But the governor, Mark Carney, insists in his letter to the chancellor that this is not deflation. This is what he says: "The UK is not experiencing 'deflation': excluding food and energy, 68% of the underlying categories of the CPI are showing positive inflation, close to the 1997-2007 average of 67%". But it is quite a big thing to exclude oil, energy and food - where price falls have been significant and sustained. And those falls are in part linked to the weakness of the global economy. The Bank also acknowledges that price pressures in general are feeble, especially from lacklustre wage increases. But Mr Carney insists this should not be seen as "generalised and persistent declines in prices" of the sort that could be characterised (in his vocabulary) as "deflation". Clear?

Obviously a large part of the deflation that is currently being felt is as a result of falling oil prices, but it seems none of those choosing to dismiss the current deflation want to address why oil prices may have fallen so much, rather they just want to dismiss the deflation that is being seen.

## BoC says no reason to fear deflation The Globe and Mail Feb 14

The plunge in energy prices could send Canadian inflation into negative territory "for a brief interval," but that doesn't mean Canada is on the brink of a deflationary threat, Bank of Canada deputy governor Agathe Côté said.

## Zeti says no reason to fear deflation MSN Money 25<sup>th</sup> Feb

KUALA LUMPUR: Bank Negara Malaysia (BNM) governor Tan Sri Dr Zeti Akhtar Aziz said the central bank is not concerned that Malaysia's inflation could dip into negative territory after January's number came in slightly lower.

Unfortunately, recent history has shown that no investor should take comfort from a central banker that isn't concerned. We have seen them dismiss the threat of a bubble in technology, a bubble in housing and now they see no threat from the deflation that is already being recorded. It certainly seems like complacency.

### **Buy the Dip**

The sentiment of any market can at times be clearly indicated by the increased use of certain phrases. Once a phrase becomes a catch phrase for the market it can start to be seen as a contrary indicator, by the time everyone knows something, or how they should react, it is almost certainly no longer useful. 'Buying the Dip' is one such phrase.

By the time everyone knows that the supposedly sensible thing to do is buy any weakness, or dip, then it is almost certain that the market has been rising for a very long time and expectations on the part of most investors are becoming super optimistic. This has to be the case when a fall in prices is seen as a being a great opportunity rather than a problem or sign of weakness.

Certainty that buying any dips was the thing to do was certainly seen leading up to the 2007 stock market peak. Two years later attitudes were totally reversed.

In March of 2009, at the bottom of the last bear market no one was urging investors to blindly 'buy any dip'. Rather they were counselling the exact opposite, sell the rally;

### **Morgan Stanley Says Sell Best S&P 500 Rally Since '38** March 30

*(Bloomberg) -- Investors should sell U.S. stocks following the steepest rally since the 1930s because earnings are likely to keep weakening, according to Morgan Stanley.*

### **Bank of America's Bernstein Says Sell Bank Stocks After**

**Rally** March 23 (Bloomberg) -- Investors should sell bank stocks after they rallied 12 percent today because the Treasury Department's plan to buy toxic assets won't stop profits from dropping, Bank of America Corp's Richard Bernstein said.

This sentiment continued to dominate as the headline below from the Daily Telegraph on 7<sup>th</sup> April 2009 illustrates;

### **George Soros warns shares will fall further**

**Stock markets slumped for a third day in a row as a welter of warnings that last week's bounce was no more than a "bear market rally" ended hopes of a sustained recovery.**

Even after what we now know was the beginnings of a great bull market the 'sell the rally' message continued to dominate the media;

### **Morgan Stanley's Todd Says 'Sell Into' Stock Rally** July 22

*(Bloomberg) -- Morgan Stanley's Jason Todd, one of Wall Street's two most bearish equity strategists, said investors should "sell into" a rally that has pushed the Standard and Poor's 500 Index to an eight-month high.*

At the end of December last year it was clear that the message for investors had once again changed. No longer were most commentators calling for rallies to be sold, by the end of last year it had become clear that the only ‘sensible’ strategy was to buy any dip that was offered and CNBC ran the following story;

### **The incredible 'Buy the Dip' market of 2014**

The stock market's unprecedented consistency in 2014 generated a trading maxim that echoed on trading floors and social media on a daily basis: Buy the dip. And traders see no reason to abandon this simple, but money-making credo in the New Year. With no losing streak longer than three days this year, any decline in the index proved a buying opportunity for investors. The S&P 500 never had a losing streak shorter than four days in any other calendar year.

This is a world apart from the sentiment that dominated the media six years ago! As I wrote earlier, it is amazing just how attitudes and expectations shift as a bear market turns into a bull market and back again, but this shouldn't be surprising given that it is undoubtedly the aggregate expectations of all market participants that are always reflected in the market. What is important for an investor is that they are able to take a step back from the noise of the news of the day and see how it is being interpreted by the market and how that news compares to the expectations that have already been priced in.

By the time making money in the market is as simple as a ‘credo’ like ‘buy the dips’ it is firstly a sign of deep complacency and secondly an indication that what works is about to change. Making money in the market can never be simple for everyone, at least not for very long.

### **Conclusions**

In late 2006 I wrote a thoughts and Observations piece titled ‘Why Worry? Or the danger of COMPLACENCY! I concluded that article with;

Now may well not be the time to panic, extremes in sentiment or mood can last a long time, but it is certainly not the time to be “*unaware of danger, trouble or controversy*”.

Complacency is always the greatest enemy for investors; this may be particularly true now.

I find myself coming to a very similar conclusion now. Looking back it was obvious I was far too early in my caution, but it did allow investors to avoid a large part of the most severe bear market seen in most of our lifetimes. Undoubtedly I have been too cautious for too long now, but that is not a good reason to abandon ones caution, particularly when warning signs such as those I have referenced this month continue to mount. As I have done many times in the past I will finish with one of my favourite quotes from the great investor and statesman Bernard Baruch.

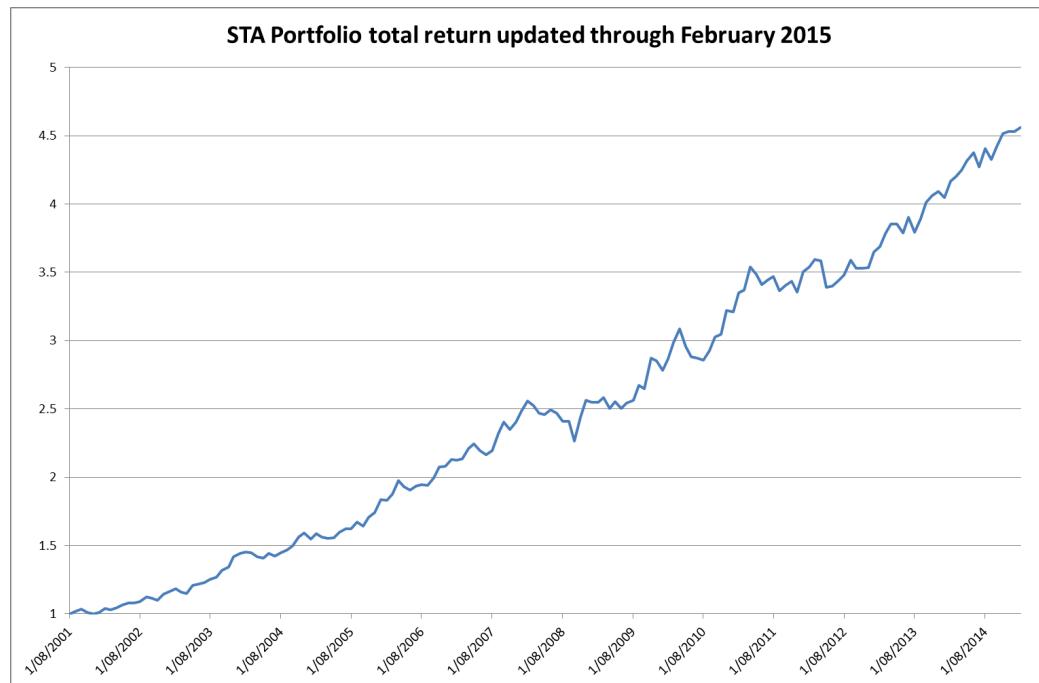
**“I made my money by selling too soon.”**

### **STA Portfolio update**

Again I want to thank all those readers who have expressed support for or interest in the STA portfolio. I must stress that this portfolio does not contradict my belief that investing is an art not a science. The STA Portfolio is designed to capture a meaningful return in a low risk manner through

investing across sectors and asset classes in a highly disciplined and structured way. It is primarily designed to prevent any behavioural biases, which we all unfortunately succumb to, affecting investment decisions which will only be made once a month. It is not designed to outperform any particular market or index and it will certainly underperform when markets rise dramatically but I believe there is a place for such a vehicle and that most individual investors would prefer to receive a healthy, albeit less than the market, return during rampant bull markets if the payoff is that they are not expected to thank their manager when they only lose 10% in a market that falls 15%.

Work is continuing on the investment statement for the STA Portfolio and I will keep all those who have indicated an interest updated both directly and through Strategy Thoughts. In the meantime I have included in the chart below the performance of the STA Portfolio up to the end of February.



In February the STA Portfolio rose 0.7%, its average rolling twelve month return has been 12.33% and average CAGR has been 11.82%. It is currently invested in nine out of the ten S&P sectors and the S&P value index, it has no exposure to gold and is 37% in intermediate treasuries.

Kevin Armstrong

3<sup>rd</sup> March 2015

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