Strategy Thoughts

February 2017

Where are the extremes?

And the importance of Discipline

Introduction

Last month I concluded that getting out of the market may feel as dangerous as jumping off a runaway train, particularly if the Trump 'honeymoon' continued, but that getting out was exactly what any investor interested in capital preservation should do. Since then, with only a brief hiatus, the runaway train has continued. Unfortunately this has only served to make the majority of investors even more comfortable that what has already been enjoyed will continue. Attitudes, and so expectations, across a number of asset classes have stretched to historically extreme levels. This doesn't mean that an immediate reversal is certain, however, it should highlight to all investors that the risk of widespread disappointment has dramatically increased. This month's Strategy Thoughts examines a number of these expectational extremes to highlight the increased risk of a reversal in both US equity markets and the oil market, and the possibility of a further bear market rally in US treasuries. Finally, this month's Strategy Thoughts examines the importance of discipline for any investor, particularly in light of the currently raging active versus passive debate, and provides some further updates on the STA portfolio.

Where are the extremes?

US equities

The Trump 'honeymoon' has continued in the US equity market with new highs above the supposedly significant Dow 20,000 level being recorded almost daily, however, investors should attempt to take a balanced perspective in spite of the gushing headlines that have abounded with each new high;

Dow Jones hits RECORD high amid Donald Trump's new tax policy

AMERICA'S top stock market has hit a fresh record high after Donald Trump promised an exciting new tax policy would be revealed in the next couple of weeks (The Express)

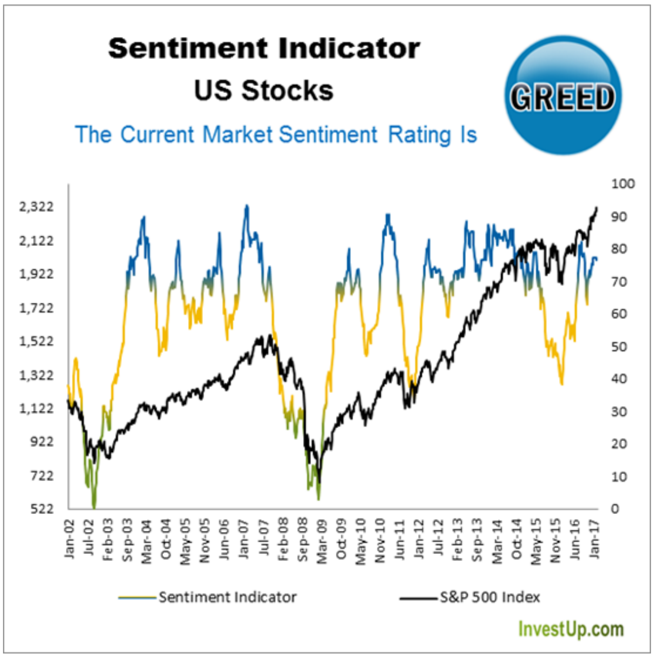
Trump Rally: Since the Election DOW Reaches New High Every Third Day

(thegatewaypundit.com)

John Hussman in his latest weekly letter provided some useful perspective and also highlighted how extreme attitudes have become;

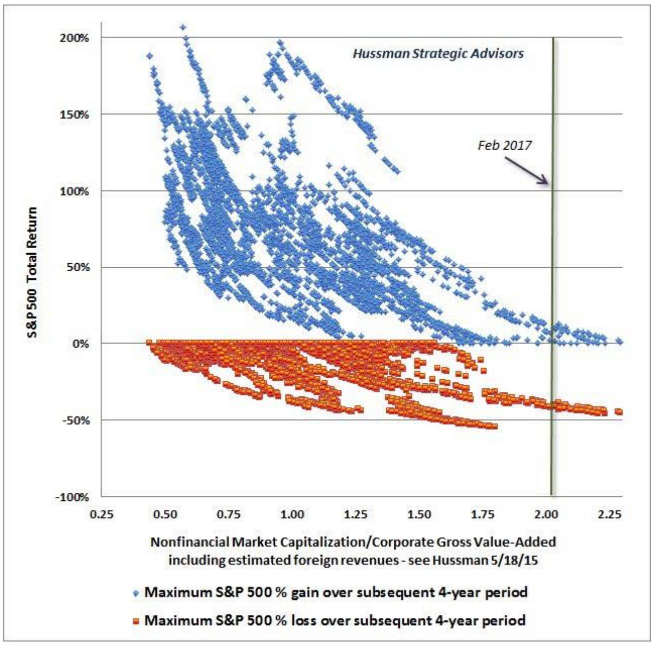
> As for sentiment, the S&P 500 has advanced by less than 2% since mid-December, but since even the most incremental gains represent fresh highs, the advance *feels* almost unshakeable and relentless. Bullish sentiment among investment advisors surged last week to 62.7%, while bears plunged to just 16.7% according to Investors Intelligence survey. The resulting bull-bear spread is among the widest 4% in history.

For the record, the current level of 62.7% bulls, 16.7% bears compares to other major market peaks in recent decades as follows: October 2007: 60.2% bulls, 21.5% bears; March 2000: 55.7% bulls, 26.4% bears; August 1987: 60.8% bulls, 19.2% bears.



This degree of optimism and hope can also be seen in the Investup.com sentiment chart (left).

Whilst not at historic extremes sentiment is firmly in the ‘greed’ zone having only briefly dipped down out of that area ahead of the US election. It is also worth noting that peaks in sentiment on the US market have often preceded the actual market peak as was seen in both 2007 and ahead of the 2015 peak.



Not only is sentiment at an extreme in the US so too are valuations as John Hussman went on to illustrate in the rather clever chart he put together comparing his own measure of valuation with subsequent four year returns for the market. Valuation is a very poor predictor of market returns in the short term but over periods of several years it does, as the trend in the chart clearly shows, offer a good indication of what can be expected.

Despite these obviously highly stretched valuations, and an historical analysis that implies a maximum loss that is three times greater than the maximum possible gain over the next four years expectations are high and seemingly rising the more markets rally.

In mid January the Investment association in the UK surveyed its members, who collectively manage over $500 billion in assets, as to their expectations of returns over the coming year. Almost two thirds of those surveyed believed that equities would once again be the single best performing asset class, a neat extrapolation of what has produced the current valuation and expectational extreme! Further, perhaps not surprisingly given their own vested interests, there was a strong consensus that the asset management industry would continue to grow in 2017.

Obviously these current extremes in equity markets, and particularly the US equity market, can continue to grow and become more extreme. However, it is vital that investors realise that a continuation of the current rally will not be making the investment environment safer, it may feel that way as more and more bullish commentary is produced but the reverse is actually the case. John Hussman painted a particularly graphic illustration of this;

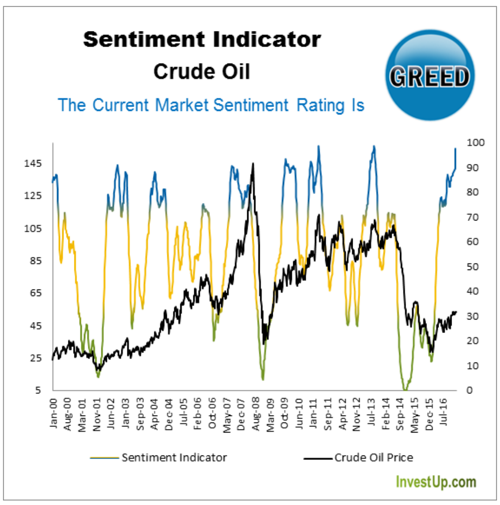
> The difference between value-conscious investors and speculators is that when they encounter a sign that says “Warning! Dynamite” and see a lit wick at their feet, every inch the wick shortens is a signal for the value investor to step further away. The speculator instead moves closer, taking the delayed consequences as evidence that it’s different this time, and the sign is wrong. There have certainly been longer and shorter wicks, but ultimately, the consequences have always arrived.

A worrying sign of complacency amongst traders in the US can also be seen in their expectations regarding volatility. The S&P500 volatility index (VIX) has fallen in the early weeks of this year to its lowest levels in many years as can be seen on the chart below.

The last time the VIX fell to such a low level was ten years ago in February 2007. An extrapolation of this current low volatility would be for it to continue and even fall to new record lows and, worryingly, this seems to be what a majority of large speculators are anticipating as they currently hold a record short position in VIX futures contracts. This complacency regarding volatility remaining low and the market continuing to rise is also apparent amongst institutional fund managers in the US who currently hold only 3% in cash, also a new record. Rather inauspiciously the previous record low cash level was set in 2007 at 3.5% and the record prior to that was seen in 2000 at 4%.

Undoubtedly such extremes can become more extreme and markets could well rise further but the risk of the extreme being unwound only continues to increase, just as it did in 2007 and early 2000.

Crude Oil



Attitudes towards the price of crude oil are now as optimistic as they have been for many years as the Investup.com chart (left) shows. It is also clear from this chart that attitudes have been whipsawed wildly over the last few years; however, what is remarkable about the current extreme bullishness towards oil is that it has come after what has been a rather modest bull market in oil. Admittedly the price has doubled but this has only retraced a fraction of the damaging bear market that preceded it.

It is therefore quite useful and instructive to revisit the changing attitudes towards oil over the last few years.

A little over two years ago, amid plunging expectations for the outlook for oil, I wrote the following:

Oil

CNBC ran the following story as oil broke down to yet another multi year low;

As oil breaks $50, Wall Street getting more bearish

With more supply hitting the market, Wall Street is getting more bearish on the outlook for oil prices and some strategists see the market many months away from finding a floor.

Again, like the European situation in late 2011 getting increasingly bearish the more a market falls is understandable, but it is important to observe how much attitudes have changed. In Europe back in late 2011 it is clear that they had gone through a 180 degree reversal, so what has happened in the oil market.

Given all the coverage that has been devoted to the collapse in oil prices it seems that virtually everyone now understands why this collapse has occurred, it all revolves around falling demand and over supply. This seems to make sense but unfortunately if supply and demand were truly what drove the oil price then the International Energy Agency and the US Energy Information Administration would be best placed to forecast prices, sadly, but not surprisingly, that has not been the case.

In June expectations for oil were quite different as the following Reuters headline illustrates;

Brent crude oil rises above $110 on global growth prospects

Later in the same month as crude continued to rise forecasts grew more optimisitic as reported in the Business Standard;

Crude oil outlook: Crude oil prices can rise above $120 if Iraq crisis escalates

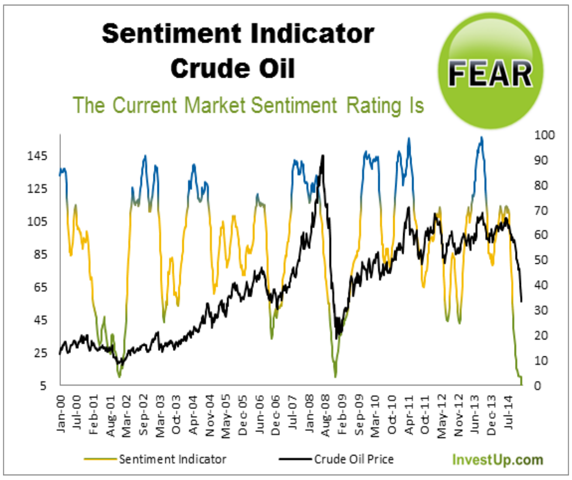
The US Energy Information Administration in its July 2014 Short Term Energy Outlook report wrote;

> The forecast Brent crude oil price averages $110/bbl in 2014, $2/bbl higher than estimated for 2014 in last month's STEO, and $105/bbl in 2015, which is $3/bbl higher than in last month's STEO.

Four months later, with prices having begun their collapse, their forecast had dramatically changed;

> The combination of robust world crude oil supply and weak global demand contributed to rising global inventories and lower crude oil prices. The forecast Brent crude oil price averages $83/bbl in 2015, $18/bbl lower than projected in last month's STEO.

One month later their forecasts were once again ratcheted down;



The forecast Brent crude oil price averages $68/bbl in 2015, $15/bbl lower than projected in last month's STEO.

Last month I showed the extreme position that sentiment towards Crude oil had fallen to. Since then it has fallen even lower to an almost rock bottom level of 0.08 on Investup's measure.

I have no idea what the supply demand picture will be for oil over the coming days, weeks or months but then that clearly is not what is required to successfully forecast the oil price, particularly if an important inflection point is imminent. Not to labour this point unduly but it is interesting to review the US's EIA's forecast around the most significant inflection points of the last few decades.

In their August 2008 report, when oil had made its all time high they wrote;

> WTI prices, which averaged $72 per barrel in 2007, are projected to average $119 per barrel in 2008 and $124 per barrel in 2009.

This showed a nice gentle extrapolation upwards but we now know that this is far from what happened. Over the next few months the price of crude plummeted. By the end of 2008 their forecast for 2009 had been slashed by 60%.

> The monthly average price of West Texas Intermediate (WTI) crude oil has fallen by more than half between July and November, reflecting the fallout from the rapid decline in world petroleum demand. The annual average WTI price is now projected to be $100 per barrel in 2008 and $51 in 2009.

The next month the forecast for 2009 fell another 15% to $43 and a forecast for 2010 of $55 was introduced. By March the 2009 forecast, which just seven months earlier had been $124 was cut to its final low of $42, unfortunately this was several months AFTER the price of oil had actually bottomed and would have to be ratcheted higher throughout the year as the actual average for 2009 turned out to be $62, 50% higher than their forecast just nine months earlier, and 50% lower than their forecast less than eighteen months earlier!

It may appear superficially sensible to believe that the basic economics of supply and demand drive the oil price, unfortunately the truth is actually very different. The oil price, like any market, is simply a reflection of the hopes and fears, the aggregate expectations, of all market participants. This is obviously harder to measure than supply and demand statistics, in fact it is impossible to measure with any degree of accuracy, that is why investing is, and always has been, far more of an art than a science. Nonetheless, it seems sensible to at least attempt to get

> a handle on those aggregate expectations and it is certainly more sensible than attempting to get better or more accurate forecasts of supply and demand!

I concluded that article with the following;

> Currently aggregate expectations towards the price of crude oil are as bleak as they have ever been, this does not mean they cannot get bleaker, but it does mean that if there is any sort of a surprise in the oil markets it is far more likely to result in higher oil prices than lower prices. I am not suggesting that one should attempt to catch the 'falling knife' that is oil prices currently, but don't be surprised by the magnitude and speed of any kind of reversal when it comes.

A year and a half later, in September last year, I noted that attitudes had shifted amid ever rising forecasts for the supply demand balance from so called 'experts'. Both the IEA and the World Bank were drastically raising their forecasts, which they had previously been slashing, after the price of crude had rallied from its historic low.

Now, with the price of oil plateauing after more than doubling, estimates, and so expectations, continue to inflate.

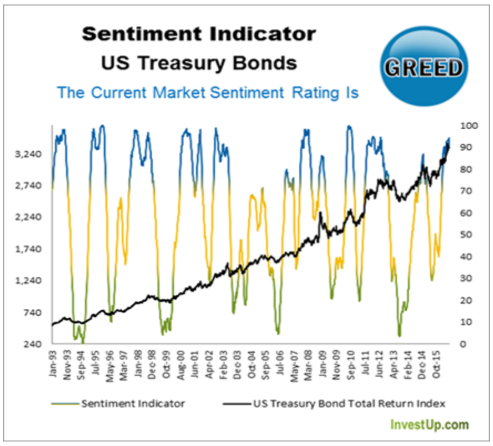
In late January and early February this year, amid positive expectations regarding OPEC compliance and production cuts, the following headlines appeared;

> **Analysts See Oil Prices Rising as OPEC Production Cut Bears Fruit**
>
> **IEA hails 'solid start' to OPEC cut pact, raises oil demand outlook**
>
> **Crude Oil Price Forecast: Possibly The Most Encouraging Move of 2017**

These are a world apart, and almost 180 degrees shifted, from those seen a little over a year ago as sentiment towards, and so expectations for, the price of oil have moved from a record low to nearly a record high, as a result the risk of disappointment has increased markedly.

It is fascinating, and can be highly rewarding, tracking these shifts in attitudes toward such an important asset, and to have witnessed such opposite sentiment extremes in such a short period of time reinforces the value of looking at markets from an expectational, rather than a perpetually lagging fundamental, perspective.

Whilst it has been valuable witnessing and tracking two such expectational extremes in real time two similar extremes have been recorded in another major asset in an even briefer span.

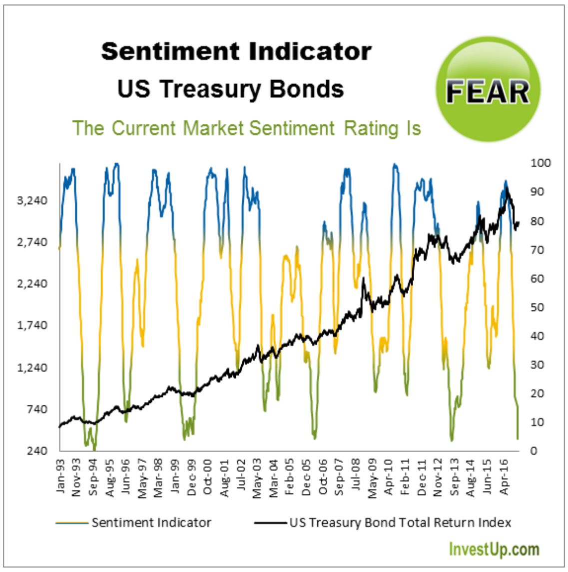


US Treasury Bonds

In August of last year I included this Investup.com sentiment chart (left) in Strategy Thoughts. It showed that sentiment towards longer dated US treasury bonds was as optimistic as it had ever been, not surprisingly this was coincident with record low yields in longer dated treasuries. At the time I wrote;

Currently sentiment towards US Treasuries is as optimistic as it has been for four years. Obviously this does not mean that bond yields are necessarily set to surge higher but it should raise a cautionary flag, particularly for those investors chasing yields in lower quality instruments.

What has happened since then has certainly been interesting with yields on longer dated bonds recording a substantial increase, however, of even greater interest, at least from a shorter term perspective, is how rapidly and dramatically expectations towards treasury bonds have reversed.



An updated version of the Investup.com chart shown seven months ago reveals that, along with the sharp fall in treasury prices (and so increase in yield) sentiment has now fallen off a cliff. For sentiment measures on any asset to fall from near record high enthusiasm to near a record low in such a short period of time is certainly noteworthy. It is probably indicates that the current correction in treasuries may well have ended and some further near term recovery in treasury bonds, and fall in yields, may be expected. None of this alters my longer term secular belief, discussed in previous editions of Strategy Thoughts, that the low recorded in the second half of last year probably marked the end to the secular bull market in treasuries that began more than a quarter of a century ago

The importance of discipline

Active versus Passive management

Passive Investing Will Overtake Active By 2024 At Latest; Could Hit Mark By 2021: Moody's

Here Comes a Passive Investing Bubble; Long Live Active Management

The current debate over active or passive investment strategies can probably be summed up in the two headlines above that have appeared over the last week. Low cost passive approaches have clearly outperformed more expensive active strategies over the last few years and have understandably attracted an increasing portion of investment assets. In the wake of this it is also understandable that proponents of the passive approach will push, and extrapolate this trend, as the first headline succinctly does. However, it is also obvious that this trend cannot go to an illogical extreme where almost everyone employs a passive strategy; an inflection point will be reached where active management can earn their higher fees at the expense of the passive managers. Whether that point has been reached, or is even imminent, as the second headline claims, is largely irrelevant and I have no idea anyway. The problem is that neither side in this most important debate are asking the right question, at least as far as the underlying investor, whose money it is they are 'competing' with, is concerned.

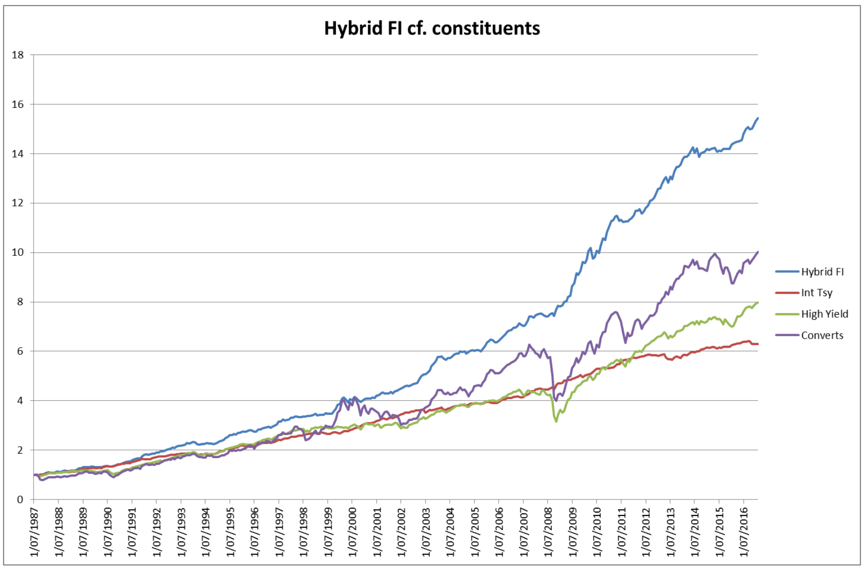
The passive fund manager is attempting to deliver returns in line with an underlying index at very low cost, whereas the active manager is attempting to beat an index and to earn a higher fee in trying. The problem is that both sets of managers are attempting to achieve a relative outcome. During rising markets this may be a satisfactory outcome for the underlying investor; however, during protracted bear markets even stellar relative performance is far from comforting.

The challenge the active manager faces is that he is continually being compared to both his benchmark and his competitors, it is therefore hard, and too steep a career risk, to look too different. Yet as legendary fund manager, academic and author, Joel Greenblatt pointed out in a CNBC interview last year, "In order to beat the market, you have to do something different than the market" which should be obvious to everyone. He then pointed to a study that showed nearly half of top performing fund managers over a ten year period spent at least three of those years in the bottom ten percent of performance.

Successful active fund managers, and their investors, must be prepared to be out of favour, wrong and underperforming, for extended periods if they are to achieve their stated aim of long term out performance.

The challenge for passive investors is that firstly it is largely just a price business and secondly that during lengthy bear markets the low fee is of little comfort to the underlying investor who sees their life savings dwindling with each monthly or quarterly report they receive. Inevitably the majority of those investors sell out of their low cost funds at just the wrong time, when the pain is greatest and they just want out at any cost, only to see the market rally soon after.

The real challenge is that investors actually have little interest in relative performance, what they really want, paraphrasing Benjamin Graham, is a satisfactory return with limited risk of permanent loss of capital. They want an absolute return, probably don't mind underperforming through rampant bull markets but certainly don't want to hear their managers encouraging them to taking comfort from relative returns in miserable years.



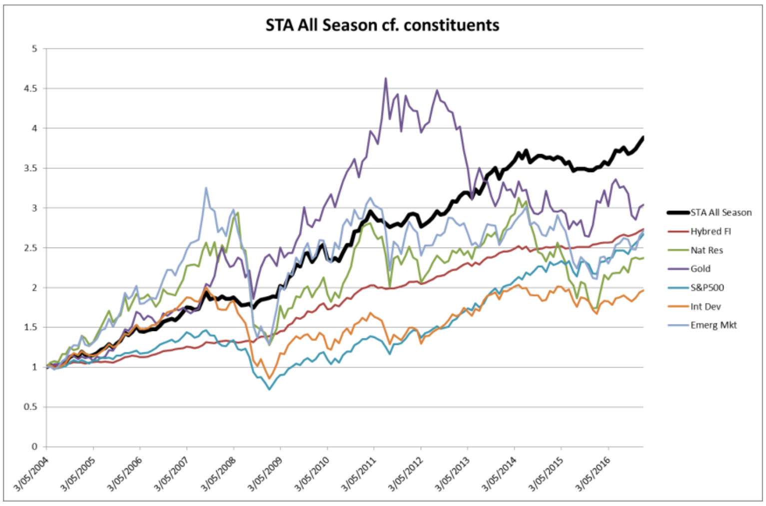
STA Update

In many ways the STA portfolio delivers what the majority of investors are looking for as I outlined at length in 'Investing: The Expectations Game'. It is rules based, so takes the emotion out of decision making, over the long term it out performs the underlying markets it invests in, and it dramatically reduces the possibility of a negative return. However, it is not magic and it certainly does not consistently outperform the underlying markets, but importantly, that underperformance usually comes in the early stages of great bull markets and it consistently outperforms through miserable bear markets.

The chart on the previous page is an updated version of an STA portfolio I first showed in the December edition of Strategy Thoughts. It is an alternative to a traditional fixed income portfolio investing in intermediate treasuries, high yield bonds and convertible bonds via low cost Vanguard funds. The average asset allocation over the almost thirty years price data is available has been 23.5% high yield bonds, 28.5% convertible bonds and 48% intermediate treasuries. The portfolio has risen 2% since December, 7.2% over the last twelve months and has delivered a compound average annual return of 9.7%.

This fixed income portfolio can be used as the alternative to other assets in a broader portfolio.

Last year I introduced the idea of an ‘All Season Portfolio’, one that invested in US equities, global developed equity markets, emerging markets, natural resources, and gold. An updated version of this portfolio has delivered the performance shown in the chart (left).



Returns from the All Season portfolio have been slightly more volatile than the hybrid fixed income portfolio, however, it has been less volatile than its constituents and has also delivered a meaningfully better return that the fixed income portfolio.

Conclusions

None of my views have materially changed over the last month and preservation of capital, rather than chasing what is looking increasingly like a runaway train, should continue to be the majority of investors’ primary objective. A number of extremes have been seen across asset classes over the last few months and the risk of reversals and accompanying increases in volatility remains high.

Finally, over the last couple of years many readers have sought to invest in a fund that replicates the STA approach and I am now hopeful that an alternative approach to investing may be closer to being available. I have begun discussions with a major asset management organisation and will keep readers posted on progress. Any other readers that would like to kept abreast of these developments please feel free to contact me directly.

Kevin Armstrong

14th February 2017