Strategy Thoughts

October 2017

The power of being an OUTLIER

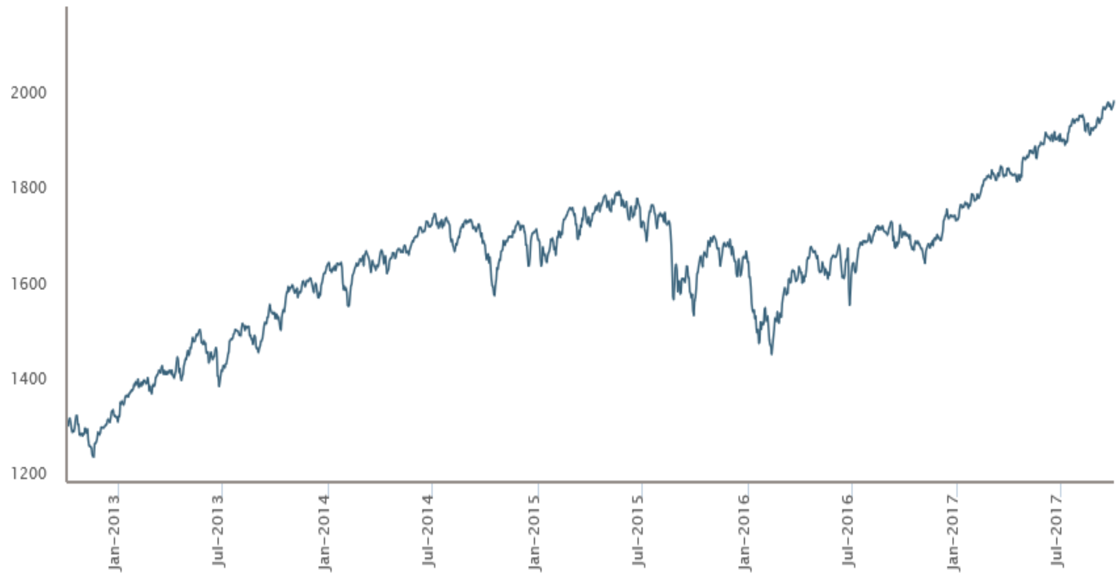
Introduction

Markets have continued to rise through the third quarter, accompanying this rise has been increased confidence and expectation with continued low volatility. On the surface this may seem to be the ideal investment environment; steady orderly gains with minimal volatility. Unfortunately, the outcome, as so often happens in investing, may well be something quite different than what the vast majority now hope for, and even expect.

This month's Strategy Thoughts reviews many of the reasons currently being used to justify a continuation of the current benign investment environment and demonstrates why most should be seen as a warning sign, not a green flag. I also revisit the value and importance of daring to be different, or the power of being an outlier as the FT described it recently, and provide an update on the STA portfolios.

Overview

The chart below shows the progress made by the MSCI World Equity Index over the last five years, what has been remarkable is the incredible orderliness of the advance since the mini bear market the index experienced through the second half of 2015 and into 2016 when it slipped about 20%. Over the last twenty months the index has risen close to 35%, over just the last year the index has risen more than 16%, it is up 14% since the beginning of 2017, 8% over the last 6 months and 4% over the last three months. Since this rally from early 2016 began it is also clear that any setbacks have been getting smaller and smaller.



Over a similar period interest rates, as measured by the US ten year treasury, after surging higher from their all time low in mid 2016, have broadly moved sideways. The current yield of 2.3% is the same level as was recorded in mid November last year and is approximately in the middle of the range that has been experienced since then. A similar calmness can be seen in the price movements of commodities over the last eighteen months.

The CRB commodity index (above), despite both frequent inflation and deflation scare mongering, and some of the most extreme weather events ever recorded is at the same level as it was in May and June 2016, and stuck very close to the middle of its trading range since then.

All this raises the very understandable question, what could there possibly be to worry about, surely a slow, steady and orderly advance is just what the majority of investors would desire. Unfortunately in investing the more people get what they desire the more comfortable they get and the more they tend to extrapolate that experience way into the future. Orderly and steady may be desirable but it may not be healthy. An albeit obscure parallel can be drawn between investing and cardiology.

Some years ago the New York Times ran the following headline;

LESSONS OF THE HEART; With Heartbeats, Slow Is Good, Steady Not So Good

The article went on to describe research into how quickly patients' heartbeats returned to normal after exercise, and a quite counter intuitive finding: the steadier the heartbeat, the sicker the heart.

> The explanation, experts say, involves the two competing nerve networks that control the heart's beats. The sympathetic system speeds up the heart, the parasympathetic system slows it down.
>
> In healthy people, the two systems are constantly working in opposition, making the heart rate fluctuate. But, said Dr. Arthur Moss, a heart disease researcher at the University of Rochester, "the sicker the heart, the greater the likelihood that it will be dominated by the sympathetic nervous system."
>
> He added, "If the heart is weakened, you can influence the output of blood by stimulating the heart to beat faster." And "if you stimulate the heart, the heart rate will be more regular."
>
> As the sympathetic nervous system flogs the heart more and more, the heart can falter. "It's very much like whipping a tired horse -- you get dysfunction," Dr. Moss said.

Perhaps investors should currently be asking themselves whether this current steady advance is evidence of something more concerning and that perhaps continuing to 'whip' what may now be a very 'tired horse' may well result in something very 'dysfunctional'.

What's to worry about?

Apart from obscure parallels with heart beats it is worth questioning the currently dominant calmness evident in markets and question just what there may be to worry about. MarketWatch recently published an article under the headline '7 Reasons to stay Bullish'. Among those reasons listed were:

1. Businesses (in the US) see great earnings.
2. The economy in the US and throughout the OECD are strong
3. Consumer confidence is high.
4. The fear index is far from scary.
5. Growth friendly agenda in DC

And then there was the catch all reason to stay bullish, where else are you going to invest with interest rates so low?

Ironically, every single one of these reasons that the author has used to remain bullish are reasons I would use to take the other side of the trade. It is not that any of these statements are not true, rather it is that these are all statements that are exceptionally well known and are reasons why the markets have already done as well as they have. None of them have any predictive value and if anything only set investors up for disappointment rather than positive surprise, and it is disappointments and surprises that drive markets, not the expected actually happening.

Earnings. An entire industry exists attempting to forecast earnings, unfortunately the vast majority of forecasters' forecasts lag the actual earnings outcome. Historically this has been particularly true at important inflection points. Earnings estimates only start to get ratcheted down long after earnings have started to decline, and even longer, given the lagging nature of earnings reports, after the stock market has already rolled over. A noteworthy example of this would be hedge fund legend Leon Cooperman who in the August 2007 edition of Fortune proclaimed his bullishness partly on the back of 'corporate profitability and balance sheet liquidity' being excellent. Unfortunately we now know that while they might HAVE been, and that may have contributed to the preceding bull market, they were not going to stay that way.

Stock markets do not peak because earnings peak, rather they peak because eventually actual earnings fail to surpass what are by then hugely extravagant expectations for earnings. It is usually many months after the actual stock market has peaked that earnings estimates begin to be ratcheted down. This is exactly what happened in 2008.

The economy. The relationship between the economy and the stock market is very similar to that of corporate earnings, they lag the market and the forecasters lag reality, usually only lowering growth forecasts long after growth has rolled over. The following quote is from the then chairman of the Federal Reserve, Ben Bernanke, in mid 2007.

> The global economy continues to be strong, supported by solid economic growth abroad. U.S. exports should expand further in coming quarters. Overall, the U.S. economy seems likely to expand at a moderate pace over the second half of 2007, with growth then strengthening a bit in 2008 to a rate close to the economy's underlying trend.

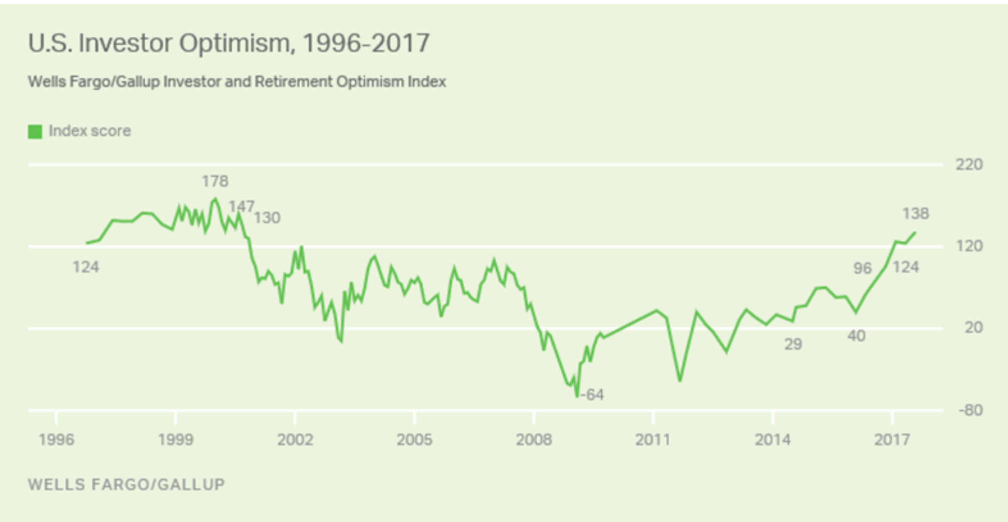
At the time Bernanke should have been one of the most informed economic commentators and yet his assessment as to what the immediate future may hold could not have been more wrong. He was correct in his observations as to the strength the economy HAD shown, which, like earnings was why the markets HAD been so strong. However, his strengthening outlook in 2008 was both wrong and extremely dangerous to any investor who thought economic forecasts were helpful in forecasting market direction.

What is perhaps amusing is that 2007 could be replaced with 2017 in the Bernanke quote and a similar constructive, measured, sanguine and comforting outlook would have fitted right into the article mentioned at the beginning of this section.

Among the many behavioural biases that beset us all are the comfort we take from company, our tendency to extrapolate the present way into the future and our inability to remember lessons that were painfully learned just when they would be of value again. Earnings and economic forecasts were almost totally useless through the two painful bear markets that the world endured over the last seventeen years, and even more useless in highlighting the remarkable opportunities that were available when those bear markets ended. Yet still, the majority of commentators and investors, when asked to justify their bullishness rely on theirs or someone else's forecast for the economy and earnings.

Bull markets are not sustained by positive earnings and a growing economy, bull markets require earnings and the economy to continually deliver positive surprises. This gets harder and harder the longer a bull market runs and the more extreme expectations become, and they are becoming increasingly stretched.

Expectations. Establishing exactly where aggregate expectations are at any time is not easy and is often dependent upon subjective interpretations of things like the article described earlier. However, it is generally something that any investor only needs to think about when expectations become extreme, when surprises and disappointments are most likely. Then less subjective inputs can be most valuable. Three weeks ago, Gallup released the results of their latest Wells Fargo / Gallup investor and retirement optimism survey. The chart below shows that investor optimism has risen in a very steady and largely uninterrupted fashion along with the stock market.



What is more troubling is that optimism levels now are higher than they have been since the early stages of the dotcom bust in 2000, and are substantially higher than they were when Cooperman and Bernanke were delivering their comforting words in mid 2007. The report went on to point out;

> Sixty-eight percent now say they are optimistic about the stock market's performance during the next year, matching the record high for the question from December 1999 and January 2000.

Matching a record high from the very peak of the tech boom, just ahead of an 80% fall in the NASDAQ should be of little comfort to any investor. And it is not only Gallup's survey that was revealing extreme optimism. Last month Market Vane's measure of institutional investor optimism reached 71%, its highest reading since June 2007, again, not a particularly comforting or auspicious comparison.

Expectations in Europe are also optimistic. After recording their best month for the year in September the prospect for further gains was perhaps not surprisingly a widely held view. With the Eurostoxx index rising for the final three weeks of September and delivering a gain of 2.3% for the third quarter MarketWatch quoted one commentator who, whilst noting there had been some headwinds for the market with Brexit and Southern Europe, now saw the ECB beginning to tighten as a positive!

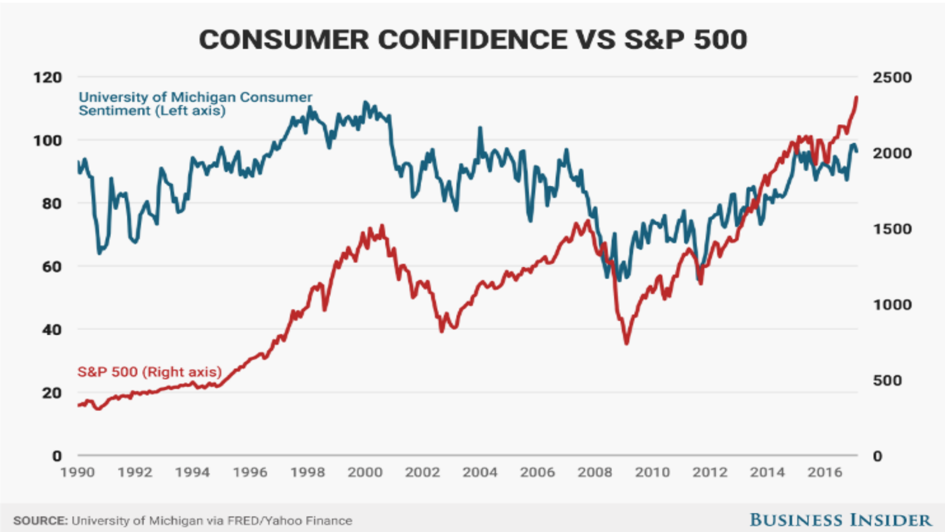
> "But we finally appear to be at a point when the tailwinds are more encouraging that the headwinds are concerning and this could continue to support stocks even as the ECB withdraws it's support, which in itself is an act of confidence in the outlook,"

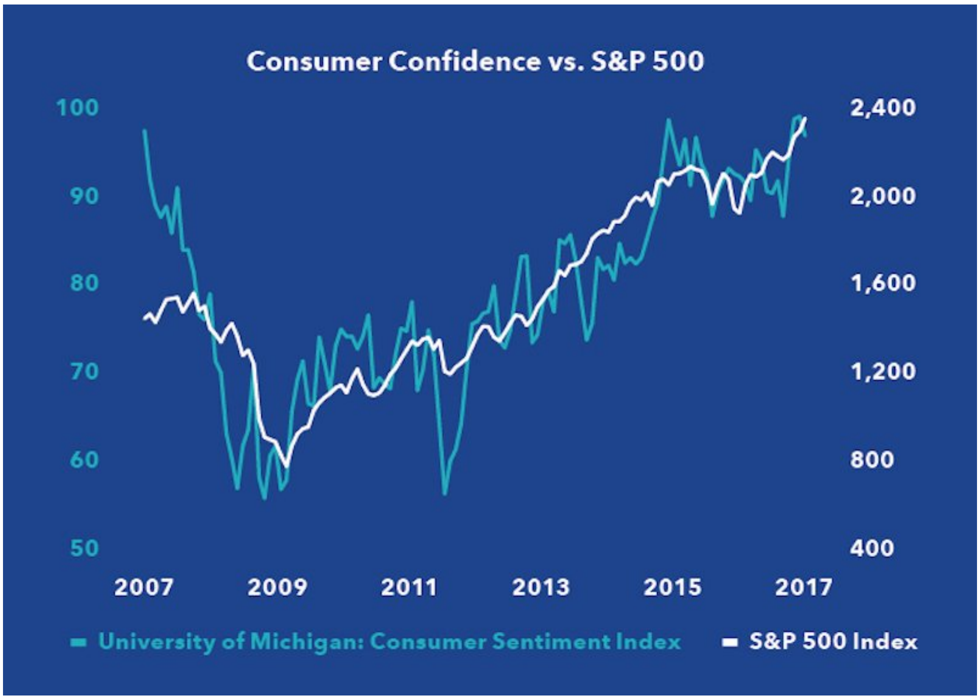
Across emerging markets expectations are also high after the regions longest bull run since 2004. Bloomberg reported this enthusiasm under the headline;

Bulls see room to run after 8-month gain in emerging markets

The article quoted numerous analysts and investors with quotes such as, "Emerging market stocks are still extremely attractive" and that "the current outperformance could last five years". Underlying all the enthusiasm and heightened expectation were similar factors to those already discussed for the US; better economic growth and higher corporate earnings.

Consumer confidence. Elevated levels of consumer confidence were mentioned in the '7 reasons to stay bullish' article, and like the outlooks for earnings and the economy this indicator feels like it should tell us something, and it does. It tells us where confidence and, to some extent, expectations are. It doesn't tell us anything about where anything is likely to go, and not surprisingly the stock market and consumer confidence move together, as the two charts below highlight;





Peaks and troughs in consumer confidence tend to coincide with peaks and troughs in the stock market. However, it is important to understand that one is not the driver of the other, they are both a reflection of the ebb and flow in social mood and levels of expectations. An elevated consumer confidence reading should not be taken as a prop for further gains in the stock market. What it actually shows is that the stock market is probably already elevated, along with expectations, and so the risk for a disappointment is actually greater.

A low fear index. This was mentioned as another of the reasons to remain bullish yet unfortunately it is as useless as all the other factors mentioned, and, like the consumer confidence index, it is more indicative of the possibility of a disappointment than a positive surprise. Over the last ten years bear markets and corrections have, not surprisingly, begun with a low fear index and ended with an elevated fear index. Again, the fact that the fear index is low should not be used as an encouragement for further equity investment.

Private equity. In addition to all the above, the signs that were supposed to allow for further upside but actually indicate heightened risk, private equity can be included. Last month the Financial Times ran a major article;

Red hot fight for PE deals will hit returns

The article focused upon the seemingly insatiable appetite that exists currently amongst investors for private equity and private equity funds. Through August private equity managers globally had raised $260 billion in new funds and are apparently on track to set a new record in 2017 for the most ever raised in a year. That record currently stands at $369 billion and was achieved at the peak of the investment boom ahead of the Global Financial Crisis in 2007. The article reported that private equity fund managers are currently looking to raise a further $578 billion, obviously so long as the markets oblige.

In the August 2007 edition of Strategy Thoughts, almost immediately prior to the onset of the worst bear market in living memory and as record amounts were flowing into PE funds, I highlighted that the IPO of Blackstone (The private equity behemoth) may be a bell ringing not only for the then rampant PE boom, but also for the market as a whole. I wrote;

> Perhaps the best description of what may be happening now was coined by Jeremy Grantham of GMO. Admittedly Grantham is, and has been for some time, an arch bear, but he writes very well and his latest quarterly letter is well worth reading. It is titled;
>
> *"The Blackstone Peak and the Turning of the Worms (The Slow Motion Train Wreck Continues)"*
>
> A little lengthy but it certainly gets the message across. It will be interesting in a year's time to look back at the Blackstone IPO. As Grantham said it may pin point almost the actual top, it won't have been the catalyst for the top but it may mark the high water mark, much in the way the AOL Time Warner deal did back in 2000. The most appealing part of the title though is the analogy of a **slow motion train wreck**, the picture it conjures is indeed an apt metaphor for a true bear market.

With the benefit of hindsight, we now know that Grantham was a fraction early, but only by a couple of months. Two months after the Blackstone IPO the stock market peaked and began its worst slide in seven decades, the private equity boom also peaked with, as the FT showed, inflows into PE funds collapsing by almost two thirds. Such an environment was not kind to the newly public Blackstone with its stock price collapsing through the GFC by about 90%. Since then Blackstone has recovered and is now, coincidently, back to the price it first came public at.

Like consumer confidence and the fear index private equity is not an indicator of where the stock market is likely to go, they tend to move together. However, private equity flows do provide some insight as to the elevated or depressed levels of expectations amongst investors. The massive flows pouring into private equity funds, at a rate not seen in a decade if ever, should, like the other factors discussed this month, be seen as a warning flag not as a comforting sign.

The power of being and Outlier and the problem with consultants

Last month, while flying back from the US I read a wonderful article in the Financial Times about the firm and the man who are the sole fund managers of the Tampa Fire and Police Pension Fund. The majority of state pensions funds employ asset consultants to guide them amongst a variety of asset classes and managers, and most state pension funds in the US are grossly underfunded to the tune of $3.85 trillion. The Tampa fund employs no consultants, is almost fully funded at 95.4% and has been one of the best performing municipal funds in America. The funds' manager Bowen, Hanes and company, has been managing the Tampa fund since 1974, it is currently run by Harold Bowen III and was run by his father in the earlier years. The pair have stuck to a disciplined low turnover, growth focussed approach to stock selection and have generated a total return for the equity portion of the fund of 34,284% over the forty three years compared to just 13,782% delivered by the S&P500 over the same period. The exposure to fixed interest has also performed well returning 12,177%.

It has been a clean, simple and remarkably successful investment fund for the firemen and policemen of Tampa, and yet the fund has attracted negative headlines, ridicule and even lawsuits. Apparently the 'problem', at least as seen by others, is that the fund has never employed a consultant and has only ever used the one manager. Understandably Harold Bowen III is unfazed by such criticism and is himself deeply critical of the consultant industry;

"The original mission of these (pension) plans when they were set up was to provide just a really good, stable retirement for these great public servants. And, overtime, I think that mission's been lost," he says.

He is quick to criticise investment consultants for their role in creating problems at public plans by encouraging funds to invest in different managers and alternative asset classes which push up fees and hurt returns.

"Genuinely, I think they're trying to add value with this modern portfolio theory and multi manager model that they use, but it is just that, historically the evidence is very much against them in terms of adding value.

Bowen, and his father before him, with the support of the Tampa board, have clearly added great value to this $2 billion fund over the long term, and they have done it by 'daring to be different', as Howard Marks put it, and by both parties, the managers and the plan's board, ignoring the chorus of the consulting consensus and being prepared to be seen as an outlier. Doing the same thing as everyone else may ensure that an investor cannot be criticised, but it also guarantees that an investor will only every be average.

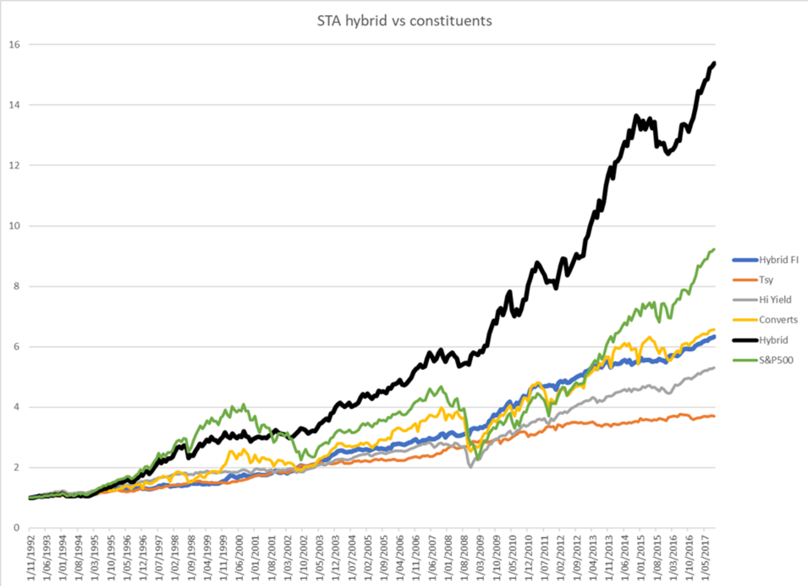
The STA approach

Daring to be different, and being prepared to be seen as an outlier is difficult, it goes against our very powerful herding instinct, and yet it is essential if an investor is to succeed. There are many successful investors and they certainly do not all do the same things; however, they are all highly disciplined and will spend a considerable period experiencing the discomfort of being an outlier.

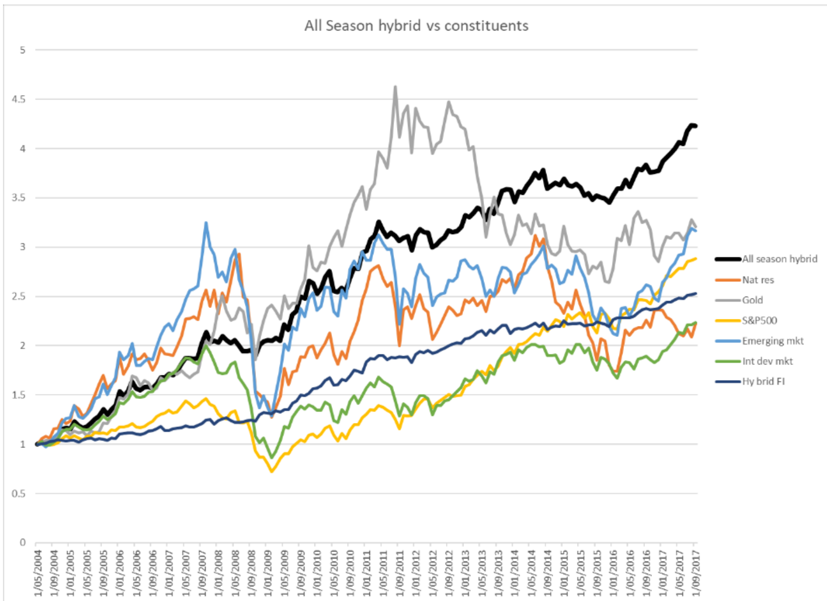
I first set about working on the STA approach to provide any investor with a highly disciplined approach, something more than just buying and holding. Buying and holding has been shown to work over the long term, however, the massive swings that equity markets have exhibited over the last two decades would certainly have challenged an investor's resolve to hold when markets were plunging and supposed 'experts' were forecasting Great Depression II.

I have not provided and update on the results generated by the STA approach for some time as I have been exploring various ways to make it available. This exploration continues and I thank readers, particularly those that have actively expressed an interest in this approach, for their patience.

The chart below shows the basic STA approach. This is made up of a fixed income hybrid which may invest in high yield bonds, convertible bonds and ten year treasury bonds. This is currently 50% in the Vanguard convertible fund and 50% in the Vanguard high yield fund. This fixed income hybrid is then the alternative to being invested in the Vanguard S&P500 fund. This hybrid, (the black line) is currently fully invested in the S&P fund. Since 1992 the hybrid has delivered a compound annual growth rate of 11.6%. It has clearly had several periods of underperformance but importantly the major drawdowns suffered by the S&P in the early 2000s and 2007-9 were largely avoided and the long term performance has been more than satisfactory.



The other STA portfolio I have continued to monitor is one inspired by Ray Dalio's all-weather fund. The All-Season hybrid can invest in US stocks, international stocks, emerging market stocks, natural resource stocks, gold and the hybrid fixed income fund. This fund is currently almost fully invested with just 10% in the fixed income hybrid. It has 20% invested in each of; developed stocks, US stocks, gold, emerging market stocks, and 10% in natural resource stocks. Since 2004, when all the underlying vehicles became available this fund has delivered a compound annual return of 11.43%. Like the STA hybrid the All Season hybrid has far from consistently outperformed its underlying assets, however, over the long term its results have been superior and much of the underlying assets volatility has been avoided.



Conclusions

The risk of something 'dysfunctional' happening continues to increase the longer this seemingly benign, steady rise continues. Rather than succumbing to the temptation and comfort of the herd and seeing everything as a harbinger of even more rewarding and less volatile returns in the future investors would do well to recognise that long term success only comes to those who dare to be different and are prepared to be seen as an outlier. Hearing day after day that everything will be fine as the economy is ok, or that earnings continue to support this market, may seem logical and sensible yet, unfortunately, history has repeatedly shown that these phrases have always been heard ahead of important reversals, not when the most rewarding buying opportunities are at hand.

Kevin Armstrong

2nd October 2017