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# Cadence clips

FOCUSED ON WHAT MATTERS MOST.

# The Kitchen Sink

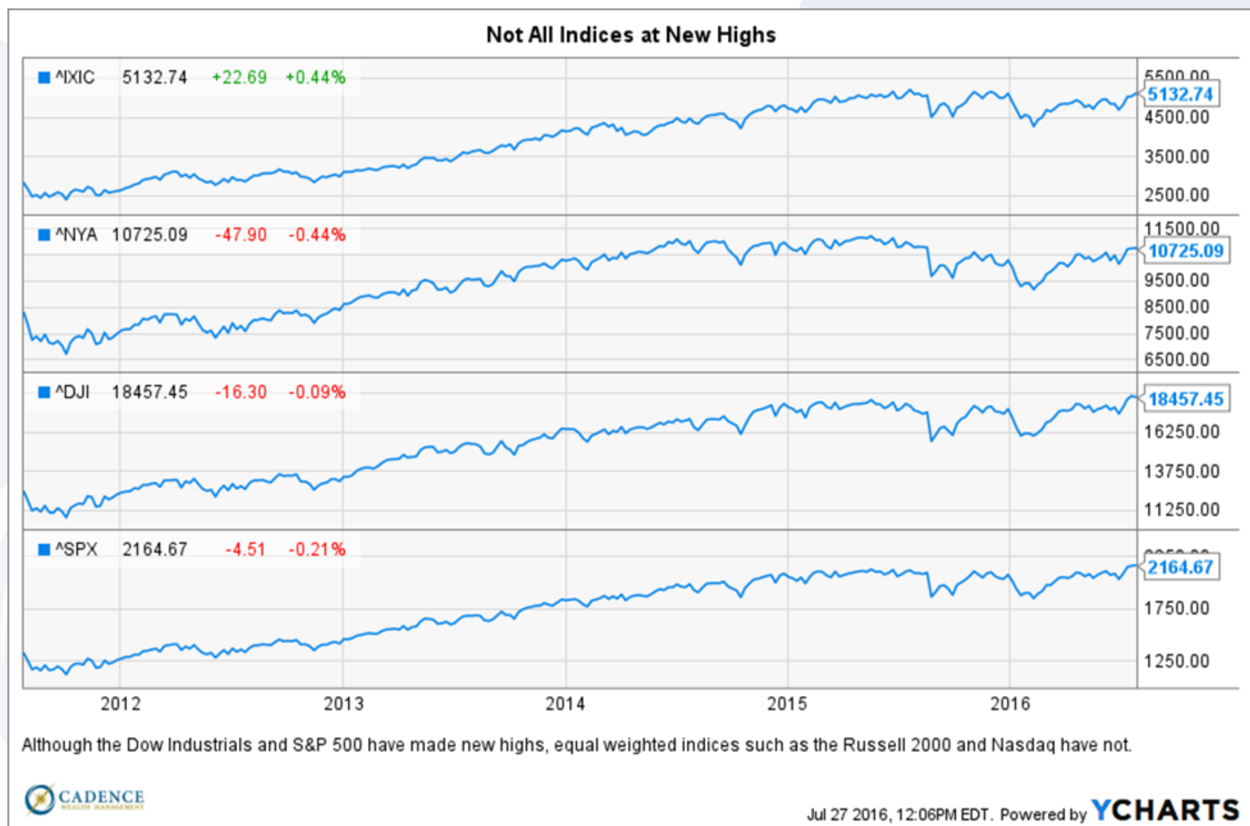
The facts are these… The stock market has been going up for a good deal longer than it usually does, it's more expensive than it usually gets (right there with 1929 and 2000, two of the biggest bubbles in history), there is more debt in the world than ever before (somewhere around 230 trillion dollars), the global economy is growing much slower than usual, and all while central banks around the world have been doing just about everything in their power to get things growing over the last several years. What's wrong with this picture?

It doesn't take a PhD in economics to figure out that something is amiss with our current situation. In fact, the irony of this whole dilemma is that the PhD in economics is probably the person most blind to the issue based on their training and their resultant propensity to want to do something to control the current set of circumstances. This sense that something must be "done" to get the global economy growing again is exactly the type of thinking that's gotten the world so tangled up over the last couple of decades and particularly the last few years. Encouraging more spending via more debt is not the solution for a world already awash in it, yet that's precisely what central bankers are attempting to do. After years of quantitative easing that's succeeded in propping up asset prices, but that's done little to stimulate economic growth, central bankers are now toying with the idea of the kitchen sink – "helicopter money".

Helicopter money is essentially debt-fueled government spending subsidized by money printed by central banks. This is equivalent to central banks printing money and giving it to governments to spend on those things it deems will stimulate the economy. Effective? Possibly for a little while – until the initial surge of activity created by that money ceases because the project is finished or the money runs out. What then? Either a slowdown from the artificial surge or more money of course. If there's one thing we've learned over the last 8 years, it's that once central bankers take action to "fix" things, they can't stop unless they see very compelling evidence that things are "fixed". Admit failure they will not – which makes the kitchen sink option very possible.

What remains to be seen is whether or not the markets will buy into the idea of it or see it as what it truly is – a last ditch effort with no realistic stopping point. Just like our Federal Reserve has moved the target and changed the rules of their own game multiple times over the years in order to continue their experiment, helicopter money would be almost impossible to end once started due to the slumps in activity after the surge. Once the money is spent and the projects finished, we're right back to where we started unless of course more money is printed to buy more debt to fund more temporary projects. The only likely exit from this destructive cycle would be due to strong price inflation that could only be arrested by central banks reversing course. If market participants understand this and give more weight to it than the initial and artificial "pop" in activity, it may not have the desired effect. In fact, it could prove disastrous right out of the gate for central banks. Time will tell.

In the meantime, we continue to favor the more defensive asset classes that are still trending well, such as U.S. Government bonds and Gold. Although stocks have moved higher over the last few weeks, so have these traditionally safer, more protective asset classes, which leads us to believe investors may not be fully buying into the latest panacea being discussed by the central banking elite. In addition, although market capitalization and price-weighted indices such as the S&P 500 and Dow Jones Industrial Average have made new highs in the last few days, equal-weighted indices such as the NYSE, Russell 2000, and Nasdaq have not. They are still within a more than year-long sideways to downward pattern that is more indicative of a bear market than a bull market. So, although markets have gotten excited over the last few weeks, we believe caution continues to be warranted – especially since there isn't much opportunity cost to being more defensive at the moment. We should know shortly how markets decide to react to the "kitchen sink" option.



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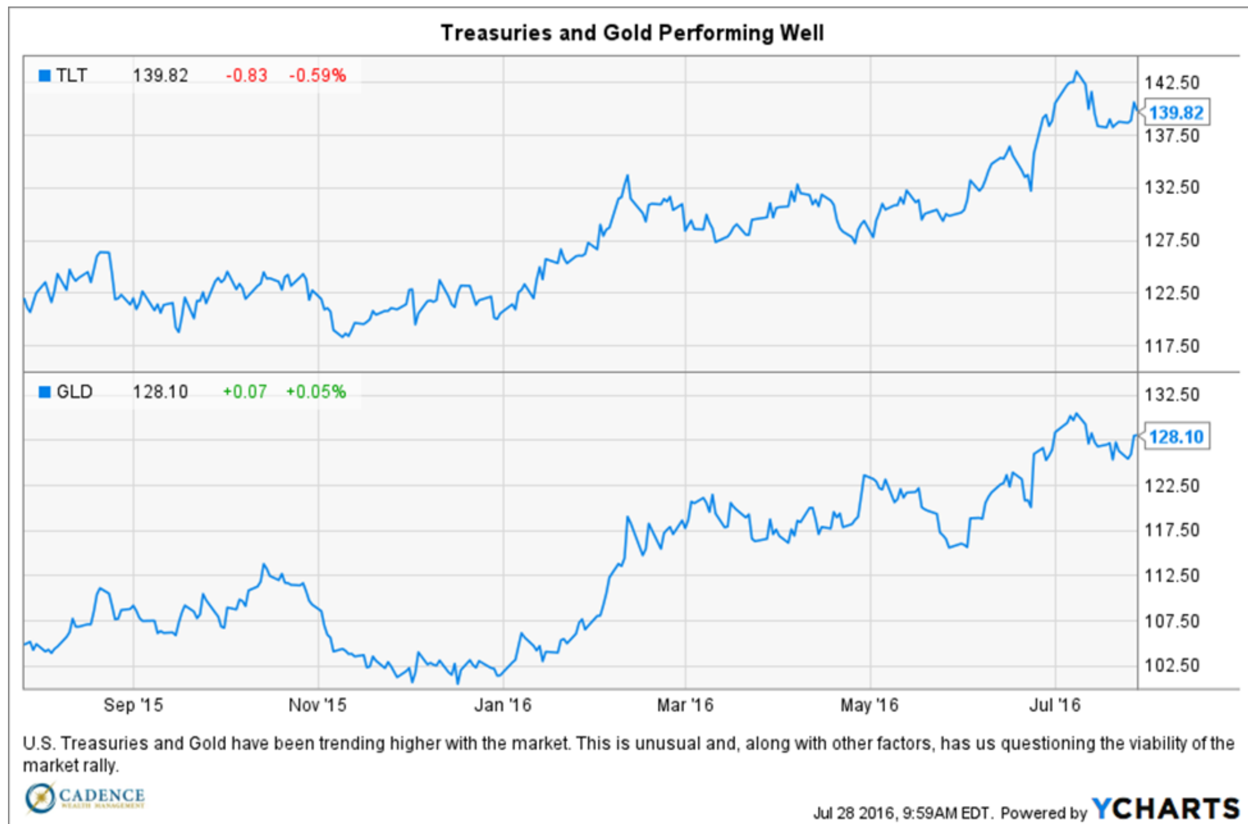


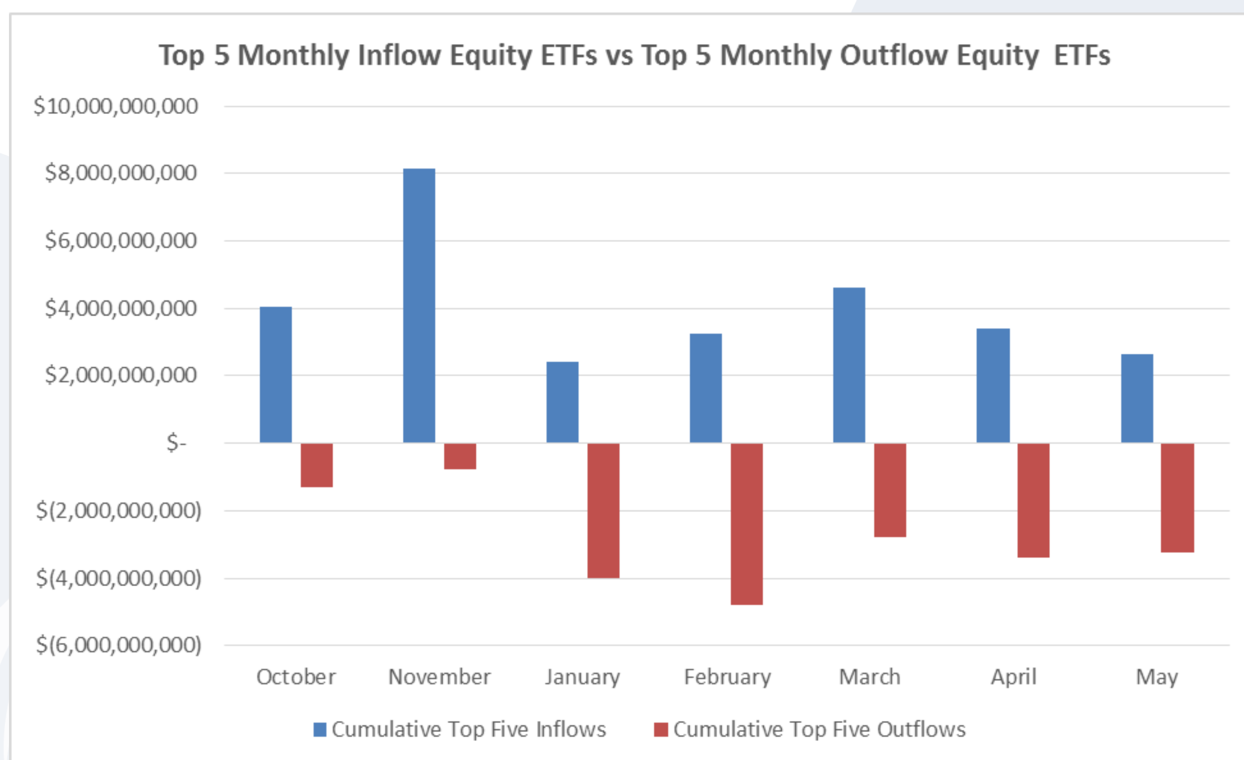

# Don’t Invest Like The Pros

One of our favorite investment topics is how these brains of ours designed to find shelter, hunt giant sloths, and run from saber-toothed tigers aren’t the best at processing short-term investment risks. One problem this causes is that even though we invest for the long-term and we structure our investments to target a certain level of return at a tolerable level of risk over time, we still have a difficult time sticking to that plan based on what happens in the short-term. As soon as the market has a good year or two, especially one as good as 2013’s 30%+ return, we start to get more aggressive. As soon as the market has a bad run of form, especially after large bear markets, we start to get more conservative. This inability to stick to a long-term plan because of what happens in the short-term might be the largest limitation our caveman brain has in our modern investment world.

We see signs of this short-term impatience everywhere, and we are still fascinated when we find it in new places. We recently found it while looking at the returns of the most bought and most sold exchange-traded funds over the past nine months. As a quick primer, an exchange-traded fund (ETF) is a security similar to a passively managed mutual fund in that it is a diversified investment as opposed to a share of an individual company’s stock, or an individual company’s bond. However, unlike mutual funds, ETFs can be bought and sold during the trading day like individual stocks and bonds, which makes them more liquid than mutual funds which settle only after the trading day is over. If you want to sell a mutual fund at 10:00AM, that trade will execute after 4:00PM. If you want to sell an exchange-traded fund at 10:00AM, that trade will execute at 10:00AM.

Because they can be bought and sold during the day, ETFs are more liquid than mutual funds and many investors, especially large institutional investors, use them to make bets that a given investment area will do well or poorly over a short time frame. The corresponding buying and selling behavior of ETF investors can demonstrate investors' ability, or lack thereof to predict the short-term future. If you think an investment area will go up next month, you buy the exchange-traded fund corresponding to that area because you know if you're wrong, you can easily sell the fund and therefore minimize your losses. Likewise, if you think an investment area's decline is imminent, you sell your exposure to that area.

To gauge how well large ETF buyers and sellers can predict the short-term future, we looked at the five stock exchange traded funds that were bought the most each month between October 2015 and May 2016 and also the five that were sold the most each month. It stands to reason that investors were buying ETFs in anticipation of those investment areas doing well in the short term and were selling the other ETFs in anticipation of those investment areas doing poorly. To see just how well these short-term moves did, we looked at what the ETFs returned the months immediately after the buying and selling occurred. The chart below shows the total value of the five most bought equity ETFs relative to the total value of the five most sold equity ETFs each month. You don't have to study the chart in great detail, just notice how much larger some of the big buying months as represented by the blue bars are relative to how much was sold as represented by the red bars that same month. November really sticks out, for example, with the five most bought ETFs totaling over $8 billion while its five most sold ETFs total less than $1B. Additionally, look at the months where the selling was more than the buying; January and February stick out.




*Data for December was mixed with a 2015 full year summary so we had to exclude buying and selling figures for that month.

Experienced short-term investors should be buying right before months where the markets are going up, and should be selling right before months where the markets are going down, right? After all, that's what "buy low, sell high" means. You can see in this case, however, that at least for these investors over this time period, that was not really the case. The large ETF investors were making their biggest buys right before market drops and their biggest sells right before market rebounds (so, buying high and selling low):

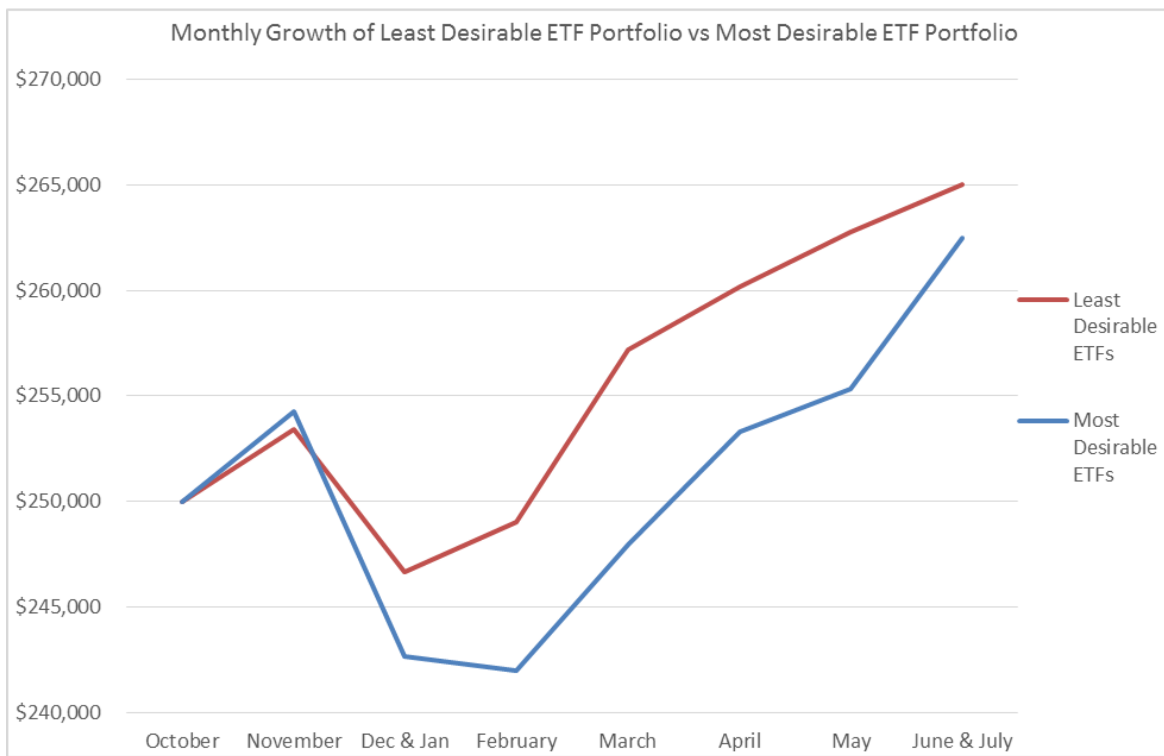
| | October | November | January | February | March | April | May |
|---|---|---|---|---|---|---|---|
| Cumulative Top Five Inflows | $4.038B | **$8.137B** | $2.427B | $3.257B | $4.625B | $3.413B | $2.656B |
| Cumulative Top Five Outflows | -$1.323B | -$768M | -$3.984B | **-$4.795B** | -$2.798B | -$3.383B | -$3.254B |
| Following Month Investment Returns | -0.1% | **-8.1%*** | -1.1% | **8.0%** | 1.0% | 0.7% | 3.4**% |

*  Returns for both December and January.
**Returns for both June and July (through July 25).

Half the time when signaling their expectations the market would rise it would go down immediately after instead, and when their expectations seemed to be for a market drop it would go up immediately after. Whoops! The coin flip nature of whether or not those investments were paying off is exacerbated by the one month where the buying was much higher than the selling, November 2015, because the next two months' returns were a cumulative -8.1%. Following suit, the months where the selling was a fair amount higher than the buying, January and February 2016 saw the next two months' returns reach a cumulative 6.9%. So, not only were these investors getting it wrong half the time, they were most wrong when they were making their biggest bets.

But evaluating the success of their buying and selling decisions after only one month seems a little short, don't you think? To this concern we offer two points. The first is that by their very nature, ETFs are well suited to being the short-term investor's instrument of choice as they're both very liquid yet also a lot more diversified than the stock of a single company would be. So they're geared to be used in this fashion and we know large institutions do use them this way, making short term evaluations of performance valid. The second is that while tabulating all the most bought and most sold investments over this period, we did track their progress one, two, and three months later. What we found is that of the 18 different time periods we could track, the stock ETFs that were sold the most (again, the ones we believe the investors thought would do the worst) actually did better than the ones bought the most in 10 of the 18 periods. For the bond ETFs, those that were supposed to perform poorly did better than those that were supposed to perform well in a whopping 14 of the 18 time periods. Over this time period, the stock calls were worse than 50/50, and the bond calls even worse than that.

Since you're not a large institutional investor, at least the last time we checked, there's little chance you're going to be dropping $8.1 billion on stock ETFs in any month, so how might knee-jerk decisions manifest themselves in a more typical investor's world? Instead of looking at individual investment performance on a month to month basis, let's incorporate these short-term buying and selling decisions into investment portfolios similar to what a typical investor would own. We'll compare two portfolios, both invested 50% in stock ETFs and 50% in bond ETFs. One portfolio, the "Most Desirable ETF Portfolio" buys the ETFs with the highest inflows each month we mentioned above, and then at the end of the month sells them all and buys the highest inflow ETFs for the next month. We'll consider this an extreme version of what we see clients and non-clients wanting to do frequently – owning the "hottest" investments. We'll compare this portfolio's performance over the past nine months to a portfolio comprised of the most sold ETFs, which we'll call the "Least Desirable ETF Portfolio". Now, the whole point about getting rid of the "bad" investments and replacing them with the "good" investments is because that approach should yield the best result, shouldn't it?




Unfortunately it seems like relying on a method like this is no sure thing, as the "bad" investment portfolio outperformed the "good" investment portfolio over this time period; 6.0% returns verses 5.0%. Of course in a real world situation, an investor is not selling 100% of her or his portfolio every month, so what real world behavior does this illustrate? This models investors buying and selling investments based either on rapidly rising or falling stock prices, or rapidly rising expectations and fears, or any other decision-making process that abandons long-term strategies and replaces them with short-term, knee-jerk reactions. These decisions will usually not involve liquidating 100% of an investor's portfolio, though a lot of that did happen in 2008-2009, but it will frequently involve wanting to buy or sell something based on short-term upward or downward swings. Since it seems like it's not easy to get these decisions right consistently, they can lead to performance erosion over time.

So what is our takeaway from this information? To always bet on the "losers"? No, an investment analysis of nine months of information is not enough upon which to base a trading strategy. Our takeaway is that reliance on short-term investment decisions does not lead to long-term success. The fact that the portfolio of "losers" outperformed the portfolio of "winners" over this time period provides our cautionary tale. Choose a level of risk based on the timeframe of your investments, allocate accordingly, and monitor and rebalance over time. Chasing returns or having knee-jerk reactions to overly-enthusiastic or overly-pessimistic market environments rarely leads to long-term success. Buying and selling at the wrong time may not have the same consequences as not being able to tell if that animal up the path is a deer or a tiger, but we still have to resist the temptation to risk our long-term returns on our short-term whims.

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