ISSUE 11 | VOLUME 5 | MAY 2017

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FOCUSED ON WHAT MATTERS MOST.

The Importance of Minimizing Losses

When markets are rising virtually unabated, people have a hard time conceptualizing how damaging to long-term returns large losses can be. After eight years of "up", the mind is conditioned to forget all about the "down". It's called recency bias, and it works against the better judgement of investors throughout every market cycle. When times are good, it's natural to pay more attention to all the money that can be made as the market continues to rise – and the expectation is that it will. On the other hand, when the market's been declining for months, it's hard to think about anything but more losses.

The fact is, losses incurred after extremely expensive markets come back down to earth can far outweigh the gains toward the end of the rise and can have devastating effects on long-term performance. Since it's impossible to know for sure when the turning point will arrive, it's usually best to trim portfolio risk before markets reach their ultimate cycle peak. Of course this virtually guarantees that investors will miss additional market returns while they're playing it safer, giving the appearance of falling behind on long-term investment goals.

It's important to keep in mind however that this short-term, intentional under-performance is part of meeting that longer-term target return objective (usually between 6-8%).

Put simply, if missing out on some additional market gains means that we protect our portfolio better against losses when tough times arrive, then we have a much better chance of getting decent returns over a longer stretch of time. We give up a little to get a lot.

Before diving into an example, let's lay out some historical facts. First (as we discussed in our March 2017 letter, Is It Too Late To Jump In?), based on the Robert Shiller Cyclically Adjusted Price to Earnings ratio (CAPE) adjusted for profit margins, we are witnessing the most expensive stock market in the last 100 years. The next five most expensive markets experienced an average downturn of -55% that lasted an average of 40 months. Those expecting a different result this time would be making a conscious decision to ignore history. As much as things in the world are different than they were during previous episodes of extreme market valuation, the laws of money and finance have not changed.

John Hussman in his April 24 Weekly Market Comment, makes the following statement based on long-term valuations: *From a full-cycle perspective, my expectation remains that the S&P 500 is likely to lose between 40-60% of its value over the completion of the current cycle. On a longer-term perspective, we presently estimate 12-year S&P 500 nominal total returns averaging just 0.6% annually. Indeed, as noted below, unless one believes that the entire structure of the U.S. financial markets has changed since as recently as 2012, investors should allow for the market to lose at least one-third of its value over the completion of the current cycle, with the S&P 500 underperforming even the depressed yields on Treasury bonds over the coming decade.*

The positive side of all this however is that some of the best market returns are found after bubbles pop. Being in a position to view markets opportunistically from the sidelines rather than as destroyers of capital from the perspective of the investor who's taken heavy losses on the way down, is incredibly powerful. Let's look at two scenarios.

First, let's assume since we don't want to miss out on strong market returns, we decide to invest fully in the Dow Jones Industrial Average. We're rewarded over the coming weeks and months by the market continuing to rise and make a quick 10% gain before the market finally peaks out and begins its decline. Over the coming months, we watch the market fall the aforementioned historical average of -55%. Fortunately, we don't panic and are able to stay invested for the recovery 40 months later and realize a gain of 180% over the next 59 months. Good news – we stayed the course and got back to breakeven and beyond. Bad news – our average annual return over an assumed 100 month timeframe was only 4.0%. It's worth mentioning that this scenario assumes a buy and hold strategy is adhered to and that at no point would the investor panic and sell out of the market prematurely. In reality, most investors sell out somewhere near the bottom and fail to get back in until much later in the recovery. Returns would be much worse under those circumstances. Suffice it to say that based on the historical averages of the last 5 episodes of extreme market valuation like we're witnessing today, a 4% annual return over the next 8 years would be a best case scenario. As John Hussman outlined in his April 24 Market Comment and as we've mentioned numerous times in prior letters, based on a host of valuation measures, we're likely looking at stock market returns of much less than 4% over the coming decade.

In the second scenario, let's assume that we choose to forgo additional stock market returns by reducing stock exposure and risk significantly within the portfolio. Here, we do not participate in the additional 10% gain as the market works toward its ultimate cycle top, but we are able to minimize market losses over the coming months and hold to a -15% loss. We then participate in 150% of the 180% historically average market recovery as we enter at a lower point (but not the lowest as it's just as difficult to pick bottoms as tops). The end result is an annualized return over the following 8 years of 9.5%. Most retirement plans do just fine with a 9.5% average annual return. **On a $500,000 portfolio, that's a difference of $369,500!**

Portfolio Balance	Scenario 1	Scenario 2
$ 500,000	Make, Then Lose	Make Nothing, Lose Less
Remaining Bull Market Gain	10%	0%
Subsequent Bear Market Loss	-55%	-15%
Recovery Gain	180%	150%
End Result	**$ 693,000**	**$ 1,062,500**
Months	100	100
Average Annual Return	**4.0%**	**9.5%**

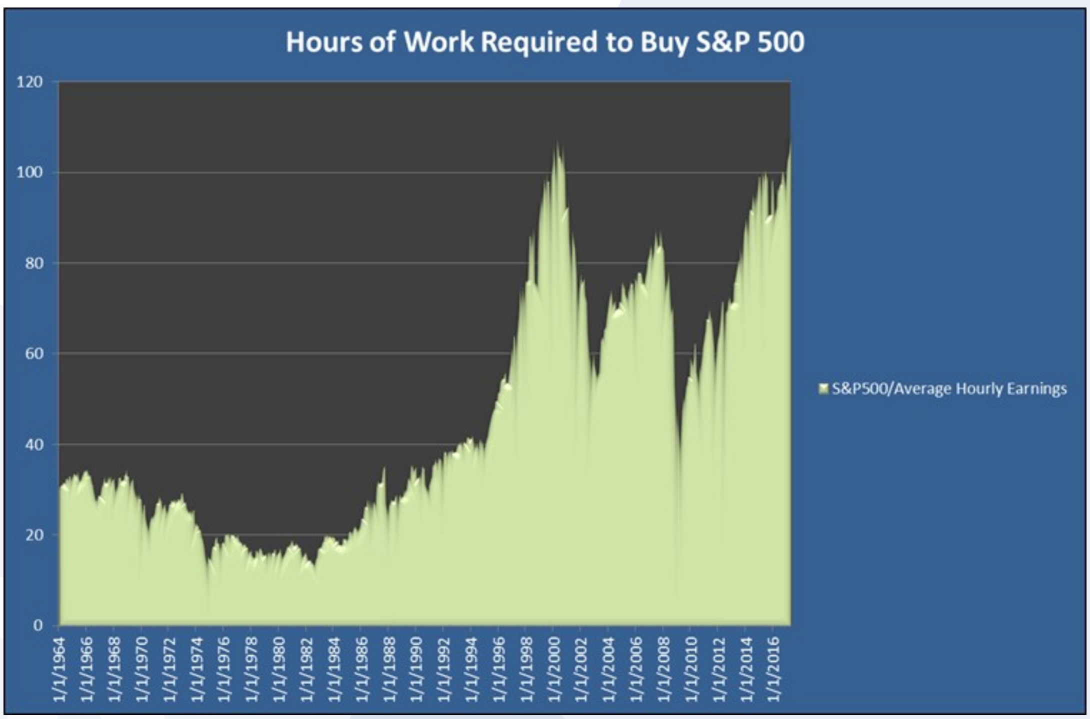
So here's the point. In the end, getting no performance on your portfolio while markets continue to rise 10% does not hurt you. Although it may feel like you're being left behind, the step you've taken to reduce the severity of the loss when it eventually does come is much more important over the long term. Gains made while markets are richly valued don't stick. History shows definitively that they ultimately vanish. The returns that stick are the ones earned during periods of average or cheap valuations. Patience and wisdom will put investors in the best position to take advantage of them. They're coming.

How Expensive Is The Stock Market?

We've incorporated our fair share of complicated charts and concepts into our letters over the months. This one, in our opinion, really keeps things simple. If we're trying to figure out if the stock market is expensive, doesn't it really come down to affordability for most people?

When we look at the average earnings of workers across America - $21.90 per hour - the stock market has never been less affordable. It currently requires 109 hours of work to buy the S&P 500 (assuming one could buy 1 unit of the index at its current level of approximately 2,390).

This compares to a pre-tech bubble average of closer to 30 hours required to invest in the S&P 500. That's roughly 3.5x the number of hours of labor required to buy the stock market than 20+ years ago.



So if we're evaluating whether the market is expensive or cheap, this chart makes a pretty compelling case that the average American worker would probably agree with.

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