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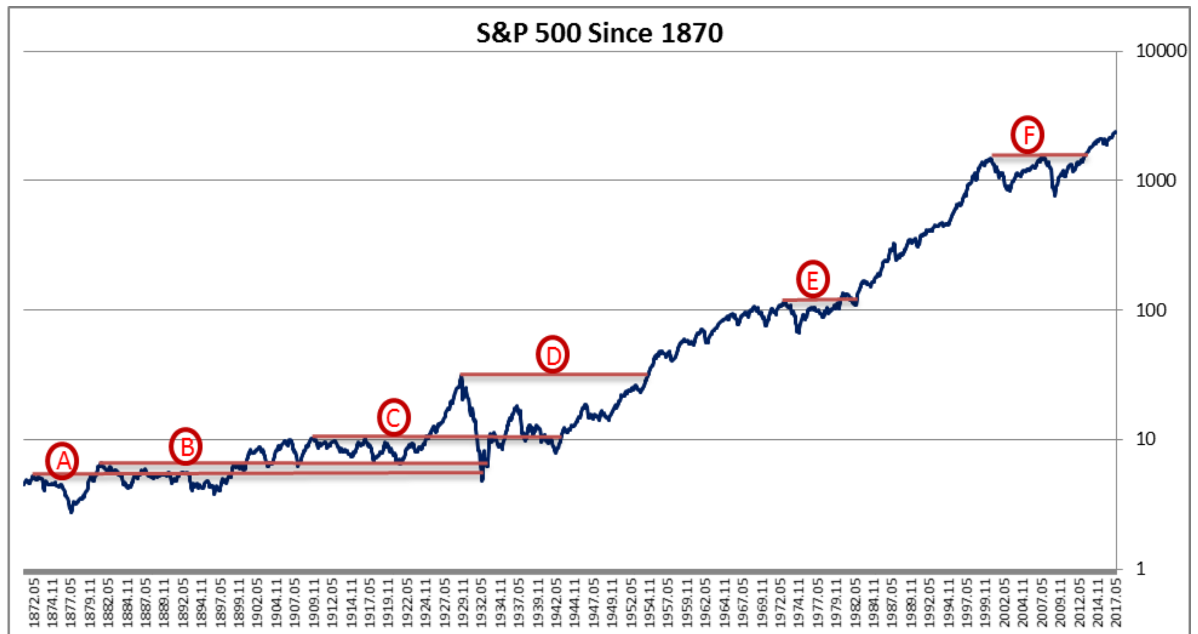
Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Could Multiple Decades of Zero Growth Happen To You?

When the price of an investment reaches a peak, it can decline and not make it back to and permanently beyond that peak price for a much longer period of time than most people realize. Long periods of zero growth can hurt people living off investments, and it can even hurt those who are still saving as they are more likely to change their long-term investment strategy in an attempt to recover from their losses. There are ways of reducing the impact of long under-water spells for individual asset classes, but let's first look at just how long these zero growth periods can last.



Source: Robert Shiller

When you look at the times the S&P 500 Index has peaked and then decreased by at least -35% since the early 1870's and how long it took before it went above and stayed above that level, you can see just how long it would have taken an investor to break even. Because for a lot of this history investors could not own the S&P 500 with the option to reinvest dividends, we are assuming the dividends would have been pocketed as cash. Therefore, we're focused on the price movements of this index only.

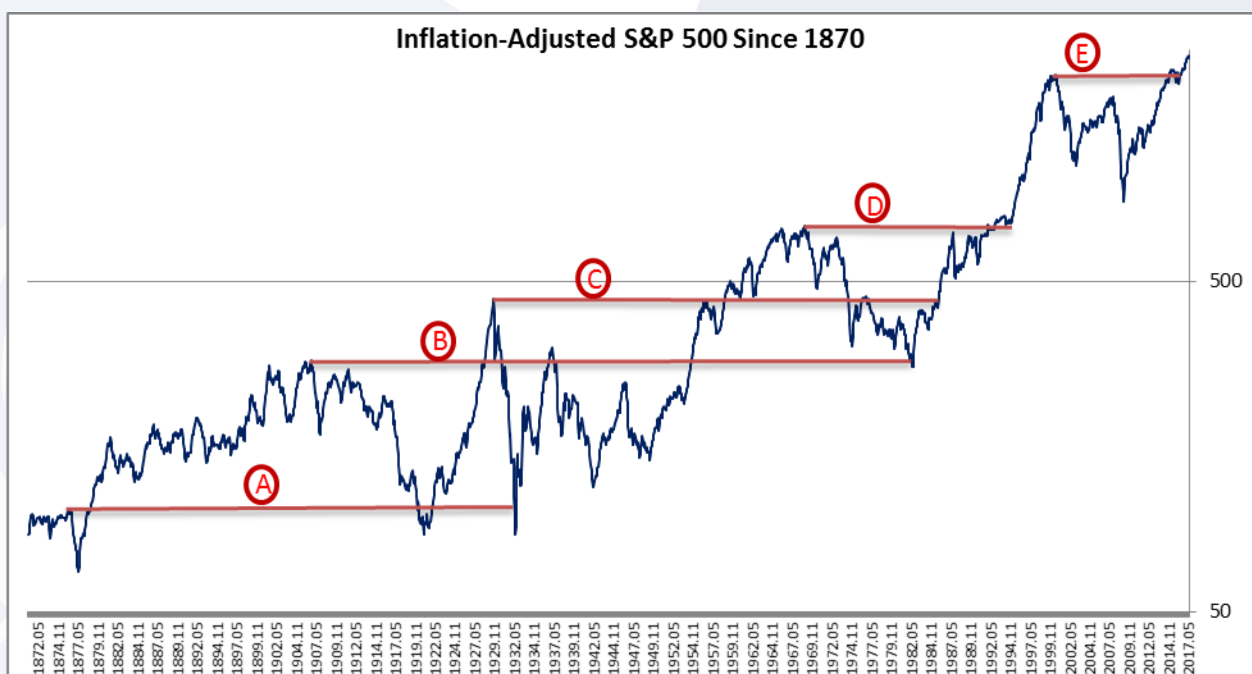
Peak to Permanent Recovery	Maximum Loss	Yrs to Recover
A May 1872 - August 1932	-47%	60.3
B June 1881 - April 1933	-42%	51.5
C December 1909 - February 1943	-54%	33.2
D September 1929 - September 1954	-85%	25
E January 1973 - September 1982	-43%	9.7
F August 2000 - February 2013	-49%	12.5
Average	**-53%**	**32.0**

This chart illustrates six historical periods where the S&P 500 peaked, declined by at least -35%, and then permanently recovered at some future point, usually decades after the original peak. It's a little sobering to see the average permanent price recovery took more than three decades, with a couple of the time periods lasting more than half a century!

Unfortunately, it gets a bit worse. When you think about the purpose of owning investments like these in the first place, it is to one day liquidate the investments to purchase goods or services necessary to live your desired lifestyle. Therefore, the price of the goods and services for which you will be liquidating your investments matter, and these prices fluctuate over time depending on the level of prevailing inflation.

For example, between September 1973 and March 1974, the consumer price index increased almost 6% in only 6 months but the price of the S&P 500 fell -8% over the same time period. Relative to those goods and services then, stocks actually fell -14%. This is called the "real", or inflation-adjusted, return. That is why it is possible for the price of stocks to go up but have their real value fall; if their price goes up less than inflation does, your investments are still falling relative to what you need those investments to ultimately purchase.

When you factor the price changes of the S&P 500 relative to inflation over the same time period as before, the chart noticeably changes, with the peaks and valleys increasing dramatically:



Source: Robert Shiller

Time Period	Maximum Loss	Yrs to Recover
A February 1876 - August 1932	-35%	56.5
B September 1906 - September 1982	-70%	76
C September 1929 - November 1985	-81%	56.2
D December 1968 - December 1992	-63%	24
E August 2000 - May 2016	-59%	15.8
Average	**-61%**	**45.7**

When factoring for inflation, the average time to permanently recover from an initial -35% or greater loss has increased by ALMOST 14 YEARS over the non-inflation adjusted average. If the inflation-adjusted S&P 500 falls by a little over -12% from where it is today, then that most recent period lasting almost 16 years will immediately get extended. For those thinking 16 years was a long enough period, history suggests that will get increased to a longer period, perhaps much longer.

It is useful to know that any one asset class you own can move sideways for a long period of time. The silver lining in all of this is that there are ways to avoid having your own investment portfolio peak and spend decades finally getting back to and passing that level.

First, diversify your investments. Investing in only one or a few highly correlated investment categories, especially volatile categories like stocks, increases both the potential loss and the eventual years needed to recover from the loss. While an asset class languishes and moves sideways, there are other asset classes that are growing, and a diversified portfolio will own those areas.

Second, do not ignore the current value of investments relative to historical values. The higher the current value, the more likely that asset class is close to peaking. Peaking in and of itself is not overly concerning, but the higher that peak is above long-term averages, like the inflation-adjusted S&P 500 today, the more likely a large and/or long drop is close. Knowing whether investments are expensive or cheap from a historical perspective can help you allocate your portfolio more strategically over time.

Third, allocate your portfolio more conservatively, especially when valuations are so high above their long-term averages and have been above for as long as they have today. You have to be patient, because asset values can remain high for longer than you think they should, but by reducing the losses on the downside and then allocating more aggressively after asset prices have fallen can both reduce the size of your loss as well as shorten the amount of time your portfolio needs to recover.

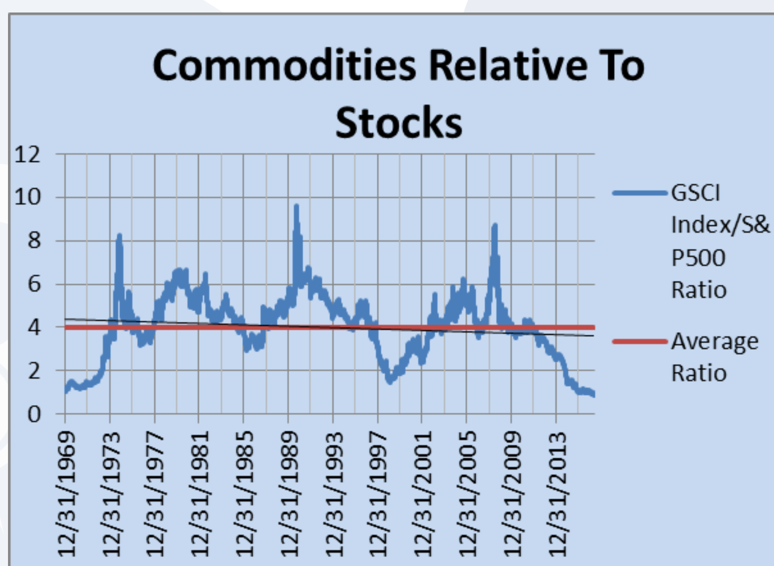
As a Cadence Wealth Management client, your portfolio already reflects these three principles. The good news is that by following them, even in multi-decade runs of zero growth for some asset classes, investors can still grow their portfolios to achieve their long-term goals.

Is Gold Out-Glittering Stocks?

Our job as wealth managers is to both grow and preserve our client's hard-earned savings. At times, those two objectives can be weighted equally through a combination of broad asset allocation and active management. However, there are times when either growth or principal preservation take priority based on how expensive or cheap risk assets (growth investments like stocks) are. For our clients and loyal Clips readers, you're well aware that we're currently weighting principal preservation above all else based on the fact that, well, stocks are the most expensive they've ever been according to a host of valuation measures. We've covered a good number of them in recent letters.

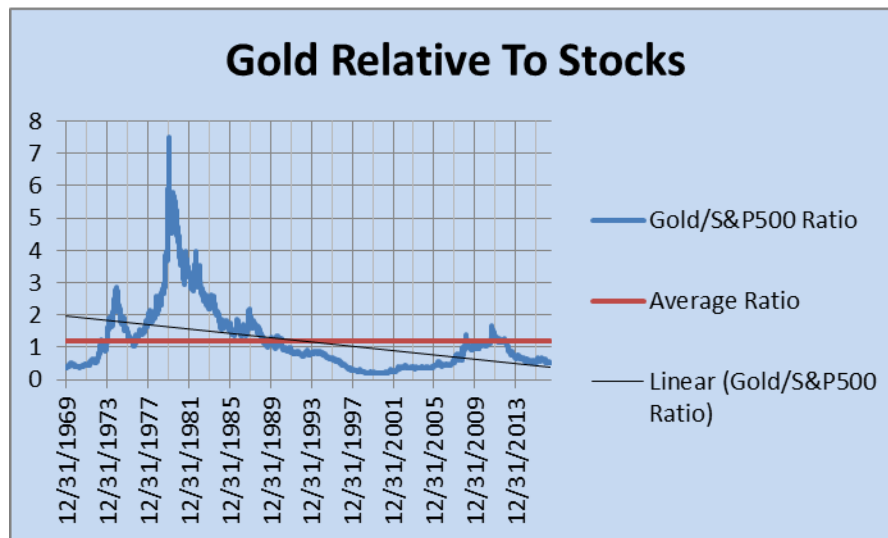
Most valuation measures are nothing more than ratios – where you take one thing and divide it by another. The key to any ratio is to look into the past to see what could be considered "normal" as well as what the fluctuations around that average level have looked like. In doing this, we've found over the last couple years that the ratio of the stock market to things like Gross Domestic Product (GDP), corporate earnings and sales, hourly employee earnings, and industrial production, is unusually high. This is how we've arrived at the opinion that stocks are dangerously expensive.

Well, there's another ratio that supports the idea that stocks have drifted wildly from their sustainable path – commodities relative to stocks (GSCI Commodity Index divided by S&P 500). In fact, we have to go all the way back to 1971 to find a similar extreme reading in this relationship. **As you can see from the chart below, stocks haven't been more expensive relative to commodities in the last 46 years than they are today.** In fairness to stocks, both factors play a part in the resulting ratio. It can also be said that commodities have never been cheaper relative to stocks in the last 46 years. The truth is stocks have risen and commodities have fallen. As with any ratio, the two components moving in somewhat opposite directions are what typically lead to extreme readings. With that in mind, it's fair to conclude that stocks appear **much** less attractive than they typically have in the past relative to commodities.



Source: Trading Economics

Does this mean that we should sell all of our stocks and buy commodities? From a risk management perspective, that wouldn't be the smart way to act on this information. Over the short term, this skewed relationship between commodities and stocks could become even more extreme, meaning that stocks could continue to rise while commodities struggle. Also, given that we're statistically overdue for a recession, most commodities could slump further when that recession finally plays out. This is why some amount of diversification and/or risk management is always important regardless of how extreme things become. The main lesson here is that this ratio of commodities to stocks suggests that stocks are priced high and commodities low. If we're trying to follow the age-old investment rule of buying low and selling high, then we'd want to take this into account when allocating our portfolio.



Source: Trading Economics

The ratio between gold and stocks is also very low relative to its historical norm. This particular relationship is probably more relevant given gold's potential appeal as a safe haven and store of value during times of financial market distress. In looking at the last three significant market shocks, investors would have been well served in weighting gold more heavily within their portfolios. From the peak of the S&P 500 in August 1987 shortly before the dreaded Black Monday crash on October 19, until the market bottomed out -34% lower four months later in early December, gold held its value and rose roughly 5%. From the market peak in March 2000 through the low -51% lower in October 2002, gold was 12% higher. Finally, throughout the financial crisis as measured from October 2007 until March 2009, while stocks were over -55% lower, gold was ~26% higher.

This isn't to say that gold or any other asset class is guaranteed to gain value when stocks decline in the future, but it is worth noting that the possibility of gold serving as a safe haven during the next market downturn is a rational one. Also noteworthy is that the gold to stock relationship immediately preceding these three market meltdowns was near or below average in every case. Right now it's virtually identical to where it was at the onset of the financial crisis. In other words, by being below average, it could more likely be viewed as a reasonably priced asset in the event that money leaves the stock market looking for a new home. Although we feel more comfortable that gold could garner more interest in the event of a stock market or financial system shock, this concept of relative attractiveness applies to a number of asset categories. Those that are relatively cheaper could be viewed as better alternatives when investors feel the need to flee.

We've incorporated these lessons and observations into our client portfolios at Cadence. At the moment our exposure to stocks is lower than it normally would be, and our exposure to gold is higher than it ordinarily would be. At some point in the future we may incorporate commodities more broadly when we feel it's safer to do so – based on their relative attractiveness to stocks, they're certainly on our radar screen as a potential opportunity. Taking this approach does not make us pessimistic on the future, nor does it qualify us as "gold bugs" - It's simply a historically-informed way to adjust our asset allocation to best prepare for what may lie ahead. As always, diversification is important as well as intelligent risk management along the way so it's never as simple as just swapping one investment type for another. We would advise any readers not working closely with us against doing that. If you're a client, you're likely already well aware of how your portfolio has been positioned to reflect these observations. You needn't do anything differently.

Again, there's no assurance that any asset class will act the same way in the future as it has in the past. Every crisis is unique and therefore plays out differently. However, if one's trying to get a general sense as to how to stay safe over the coming years, the lesson here may be two-fold: First, relative to real assets (commodities), financial assets (stocks) are tremendously expensive according to their historical relationship to one another. Second, real assets (gold and other commodities depending on the nature of the crisis) historically have been superior performers through severe stock market downturns. Although history isn't guaranteed to repeat, if principal preservation is the focus, these two lessons could provide some valuable guidance in helping one achieve that objective. How well one does in achieving principal preservation will determine how successfully and fully he or she can transition to the next objective down the road - Growth.

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