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Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

What The Future Holds For Stocks – It's All About Price

In our client meetings in recent months, we've had plenty to discuss. Between politics here at home, North Korea tensions, and strained relationships with China, Germany, and of course Russia, it's virtually impossible to cover all the potential risks to markets within the time constraints of a typical review meeting. There's plenty of potential trouble out there that could dent portfolio returns going forward. However, as troubling as things seem in the world today, these problems aren't unique to 2017. Risks, bigger or smaller, have always been present throughout history, and they'll always be a part of investing. What concerns us about investing today has more to do with valuation than it does any of the issues of the day. In the end, it's valuation that will drive portfolio gains and losses, almost regardless of any of the unpleasant, scary, or dramatic events that take place. And so, we continue to focus on controlling what we can.

Our philosophy on investing is based on the following truths:

1) Markets can remain irrational over the short term (and sometimes the short-term can run on for much longer than usual – this period we're in being no exception.)

2) Over long periods of time, generally 7-12 years, markets behave much more predictably and rationally.

3) Portfolio returns over these long periods of time are determined, more than anything else, by the price paid for investments now.

4) We have much greater control over long-term portfolio returns based on the price we pay now than we do on short-term portfolio performance which has very little to do with valuation and more to do with external factors such as geopolitical events, money flows, and investor sentiment. This is often referred to as the "noise" that we just have to gut through.

5) Minimizing large portfolio losses is much more important for long-term performance than seeking to maximize gains.

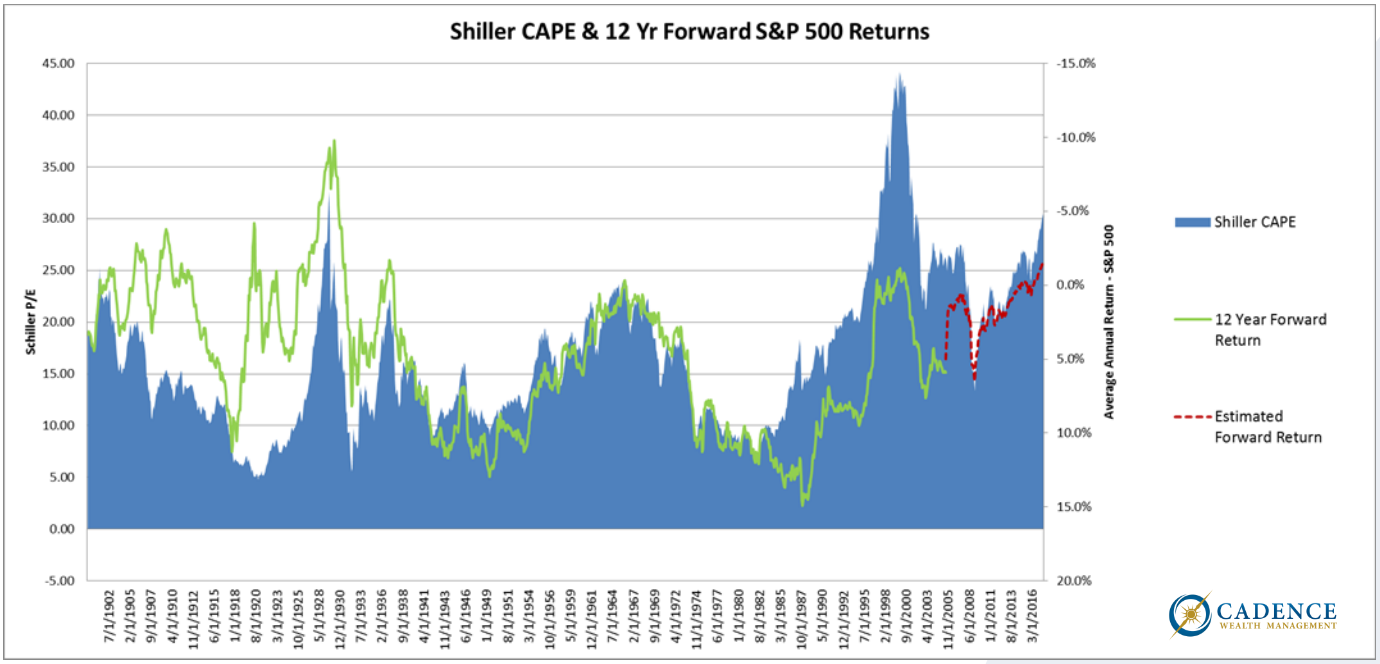
In rolling up these points from the bottom, seeking to minimize large losses is paramount to us in helping our clients achieve their long-term growth objectives. We're always thinking about it and guarding against it as best we can in our pursuit for growth over time. Focusing on points 2-4 allows us to manage this process without having to guess or attempt to predict a particular outcome. In focusing on valuation and the price we're paying for investments within a portfolio, we can increase the likelihood of attaining the returns we need over time. And finally, the first point… What can we do about that one? In portfolios that have a strategic asset allocation, we tone down risk as valuations get further and further out of whack. This means we're making a conscious decision to forgo returns that may not end up sticking when markets regain their senses. The only alternative is to be willing to lose gains very quickly when the second part of the market cycle plays out. To think that one will know when a medium-sized downturn is going to turn into a large, intolerable loss is an illusion. In real time, it's often a coin toss decision.

More active rule-based portfolios on the other hand may be able to take on a more aggressive position through this "irrational" phase if there are objective criteria that can allow them to reduce risk quickly if things get ugly. There are countless strategies out there that could allow for a more aggressive portfolio mix, but here's the key: If an investor is going to willingly ignore valuation and pay too much for an investment, there must be a well-defined exit plan that goes beyond gut feel. Because markets can be volatile at the turn of a cycle, this process of de-risking (and potentially increasing it again multiple times) can be excruciating. This is why we believe that when it comes to maximizing returns over the long run, the price paid today matters most.

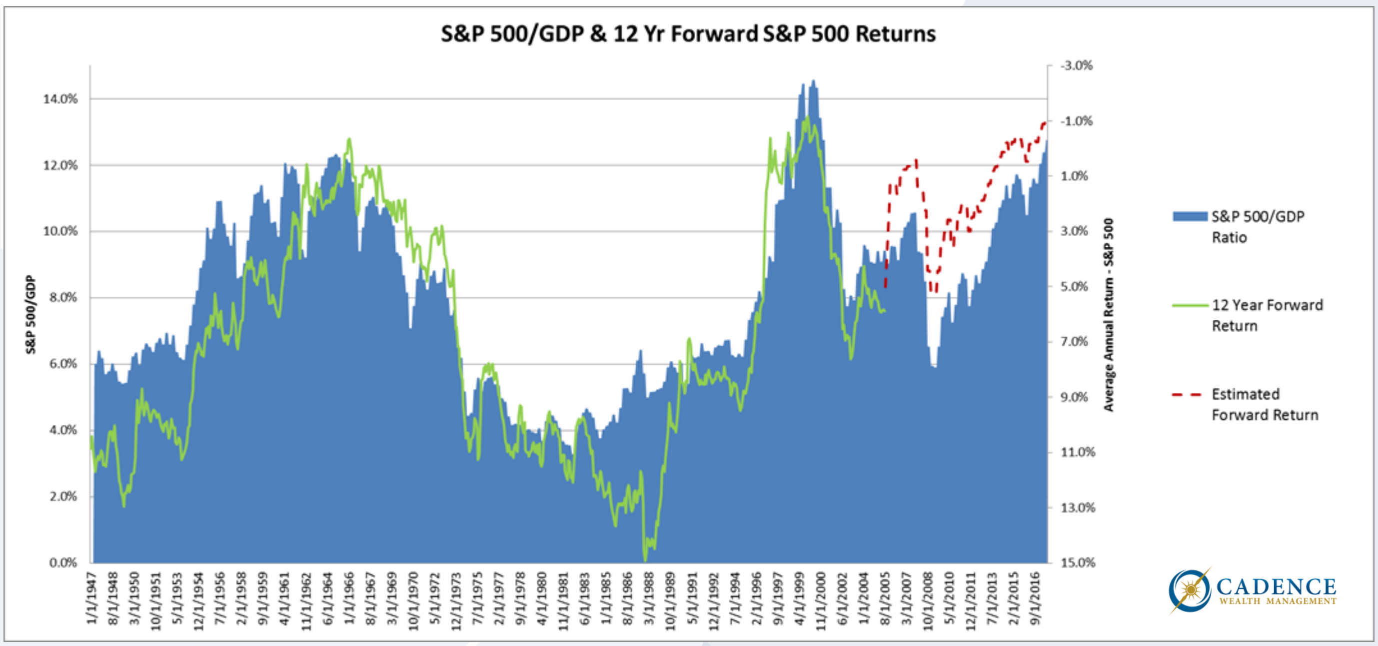
Today's Price and Forward Returns

Let's keep this simple. U.S. stocks by almost any measure that doesn't obscure reported earnings are either at or very near record levels. Here's a look at a couple valuation measures we've discussed in the past – the Shiller CAPE and the S&P 500/GDP. What's immediately noticeable from both measures (shaded in blue) is that they are toward the top of their historical ranges, exceeded only by the tech bubble in 1999. What both of these charts don't show however is what happens when we adjust for the above average corporate margins and below average economic growth that we're observing today. When taking these things into account (the former we discuss in the March 2017 letter "Is It Too Late To Jump In"), valuations shoot right up to where they were in March 2000 if not beyond.

What's more relevant to investors than record-setting stock valuations however, is what tends to happen to actual portfolio returns when this condition exists. The green lines in the charts below represent returns that investors in the S&P 500 actually would have received over the next 12 years from the date plotted. What we can see is that these forward returns correlate very closely to how expensive or cheap markets are at any point in time. As an example, when we look at the Shiller CAPE chart, we can see that stocks were much more expensive than usual in 2000 and as a result, the average annual return an investor in the S&P 500 would have received from 2000 to 2012 would have been below 0%. We had another 12 year stretch of below 0% returns beginning in 1966 when stocks were historically expensive. It would have taken until after 1978 to get back into positive territory. The horrendous market returns of the 1930's correlate very closely with the richly valued market in the late 1920's. It's very clear that expensive markets as measured by the two metrics below tend to precede below-average long-term returns – in some cases by a large margin. The degree of overvaluation tends to correlate very highly to the degree or severity of the subsequent underperformance.



Data Source: Robert Shiller, Cadence Wealth



Data Source: YCharts, Cadence Wealth

It's also important to note what the 12-year subsequent market returns have been 2-3 years before past peaks in market valuation. For example, had an investor been fully allocated to the S&P 500 in 1997, he would have enjoyed 2 more years of incredible market gains. Ultimately however, his total return by 2009, 12 years later, would have been around 0%. A full investment in the S&P 500 in 1925 would have enjoyed almost 5 additional years of record-setting gains up until the market turn in late 1929. By 1937 however, that investment would be just about where it started. So here's the point, and this is very important: Being early to reduce risk in expensive markets doesn't mean you've missed out on gains that you can never get back, because those gains ultimately don't stick anyway. Expensive markets tend to get more expensive before they revert back toward their longer-term averages. This is to be expected. In the end, avoiding over-exposure to expensive markets is the goal, not necessarily trying to time the ultimate turning point.

Now, here's where things get really exciting. What we can also see very clearly from this data is that returns get very, very good when markets are valued cheaply. In the 1940's as well as the mid 1970's into the 80's, returns over the following 12 years were well above average – north of 10% per year for the S&P 500. There are also plenty of points where returns would be "good enough" for most investors to reach their investment objectives. When valuations are reasonable or cheap, good returns tend to follow over time.

The point is this – the price we pay now determines the returns we can expect over the long term. The steep valuations we're experiencing today are not normal and won't persist forever. There will be better opportunities down the road that will allow for much better return potential than those we're facing now. Seth Klarman, an extremely successful value-oriented hedge fund manager in Boston has likened that feeling that we have to choose our investments from today's opportunity sets to thinking that we have to find our future husband or wife from our classmates in high school. The reality is that we may find a much better match in college, at our first job, a future networking event, etc. Klarman suggests the same is true with investments. The reality is that our investment choices don't just include the opportunity sets presented to us today, but also those from the future. As we're seeing from historical valuation and return relationships, the best investment opportunities (for equities anyway) are very likely to be in the future.

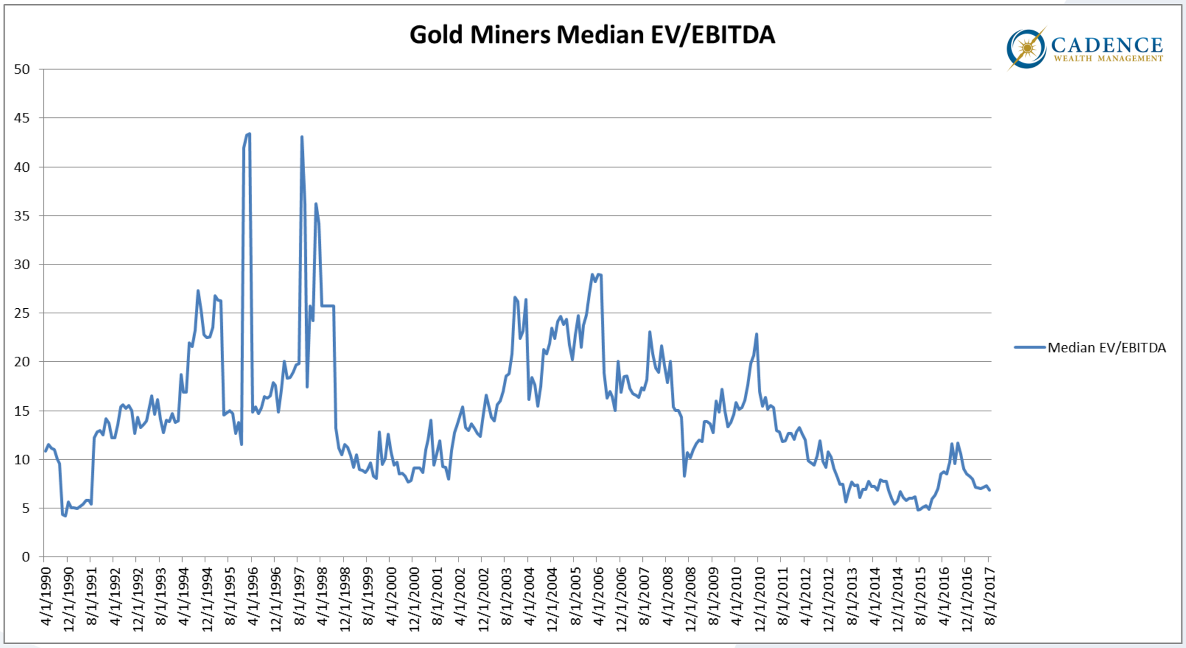
A Reasonable Plan of Action

Our contention is that any investor who wants or needs to average a return over the next 10+ years of better than 3-4% should be taking a much more conservative approach than normal. What history has shown very clearly is that markets move in cycles. Every up-cycle resulting in rich valuations has always been followed by a down-cycle. How much stocks have risen over recent months or years doesn't change that fact. We will at some point face the downward part of this market cycle and as it plays out, whether it starts tomorrow or 2 years from now, much of what markets have gained recently will be taken back. Given estimated rates of return on stocks over the next 10-12 years are hovering around 0%, we're very comfortable hunkering down and waiting for better deals. (That said, if an investor is historically informed as to what the future may hold for his portfolio and chooses to ride out a rough 10-12 year period in pursuit of a better 20-30 year result, then an aggressive allocation could well make sense).

Our feeling is that a defensive posture should be expressed in a diversified way across a number of asset classes. Maintaining a modest exposure to stocks could make sense so long as those positions are attractively valued and possess a good risk reward profile. Exposure to the broad market as we've discussed presents just the opposite. A good amount of cash even though it pays very little makes sense from a capital preservation standpoint. It will always be available for opportunities that present themselves down the road.

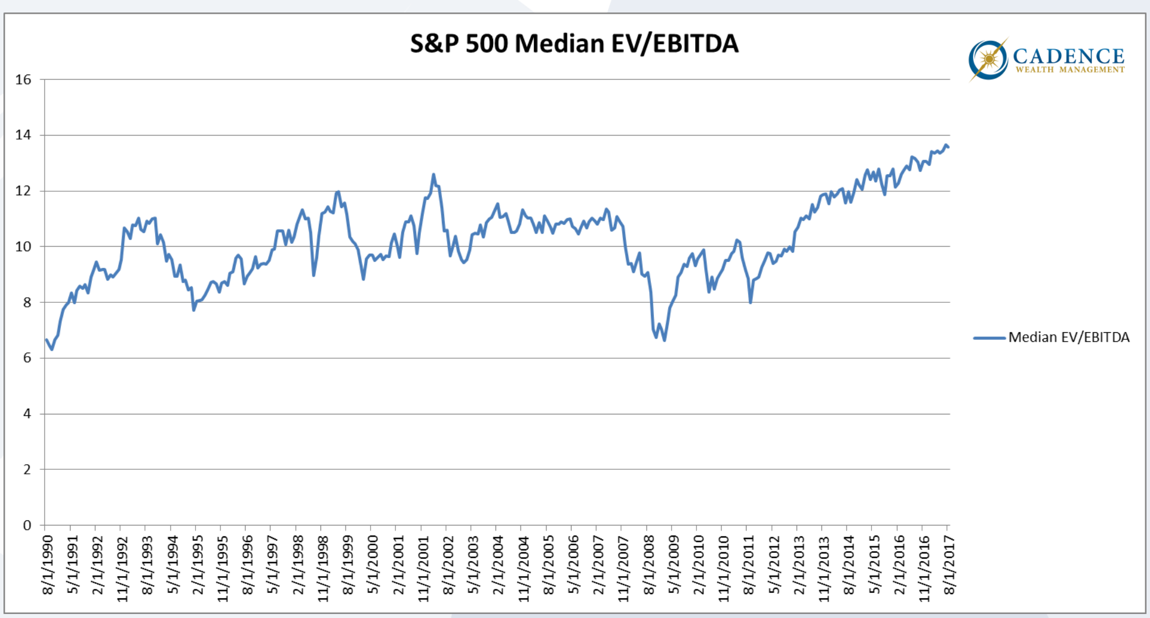
In addition, very high quality bonds and gold could provide some protection and help with the goal of capital preservation through the next part of the market cycle. When it comes to bonds, the fact that interest rates are near historical lows doesn't necessarily mean they're facing an imminent rise. The fact is, economic growth has been running well below average and will likely continue to struggle given low population and productivity growth rates, the key contributors to GDP growth. In addition, the amount of debt hanging over our economy both locally and globally has never been larger. These two factors suggest interest rates could stay low for much longer than most expect – especially in the event of a market crisis. We need look no further than Japan for a template of how this could play out. They've been dealing with low interest rates for decades as a result of their economic stagnation and debt overhang. Past may be prologue here. In addition, the spread between U.S. and German interest rates is historically wide providing a nice buffer in a rising rate scenario. On a relative basis, U.S. bonds appear much more attractive than German bunds (yes, it's "bunds") or almost any other high quality sovereign bond in a flight to quality scenario.

Clients who've been with us for long enough know that we're anything but "Gold Bugs". Gold is kind of like indexed annuities in that it could be pitched to almost anyone at any time if you present a scary enough scenario. However, unlike indexed annuities, Gold is an asset class, and just like any other it can fluctuate in appeal based on relative valuation. Like we discussed in our July 2017 letter "Is Gold Out-Glittering Stocks", gold is starting to look attractive relative to stocks. Further, gold mining stocks are toward the low end of their historical valuation range, which could suggest that investors may find them an attractive alternative to stocks when the tide changes. The chart below looks at the median EV/EBITDA ratio for the gold mining sector, a form of price to earnings that's harder to manipulate quarter to quarter through fancy accounting.



Data Source: YCharts , Cadence Wealth

As a comparison, here's the same metric for the S&P 500. The EV/EBITDA valuation for companies in the S&P 500 on a median basis is higher than it was in 2000 and 2007, and about twice as expensive as that of the gold mining sector. This isn't to say that one will outperform the other over the short term, but if we're defining future return potential as the price we pay today, then we have to place the long-term odds with gold miners.



Data Source: YCharts , Cadence Wealth

One very important question is this: With stocks at all-time valuation highs by a number of historically reliable measures, does it still make sense to maintain some exposure to them? The answer very much depends on the investor. For some, the decision might be to eschew stocks entirely with the understanding that the next downturn will ultimately wipe out any gains that will be made going forward. For these investors, the bigger picture and confidence in historical precedent must outweigh the emotional distress of missing out on additional gains in the near term.

For most however, keeping a reduced exposure may be a good idea. Since timing market turns involves an element of luck, there's a good chance that we'll see more market growth before we start trending downward back toward the long-term averages. Participating in this in some form can make the process easier to deal with emotionally, which when it comes to investing, is half the battle.

In thinking about markets over the short and medium term, one axiom comes to mind. The only certainty is uncertainty. Anything can happen. We live in a very dynamic interconnected world where nothing can be ruled out. However, we get some comfort in knowing that there's a very deeply established historical precedent for returns correlating very highly to valuation. This helps us temper emotions relating to FOMO (fear of missing out) while we're geared for principal preservation and feel genuine enthusiasm and excitement about a more opportunistic environment down the road. So although the next few months and years are likely to present some drama, the price-sensitive, value-conscious investor has time on his side. If we're investing in things at attractive prices, then the performance over longer periods of time should take care of itself. And if we ignore price? Well, unfortunately history isn't on our side.

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