▶ Price Will Matter – Eventually................ 1-8

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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Price Will Matter – Eventually

If there's one thing that we should know from multiple lessons throughout history, it's that the return we make over a longer period of time is all about the price that we pay today. Whether it's our house, a private business, stocks, or a tulip bulb, if you pay more than it's worth, you're likely to lose money eventually. Along the same lines, if you're keen enough to invest in something of value that's price is cheap, you'll likely do very well – eventually.

The operative word here is eventually. This is what most investors/human beings have a very hard time with. How do we get from what we're experiencing in the here and now to the "eventually"? There isn't an easy answer to this question. Unfortunately, it requires a good deal of restraint, understanding of financial history, and patience in order to avoid paying too much for the investments that seem like no-brainers today and instead invest in those that are priced more attractively but are out of favor. One can feel lonely and wrong for quite some time. Avoiding expensive rental properties in 2002 felt wrong until 2006-2007. Steering clear of technology stocks in 1997 would have been excruciatingly painful for 3 or 4 years.

This is what makes value-based investing hard. You have to be willing and able to be wrong for some period of time in order to be correct about that thing that really matters. In this case, what matters is preserving capital and earning returns that won't vanish at some point in the near future.

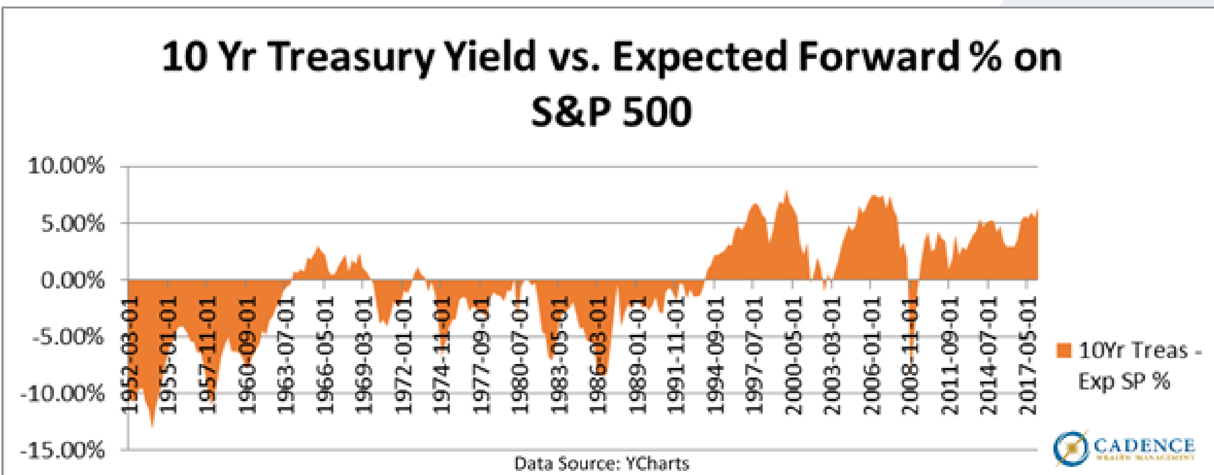
The challenge we're faced with today is that there really isn't much that's attractively priced on an absolute basis. In other words, stocks are as expensive as they've ever been (see any number of our recent letters for our rationale on this), but bonds aren't cheap either. Real estate provided an alternative to stocks in 2000, but is currently right back to or beyond where it was in 2007 – expensive. Even artwork is selling at record prices these days.

And so the challenge is to not just identify those investment options that offer attractive absolute value, but relative value as well. On its own, an investment may not be as cheap as it has been in the past, but if it appears cheap relative to something else based on the historical relationship between the two, then it offers good relative value.

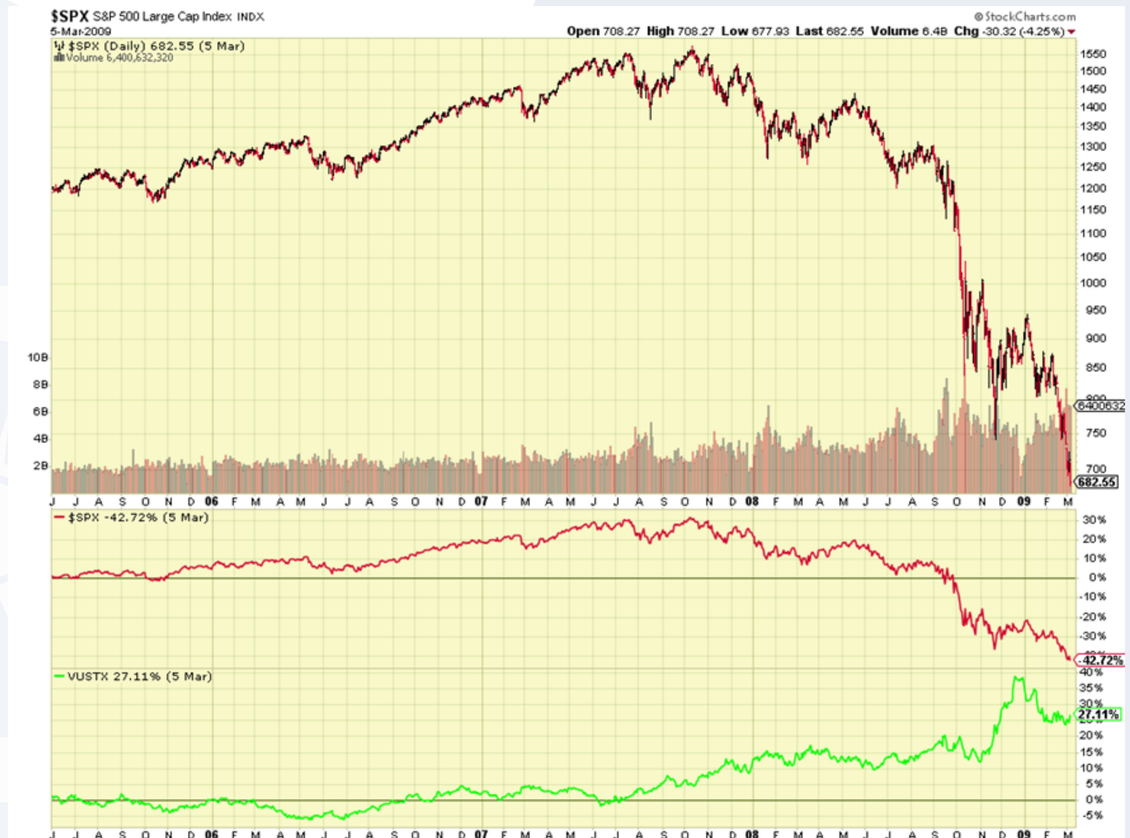
U.S. Government Bonds

In a stock bull market, nobody cares much for bonds. Why invest in something paying modest interest when you can grow your money in stocks at the long-term market average of ~9%? The answer in our opinion is because at valuation extremes, rules of thumb around long-term averages go right out the window. A 9% stock market return going forward would be realistic if prices/valuations were average. Right now they are not. History and common sense tell us if we start at a high price, returns down the line will be below average.

When viewed against this reality, the 10-year U.S. government bond yielding around 2.85% may not be so bad. It's lower than the 5% it was yielding more than 10 years ago before the financial crisis, but is it attractive on a relative basis? The chart below suggests it may be. When looking at the yield on 10-year government bonds against what we expect the stock market to return over the next 10 years given current record valuations (really high prices), we can see that it's rarely been better.

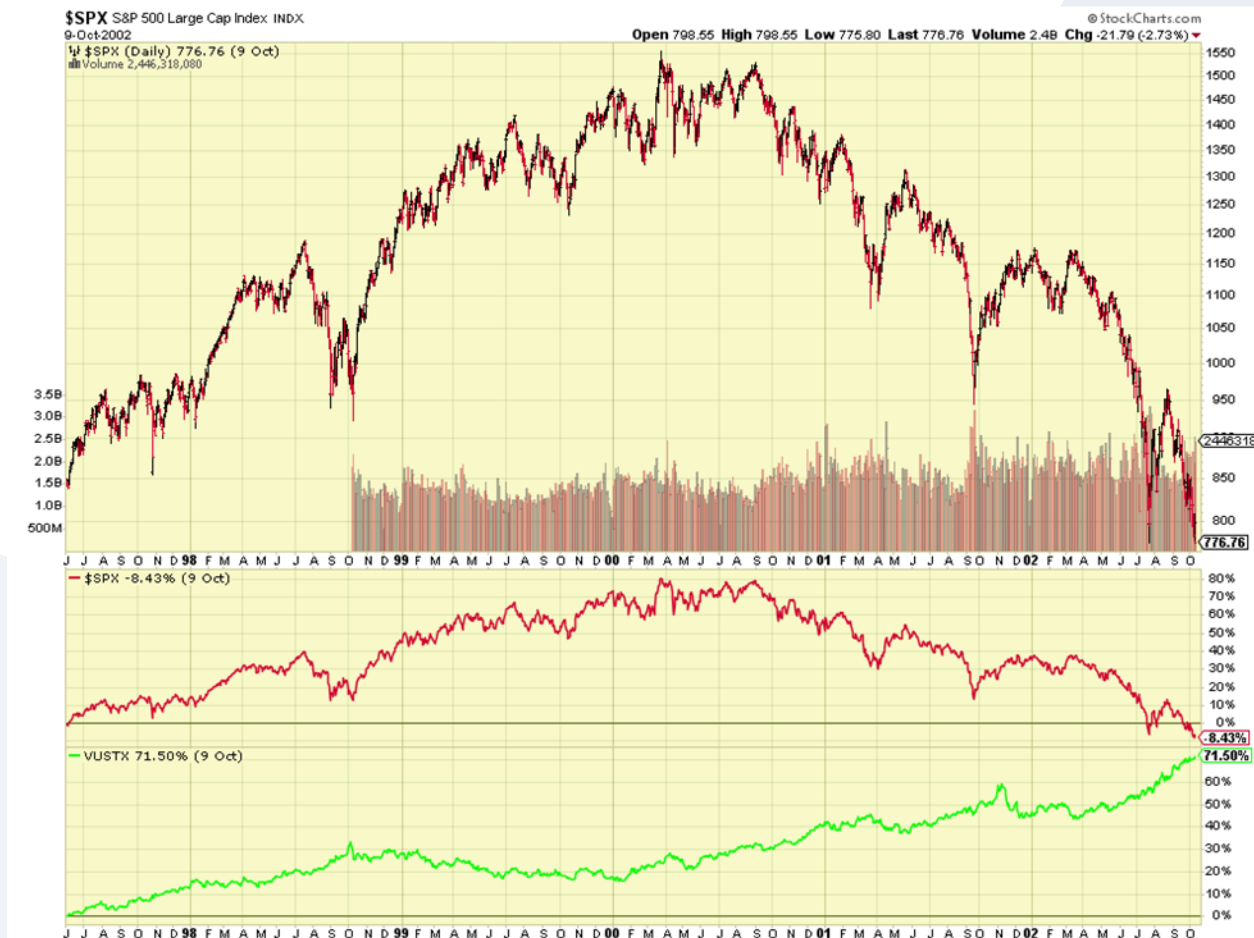


The last time the spread between the two was around 5% was 2005, at which time the S&P 500 went on to decline more than -40% by March 2009. The Vanguard Long Term Treasury Fund, a mutual fund investing in longer duration U.S. government bonds, increased in value by more than 25% over the same timeframe.



Prior to that, we saw the spread between 10-Year Treasuries and the expected forward 10-year return of the stock market cross the 5% mark in 1997. An investment in the same and much less exciting Vanguard Long Term Treasury Fund would have returned more than 71% through October 9, 2002, while the S&P 500 would have lost more than -8% over the same period. An investment in the high-flying Nasdaq in June 1997 would have been more than -20% lower by October 9, 2002.

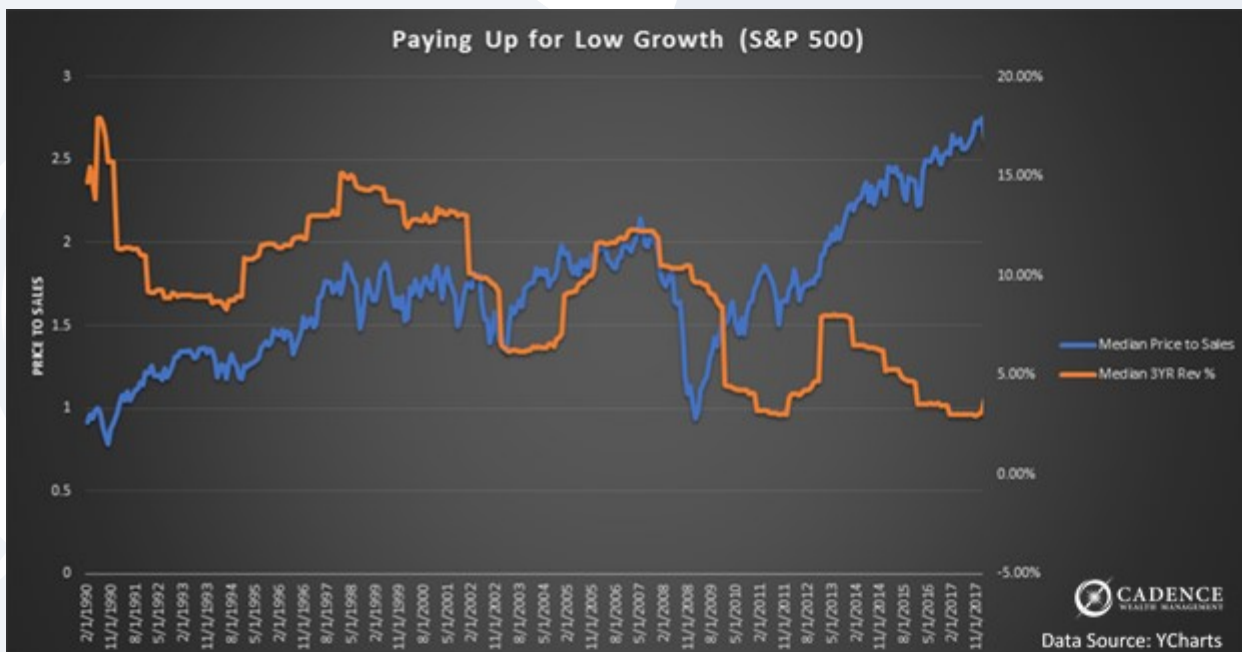
Here's the key point – although the S&P 500 was up more than 17% per year between 1990 and 1997, those able to minimize exposure to high-priced stocks in 1997 would have been far better off settling for the boring ~6% government bond over the subsequent 5-year period. Although this decision wouldn't have been easy given that stocks continued to move higher for 2-3 more years, it would have been worth it over time.



Going back even further to the last time Treasury bonds appeared to offer more relative value than stocks we find a similar outcome (see chart on next page). By 1966, stocks had risen to the point where prices were no longer attractive. Anyone paying attention to valuation would probably have been looking for a better alternative. With 10-year Treasury bonds yielding ~4.6% and the expected return on stocks over the next 10 years at about half that due to steep valuations, one couldn't be blamed for swapping out their stocks for bonds. By the end of 1975, ten years later, the S&P 500 was -2% lower while an investor holding a ten-year Treasury bond to maturity would have pocketed 4.6% in interest payments. It's important to note that interest rates almost doubled over this timeframe which likely would have resulted in losses had investors held their bonds in mutual fund form or continued to purchase individual bonds that matured later than 1975. The lesson to be learned here is that although 4.6% may have sounded bad at the time given recent stock market performance, it proved the better option than staying invested in stocks. Price mattered.

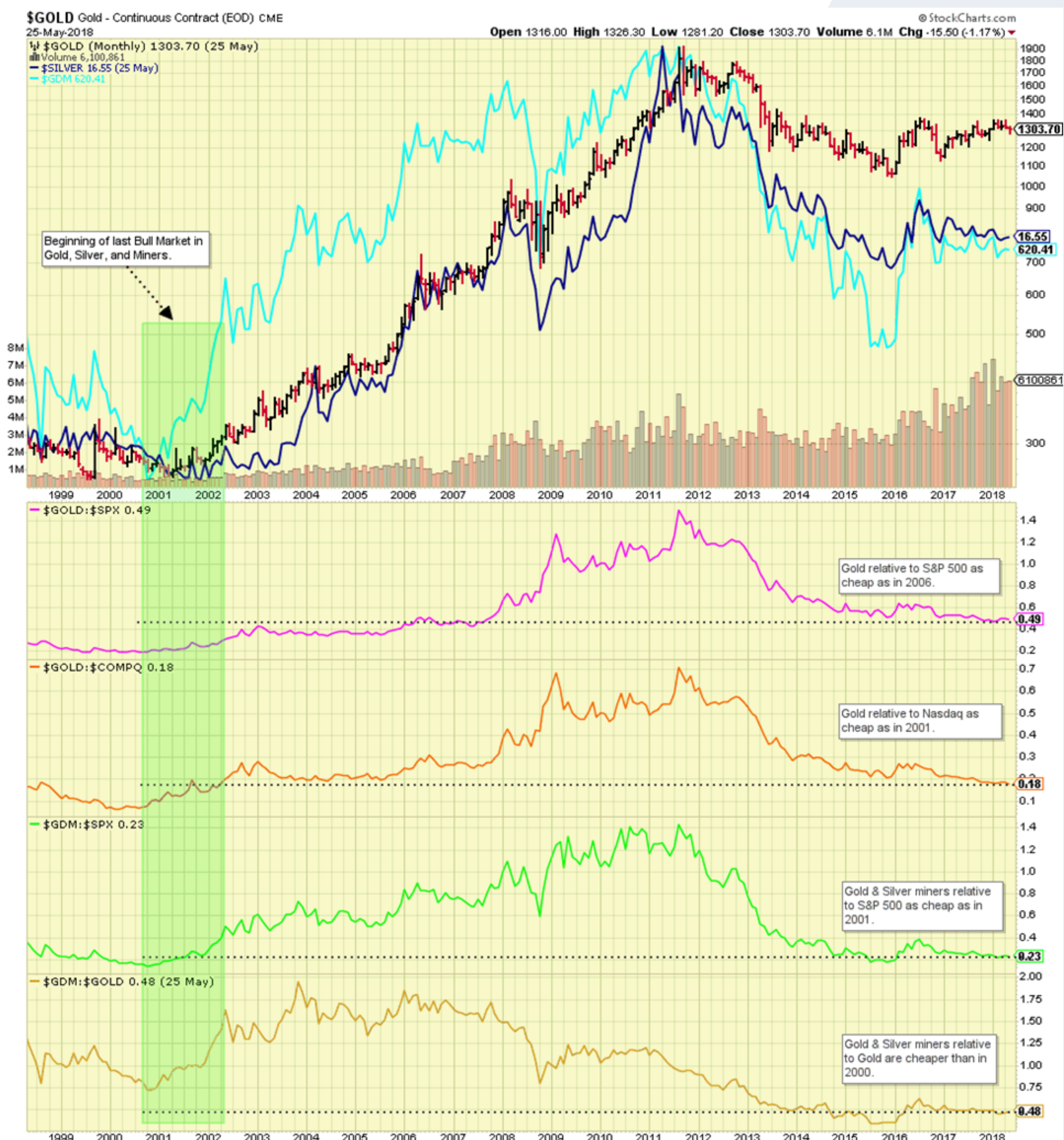
Gold, Silver, and Miners

Relative value is an especially important concept when it comes to evaluating investments that don't generate a stream of cash flow like public companies do. When there is cash flow or profit, one can put a price tag on it and decide whether a stock's existing price offers good value. If future cash flows and profit won't be enough to provide an attractive return on investment at the stock's current price, then one could conclude shares are too expensive. On a market-wide basis, this is precisely what we're finding at the moment as illustrated in the chart below. Investors are paying more than they have in the last 28 years for each dollar of corporate sales/revenue even though those revenues are growing at the slowest pace over that period of time. Either revenues increase dramatically very soon to justify current prices, or prices come down substantially. Either way, we have a clear way of evaluating how attractive, or in this case, unattractive stocks are due to the profitability and cash flows that businesses generate.



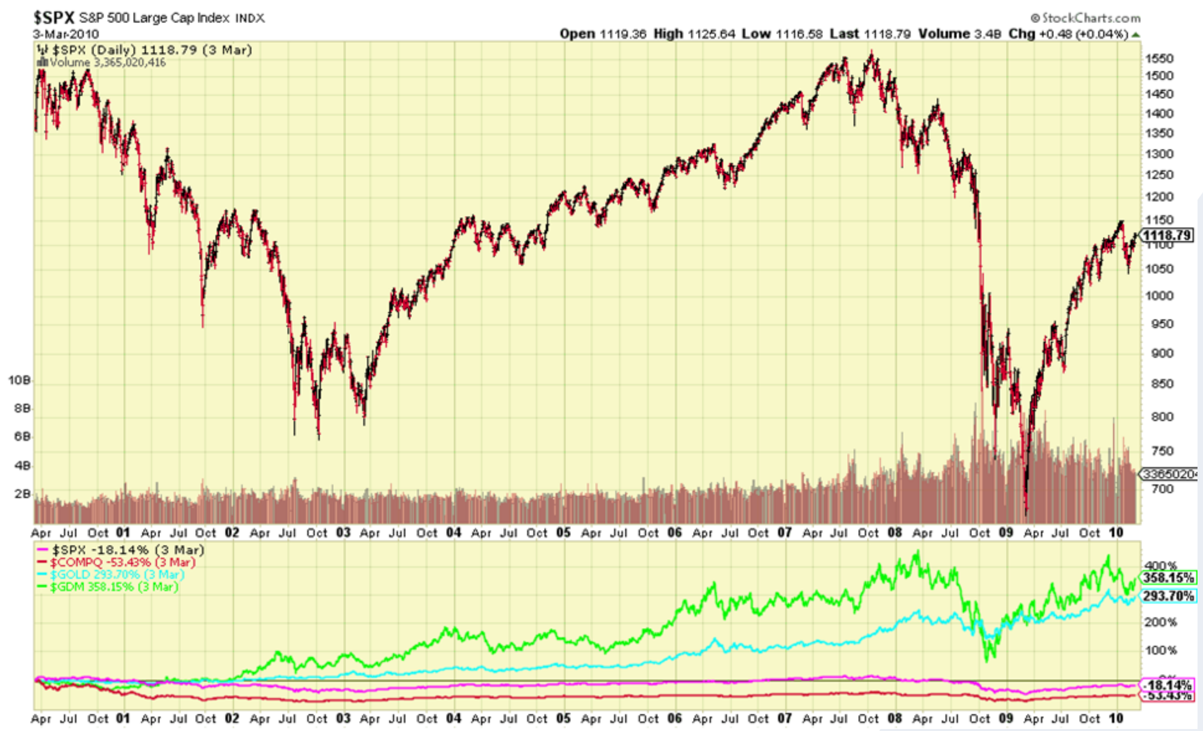
When it comes to commodities such as gold, since there is no business function generating cash flow, they are more often evaluated on a relative basis. What we can see below is that since gold, silver, and gold mining shares topped out in 2011, they have all come down in price significantly while stocks continued to appreciate. This has created a situation where those three commodity-related investments are very attractively valued relative to stocks. Gold is as cheap as it was relative to the S&P 500 back in 2006 while relative to the Nasdaq, it's as cheap as it was back in 2001. This is especially interesting since gold began its 10-year bull market in 2001 where it appreciated by more than 600%.

When looking at gold and silver mining stocks as a group, they are as cheap relative to the S&P 500 as they were back in 2001 as well, but relative to gold bullion, they are cheaper now than they were when they began their corresponding bull run from 2001 to 2011 and increased in value by over 800%. Because mining shares are companies that produce cash flows, they can also be evaluated on an absolute basis. Suffice it to say that when looking at the price of their shares relative to revenue and book value, they look equally cheap relative to historical averages. Thus, gold and silver mining shares appear extremely cheap on both an absolute and relative basis.



The last time gold bullion and mining shares were this attractive relative to stocks in 2001, not only did they weather the ensuing bear market well, they actually came out of it with positive returns. It's important to note that this didn't mean one wouldn't have experienced losses along the way. In the early months of market turmoil, both gold and mining shares also turned lower, but started moving higher in early 2001 and late 2000 respectively. If one stuck with them, they would have come out ahead while stock investors suffered dearly if they had exposure to either the S&P 500 or Nasdaq (see chart below).

What's even more interesting is what happened to this relative value match-up between gold, miners, and stocks over a ten-year period of time. This seems appropriate since the price we pay tends to drive returns over longer periods rather than shorter ones. Since stock market valuations never really got that attractive after the tech bubble bear market due to Federal Reserve intervention, and ran back up rather quickly into 2007, it set the stage for another market drop – the Financial Crisis of 2007 and 2008 – which took stocks even lower than they were in 2002. This created a situation where an investor in stocks (without factoring in dividends) would have seen an -18% loss in the S&P 500 and a -53% loss in the Nasdaq. Gold and mining shares over the same period increased in value by ~290% and ~350% respectively. This isn't to say an investor would or should have avoided stocks or been exposed to gold and miners for this whole ten-year period, but it does speak to the importance of initial valuation and price level driving returns well into the future (see chart on next page).



Finally, silver is another commodity that offers compelling valuation when looking at it relative to both the stock market and gold. Relative to the Nasdaq, silver is priced at levels last seen in 2001, while relative to gold, it's rarely been cheaper the last 30 years. Both relative valuation levels were present at the time silver began its ten-year bull market run between late 2001 and 2011 where it increased in value over 1000%.

At $16.55 per ounce, silver is down over 70% from its 2011 peak, which would certainly succeed in shaking out any speculative investors along the way. These kinds of losses are not inconsistent with subsequent long-term bull markets. Asset classes that are both cheap and completely unloved tend to be the ones that perform best over long periods of time. Everything we've talked about in this piece thus far are examples of that.

The last few years have been very difficult for those investors who have taken valuation seriously. Refusing to pay up for pricey investments has had the appearance of being the wrong decision. Without a meaningful allocation to stock, investment portfolios struggled to grow. At the same time, investing in asset classes that offer better relative value has not been very rewarding. For the prudent investor, it's been a difficult stretch.

Fortunately, we have ample historical precedent that this course of action over the long term will most likely succeed. Is it possible that this time is different? Sure. It's almost certain to play out differently, and in many ways, it already has. We've gone higher in stocks than we thought possible 3 or 4 years ago. Valuations went from historically very steep and dangerous to unmatched and completely beyond logic.

Just as the last few years have been very different in this respect, one should also expect the climb down from such lofty valuations to be different as well. No one knows exactly how it will play out this time (see our May 2018 "Is There a Bear at the Door?"), but it will most likely match in the extreme, either in drawdown, duration, or both. In this respect, this total market cycle will not be any different from others.

There is reason for optimism. With relative value in mind, there are alternatives that in the past have worked out very well throughout difficult market periods. Both Treasury bonds and commodities, specifically gold, silver, and mining shares look very compelling. This isn't to say they won't suffer losses going forward. Cheap assets can get cheaper just as those we've avoided have gotten more expensive, but over time, the valuations these categories trade at today offer ample opportunity for growth.

After all, it's what happens to our portfolio over the longer term that's most important. With this in mind, not paying too much for the investments in your portfolio will keep you on the right path over the long run. Price will absolutely matter.

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