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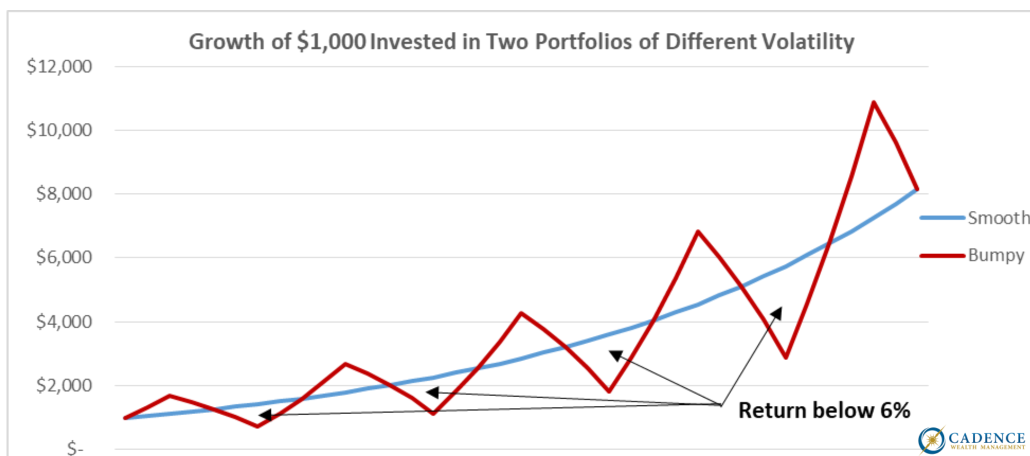
Cadence clips

FOCUSED ON WHAT MATTERS MOST.

How To Play With Fire

Everyone knows the expression "playing with fire" is a way to say someone is engaging in risky behavior, and it is frequently implied the consequences of that behavior could be particularly painful. Yet, we couldn't live without fire, be it a furnace, or an oven, or even a nice fire in the fireplace on a chilly winter night that makes the season's weather tolerable, if not downright cheerful. We couldn't live without fire, yet playing with it is how we describe overly risky behavior.



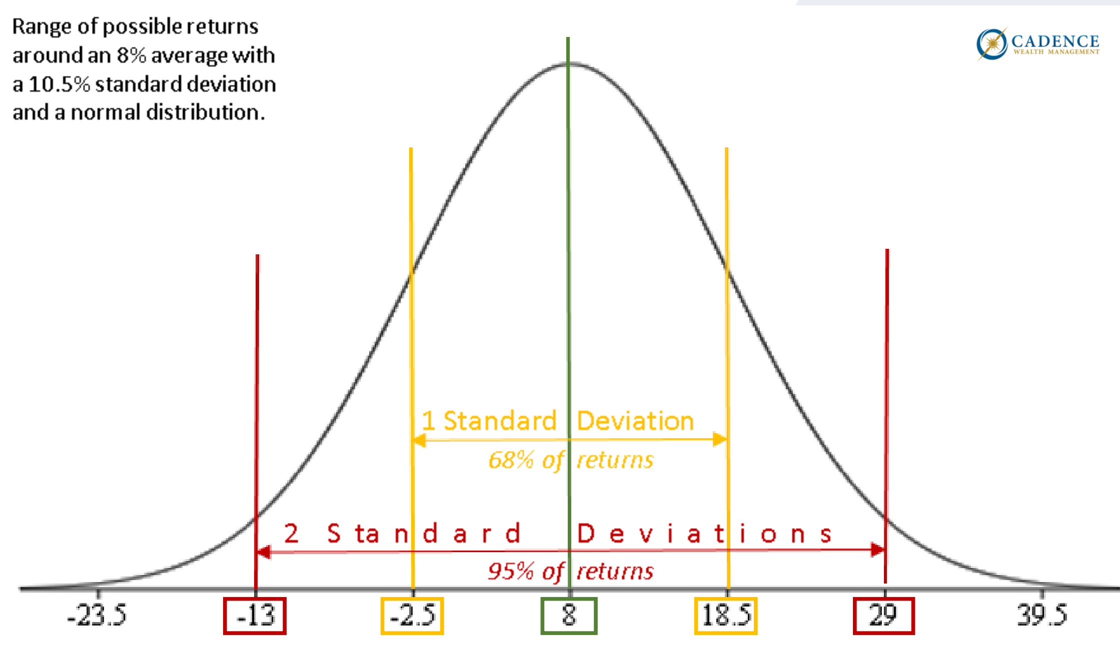
Volatility in an investment portfolio can be useful like the properly controlled fires we use on a daily basis, or it can be the kind that invites disaster; it all depends on how much potential downward volatility lurks within your portfolio relative to how much risk you should be taking at that particular time. We have written many pieces discussing investment volatility, especially relative to the likelihood of experiencing large investment losses.

In general, the larger the portfolio's volatility measure, the larger the potential investment loss. As a result, volatility has more of a negative connotation than a positive one relative to investing. That's fair, but volatility can skew toward the upside at times and isn't just reserved for downward moves. Without risk we couldn't get much growth, and even those things that one day are deemed too risky to own at a high level will eventually turn into things that are worth loading up on. Just like the fires we use on a daily basis, volatile investments have their time and place.

Statistically speaking, the less volatile an investment, the more likely it is to achieve its expected rate of return. Consider two investments which average a 6% rate of return, with one we'll call "Smooth" having a 0% volatility measure, and the other we'll call "Bumpy" having a 30% volatility measure.

Even though both of these investments earn 6% over this time period, the more volatile of the two actually returns less than that 44% of the time. Since investments that promise and then deliver a return high enough to achieve a long-term goal are few and far between, we usually have to live with some amount of volatility to achieve our goals, so it behooves us to use it to our advantage when we can. This simple chart shows Bumpy's volatility pretty evenly spread around Smooth's returns, but by being careful to include volatility when it is more likely to lead to upward volatility and not downward volatility, an investor can increase the likelihood that the fire in his or her portfolio is of the beneficial variety.

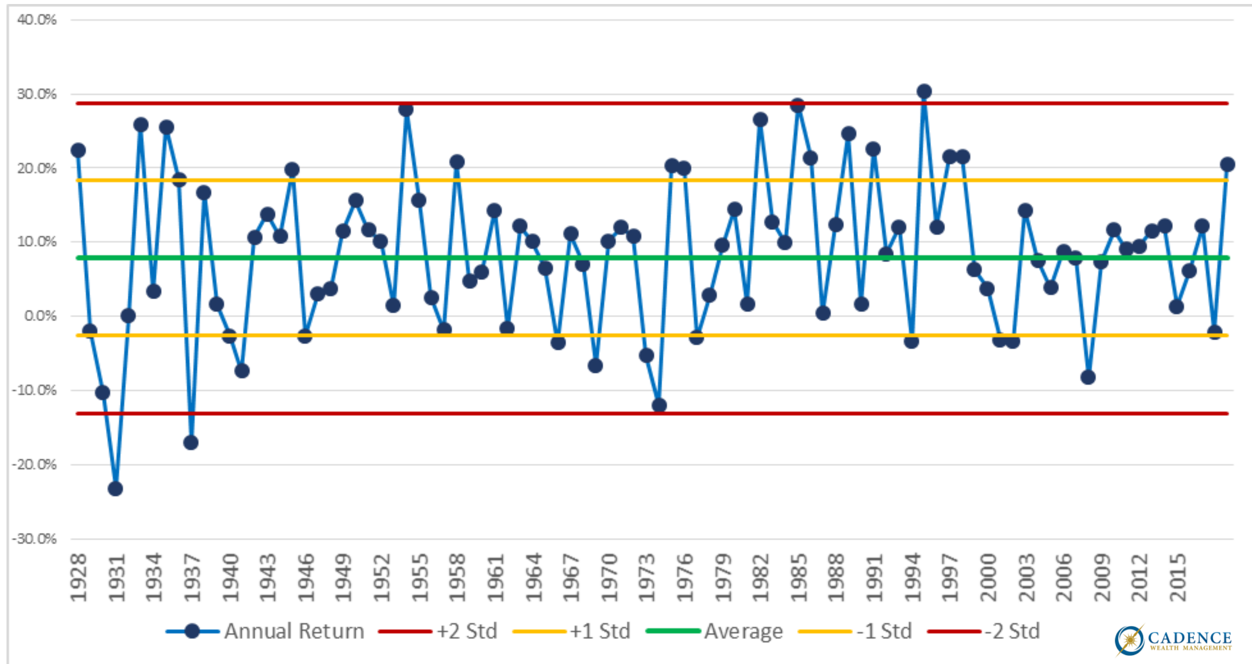
One way to measure portfolio volatility is by the statistical calculation called "standard deviation". As the name implies, this measures how much something deviates around a standard, and the standard for our purposes is the portfolio's long-term average rate of return. Determining a portfolio's potential range of returns is refreshingly uncomplicated; you just need to know its average return, its standard deviation, and a couple facts regarding "normal distribution". Remember bell curves? A bell curve follows a normal distribution pattern, with the average being in the middle of the curve, and the further away from average something falls on the curve, the more standard deviations it is from that average. Adding all these concepts together, we get that a portfolio with a long-term average annual return of 8%, a standard deviation of 10.5%, and a normal distribution pattern will have around 68% of its annual returns between 18.5% and -2.5%, and 95% of its annual returns between 29% and -13%. All you have to do to get those ranges is add and subtract the standard deviation to and from the average once to get the first range of returns, and add and subtract once again to get the second range.



Hopefully we didn't just trigger bad memories of those days where your exams and papers were graded on the curve and compared to all others. It's either fascinating or scary to consider the same things used to measure the volatility of an investment also determined if you got an A, a B, or a C on your history mid-term.

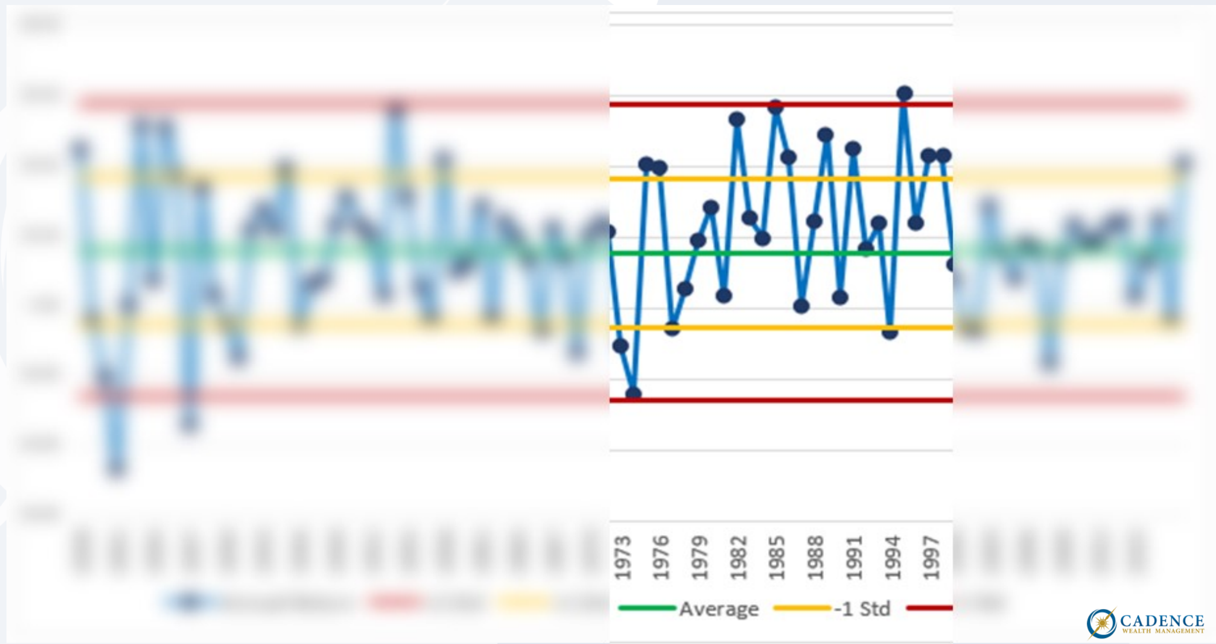
The portfolio we just described is actually one comprised of 50% S&P 500 and 50% 10 Year Treasury bonds rebalanced annually. Between 1928 and 2019, this portfolio returned 7.8% on average with a standard deviation of 10.5%. Now, with some reservation we're going to include a chart detailing this portfolio's returns and standard deviation bands over time. After the tutorial you've just read on standard deviation, we think you're ready for this, so hang with us because this particular chart is a bit of an assault on the eyes. Without further ado, we present the

very busy chart showing the annual returns of a half S&P 500, half 10 Year Treasury Bond portfolio since 1928 re-balanced annually, and with lines showing long-term average and standard deviations:



Are you seeing spots? Each blue dot is the annual return of the portfolio in a calendar year, and the light blue line connecting them all is to make it easier to see the returns from one year to the next. The green line is the portfolio's long-term average return of 7.8%. The gold lines are one standard deviation above and below the long-term average, and the dark red lines are two standard deviations above and below the long-term average. Picture the bell curve on its side. This is a pretty normal distribution, statistically speaking.

Now that you've looked at it a little more without going blind, we're going to point out just how volatile this 50/50 portfolio's annual returns were at times. There is a 26-year period from 1973 through 1998 where the annual returns fall within one standard deviation of the average only 46% of the time. Considering annual returns should fall within one standard deviation of the average 68% of the time but for this stretch they did less than 50% of the time, we'd consider 1973 through 1998 to be a relatively volatile period. Notice how many times the blue dots are above or be-low the gold lines for this period here:



The next 21 years, between 1999 and 2019, were a fair bit less volatile, with the returns of only 4 of those 21 years falling outside of one standard deviation from the long-term average. Since falling outside of one standard deviation should happen around 32% of the time, but for this period it happened only 20% of the time, we can say it was a 21-year period with less than average volatility. Notice how often the blue dots practically hug that green average line and stay inside the one standard lines for this period here:

The higher volatility period for the 50/50 portfolio paid off, with an average annual return during that stretch of a little over 11% per year, well above the long-term average of 7.8%. Conversely, for the following lower volatility period, the portfolio averaged only 6.3% per year. This is an example that valuations, economic cycles, and other factors can reward those who own the right assets, higher volatility or otherwise, at the right times, like for that lucrative stretch from the 70's through the 90's. The next 21 years saw stock market valuations grow to historical highs right before the tech and real estate bubbles burst in the early and late 2000's. Even though the 50/50 portfolio's volatility was lower than its long-term average at that time, it was still not a great time to take risks with certain asset classes, as the stock market's volatility trended violently downward for much of the 2000's.

So, wait a minute. We just got done telling you on the first page that a more volatile investment decreases your chances of hitting a particular target rate of return, yet now we've contradicted ourselves with actual data and shown that more volatility is somehow better?

Well, not exactly. The first example was comparing two different investments over the same time period, whereas the second example was showing the same investment mix over different time periods. That's a very important difference and we want to make sure there is no confusion between those two points. Though the 50/50 portfolio was more volatile than its long-term average between 1973 and 1998, it was still less volatile than an all-stock portfolio, so anyone needing a 10% return, for example, would have achieved their target return in the less volatile (smoother) 50/50 portfolio without needing to invest in a more volatile (bumpier) all stock portfolio.

Which brings us to our final point: how can we include volatility in a portfolio so it is the kind of fire that heats your dinner and not the kind of fire that burns a house down? All investments carry some level of risk, and it changes over time. When any asset class's valuations are toward the historically high end, that's when you're more than likely

playing with fire; when they're toward the historically low end, that's when you're more than likely cooking with gas. When asset valuations are high, their forthcoming volatility has a greater chance of being of the downward, detrimental variety; when asset valuations are low, volatility has a greater chance of being of the upward, beneficial variety.

In addition, having a good understanding of where we are in the economic and inflation cycles can also steer us toward the right type of volatility. While certain asset classes tend to perform better in an accelerating growth environment, others can perform relatively better in a decelerating or contracting growth environment. The same is true when we add inflation to the investment picture. Price inflation or deflation affects asset classes differently. Understanding where we most likely are along the sine curve of these varying cycles can help us avoid a wild fire of volatility.

Two investment categories we believe currently have relatively low valuations that may perform well in a decelerating growth environment with higher inflation are precious metals and mining company stocks, which is why our separately managed portfolios and our core diversified portfolios include allocations in one or both categories. This is not to imply that identifying which asset classes are likely to have upward trending volatility by comparing valuations and historical measures is foolproof, because it is not. Assets that seem ripe for a downward move can continue climbing longer than seems logical, and assets that seem like a good bargain can keep falling in price even after you've added them to your portfolio. However, reducing exposure to an expensive asset class that keeps growing and increasing exposure to a cheap asset class that keeps shrinking can often times be rewarded by patience and faith that expensive and cheap assets cannot stay that way forever.

Like heat sources in your house, volatility is less something to be completely avoided and more something to be carefully managed. Ultimately, the main drivers of the risks you take with your investments should be how much you can or cannot afford to lose, your timeframe for investing, and where investment valuations are currently, but paying attention to an asset's or a portfolio's volatility measures are a good beginning point for understanding just how much potential volatility you are carrying. Now is probably not the right time to load up on equity investments as their valuations were high even before a global pandemic-fueled recession. Volatility like we've experienced recently is normal, and has occurred many times in the past and will again in the future. Managing that volatility and using it to our advantage allows us to buy more of those assets we believe have a chance to boost portfolio returns in the coming years and avoid those we feel could burn us. Though a fire in the winter makes you feel safe and cozy, we contend that properly managed investment volatility is equally heart-warming.

Market Update

Flows and confidence

The major U.S. stock market indices are at new highs, residential real estate markets are arguably even hotter than they were a year ago, and by and large household net worth is as high as it's ever been across the country. This leaves the impression that all is well with the world, does it not? If these things are how we define "well", then all is in fact well with the world. If however we judge wellness based on things other than asset values, as hard as this may be and as preposterous as it may sound to some, then it's fairly clear to see that things are not well. Our inclination is to take a more holistic approach in evaluating the world, the trends within it, and the implication this may have on markets tomorrow, despite what they may be doing today. Markets in the short term aren't always guided by reality, but

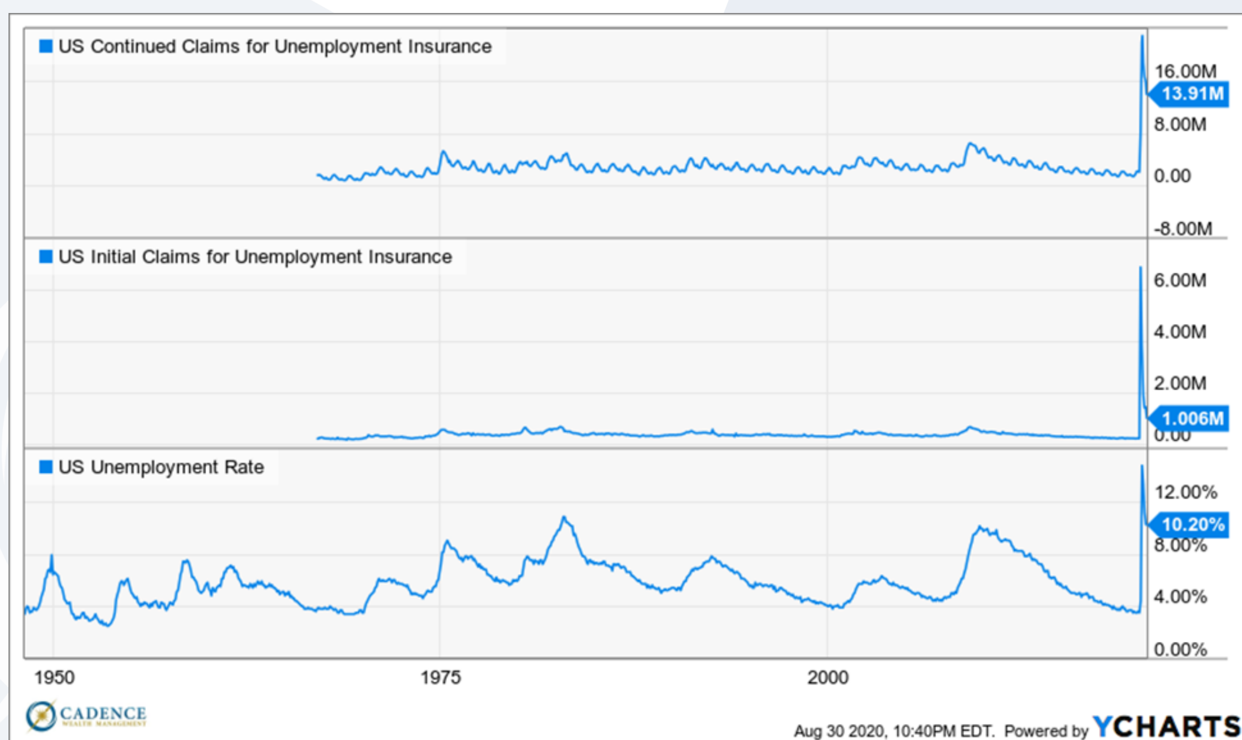
rather other factors that are more emotional and technical in nature. Sometimes these forces are intentional and by design, whereas other times they happen almost by mistake or happenstance. The primary forces at work in keeping asset value propped up today – and over the last few years – are the confidence created by the Fed's commitment to saving markets should they decline as well as passive fund flows into 401k plans and exchange traded funds (ETF's). This has been a powerful duo that has brought markets to valuations never seen before and investor confidence and/or complacency to equally unprecedented levels. The implications of this on unsuspecting investors will be extraordinary.

Wellness Check Excluding Asset Values

As we've recently written about, there is tremendous social upheaval within the country at the moment. We hear a lot about the BLM movement, but it goes beyond this. People are upset for a variety of reasons, not least of which is because of extreme social stratification and the wealth disparity created by it. This is a trend that will play out over time; things will not settle down tomorrow. The chasm has reached a point where pretending it doesn't exist is not a viable option. The return pendulum swing is likely underway.

Straddling the social and economic landscape is the current unemployment picture. Despite the recovery that some are celebrating, the employment picture is as dire as we've seen in decades. Continued claims for unemployment assistance are over 13 million, more than double the level seen during the financial crisis in 2008 and 2009 which was the record for decades. Initial new unemployment claims are still hovering around 1 million per week, 300,000 more than the highest weekly figure seen in the financial crisis. These are more than statistics however. They are real people, and there are more of them out of work than at the depths of prior recessions spanning decades. Not only does this create a more accurate picture of our current economic reality, but it has implications for the short-term factors that have been keeping markets afloat. Very important ones.

Below: The current employment picture even after the summer "recovery" still stands out as the worst in decades:



Unemployment Poses a Risk to Flows and Confidence

Over the last decade, the amount of money in passive index funds, including ETF's, has grown rapidly finally surpassing that in actively managed mutual funds last year. What makes this such a big deal is that when investors put money into these index funds, rather than expecting a manager to invest the funds in stocks that offer good return potential for whatever reason, they choose to distribute the funds across an index of stocks to achieve better diversification, since, well, beating the market is really hard over time. Although there's some truth to this for most investors, what the proliferation of indexation has created is a system where over half of the money entering the stock market is completely price indiscriminate. Because index funds just buy more of the stuff that comprises the underlying index, and usually in proportion to the size of each constituent, the big continue to get bigger and the expensive continue to get more expensive. What results is a whole investment community that cares nothing about the price of what they're buying. If we were to write a book on how not to invest over the long term, it would contain many of the no-no's we're seeing most investors doing through index investing. We've systematized bad investing and very few truly realize it.

The first implication of this is that as we've said; it makes the big bigger and allows companies that may not be truly profitable to carry on via the tailwind and financial cover of a high stock price. Without casting judgement, Tesla and Amazon are a couple companies that come to mind. Where would Tesla be if investors cared about how much they paid for its stock? And how would a lower stock price have affected Tesla's ability to raise capital to carry on making cars and no profit for shareholders over the years? Same questions for Amazon who's just recently turned more of a profit. Where would they be if their shareholders demanded more profit earlier on? Would their product pricing have made it easier for brick and mortar competitors to survive? Would that have been fairer? These are contentious questions, but it's fair to say indexation has played a large part in the world we live in today good or bad.

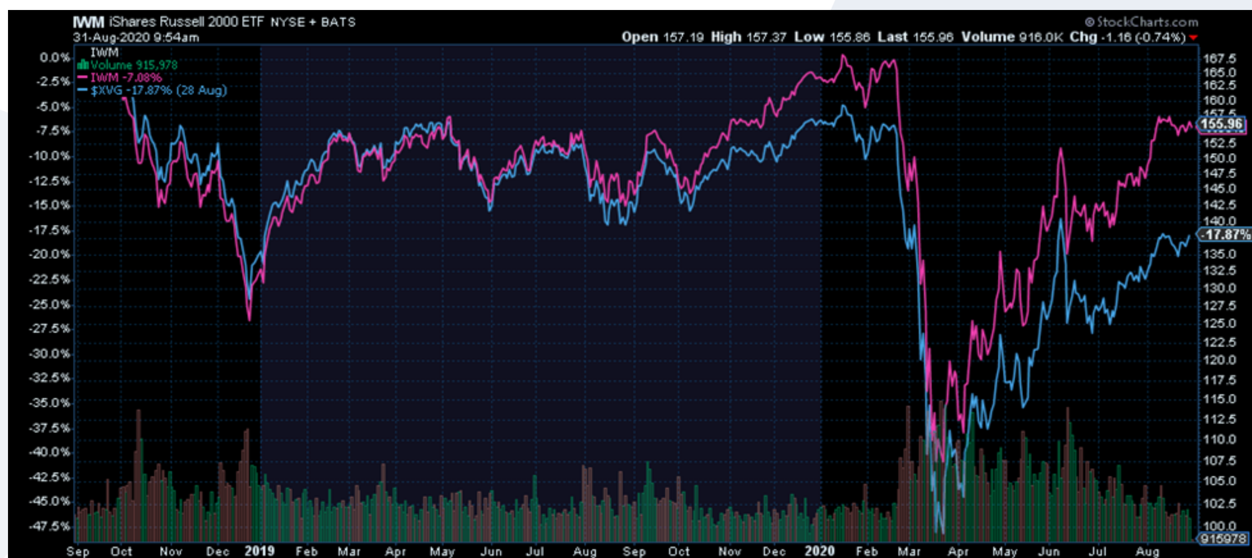
The second implication of indexation is what happens if or when the flows into index funds slow. Many employees saving into retirement plans contribute a portion of each paycheck directly into them within their 401k plans – there's often very little thought about what's happening in the economy or markets associated with these contributions – they're automatic. Workplace savings into stocks has provided a very stiff "price-indiscriminate" tailwind over the years with index funds finding their way into more and more retirement plans. Here's the downside: remember the charts above? There are far fewer employees right now adding to their 401k plans. If this employment situation doesn't improve quickly, this reduction in investment flows could have a significant impact on the markets persistent upward momentum most have considered normal. Time will tell, but we'll be watching those flows. If slowing turns into a reversal, we'll all get to see what price-indiscriminate selling looks like. Indexation in reverse is something we need to be prepared for.

On the confidence front, between the Fed making it a priority to save markets from declining and the perpetual bid placed under the market's bigger stocks via indexation, it's clear to see how investors might feel a sense of infallibility. Add to this a little hope of a quick economic recovery and a Covid-19 vaccine, and markets care not what the current data suggests. This looking into the future is how markets work, and generally, it's a good thing. Any smart investor cares more about the potential for his/her investment down the line than the current and more obvious set of circumstances. This is how attractive prices are found. The problem with how investors today are discounting the future is that they're not only most likely wrong about the sharp economic recovery, but they're not getting a good price in discounting that scenario either. With the major U.S. indexes at all-time highs, there is no deal to be had in taking this view. It is the consensus, which means if it doesn't play out (the recovery) the surprise would probably be to the downside for stock markets.

So, what would happen to stocks if, little by little, investors lost confidence in the Fed's ability to save the day? We would argue that its abilities are actually rather limited and it's the perception of power that gives the Fed power. If

that perception changes, the whole game changes. We have to remember that during the market declines of 2000-2002 and 2007-2009, the Fed was cutting rates consistently with little effect. Markets continued to fall anyway probably because the forces at work both psychological and technical outweighed the confidence investors had in the Fed to make things better. This can certainly happen again, and it will. There will likely be that emperor has no clothes moment when markets wake up to the fact that persistently low interest rates and increasing levels of debt are not good for anyone, and have actually helped to create many of the problems we see around us today. What started off as a steroid shot to boost confidence and jumpstart the markets and economy (back to their natural state of functioning) turned into a perpetual high dose steroid IV drip. What we're witnessing now is the ugly downside to this course of treatment. Hundreds of zombie corporations with too much debt, companies that are too big to fail, public markets that have placed profit-maximization above employees and customers, the thinking that the Fed and government has no choice but to bail these same companies out by incurring yet trillions more in debt, etc. Have you gotten the image of a giant snowball rolling downhill? Change is afoot, and it's happening at an accelerating pace.

Finally, it's important to point out that although major U.S. indices are at all-time highs, the average stock is not. The chart below shows the Value Line Geometric Index and the Russell 2000 Small Cap Index both off their highs from late 2018. It's no coincidence that late 2018 was also the peak in the economic cycle and it makes sense that the average company would struggle a bit in a decelerating growth environment. It's also important to keep in mind that these two indexes don't suffer from the same big stock bias in the major indexes created by indexation. They are a truer reflection of what's actually happening to most companies and people across our economy rather than within the narrower part of the economy that is benefiting directly from asset appreciation via flows and confidence.



The dramatic divergence across different stock market indexes in many ways is emblematic of what we're seeing across our society as a whole. A select few are doing just fine, in fact never better, while most are in a worse spot than they may have been a couple years ago. Given the reality of our employment situation – just how many people are out of work currently – we have to be thinking about the impact this reduction of savings could have on passive investment flows. Any slowdown could be meaningful. In addition, with awareness growing that Fed and other central bank policies do not benefit the average person, but rather favor the biggest strongest players within our society, it's easy to see how confidence in their ability to continue propping up markets for the few that benefit from them could wane. It could also be that the power to tinker is taken away or reduced given growing political and societal pressures. Regardless of how this plays out, it's possible to see the Fed playing less of a role in markets going for-

ward, which of course would be an unwelcome surprise to many. We'd argue that this would work out for the better after a bit of an adjustment period, and it should be viewed as a normal, healthy cycle just like that of most other things.

In sum, don't be fooled by the large company stock indexes. The economy is weak and most stocks are reflecting that, although not fully. Indexation through passive investment flows has played a huge role in keeping markets buoyant. If these flows recede due to millions more workers no longer contributing to 401k plans systematically, as well as a loss of confidence among investors as a whole (for whatever reason), markets could very quickly reprice to match up more closely with the current and most likely economic reality we'll be facing over the coming months and years. This may not be the typical market/economic cycle that markets are hoping for; there are too many extremes that have built up over the years that impart greater forces, stronger gravity, a bigger pendulum swing. It's growing increasingly likely we're experiencing more of a big change moment that won't be entirely obvious without the clarity of hind-sight. We're investing for our clients and their futures accordingly.

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