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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

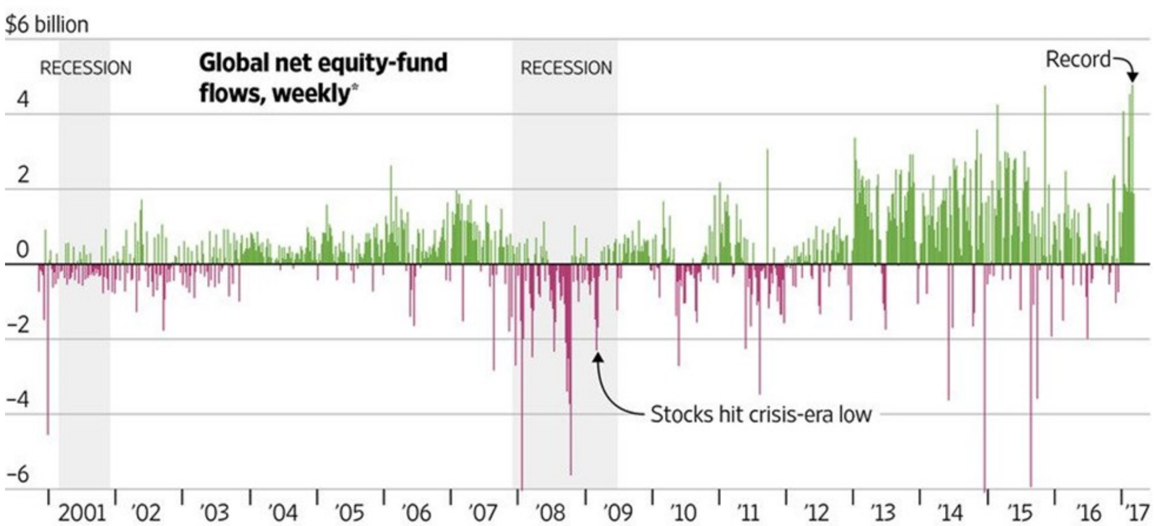
What Does "Getting More Aggressive" Mean, Anyway?

Since 1950 there's only been one bull market that gained as much and lasted as long as the one in which we currently find ourselves. In this case "bull market" means a sustained period of rising stock prices. The current increase of 254% above the March 9, 2009 stock market low is 40% higher than the average bull market gain, and this bull market has also lasted 40% longer than average. No matter how you look at it, this run we're on is way beyond normal in both scope and duration, so it's little wonder that many investors are tempted to get more aggressive.

Unfortunately investors have a poor track record of timing when to get more or less aggressive. History has a lot of examples of investors buying before markets fall and selling before markets rise. If massive investor withdrawals frequently happen before the market goes up and if massive investor additions frequently happen before the market goes down, where are investment flows currently, you might be wondering?

Piling In

Investors are returning to stocks, pushing flows into mutual funds and exchange-traded funds to the highest level on record.



*Through the week ended March 8

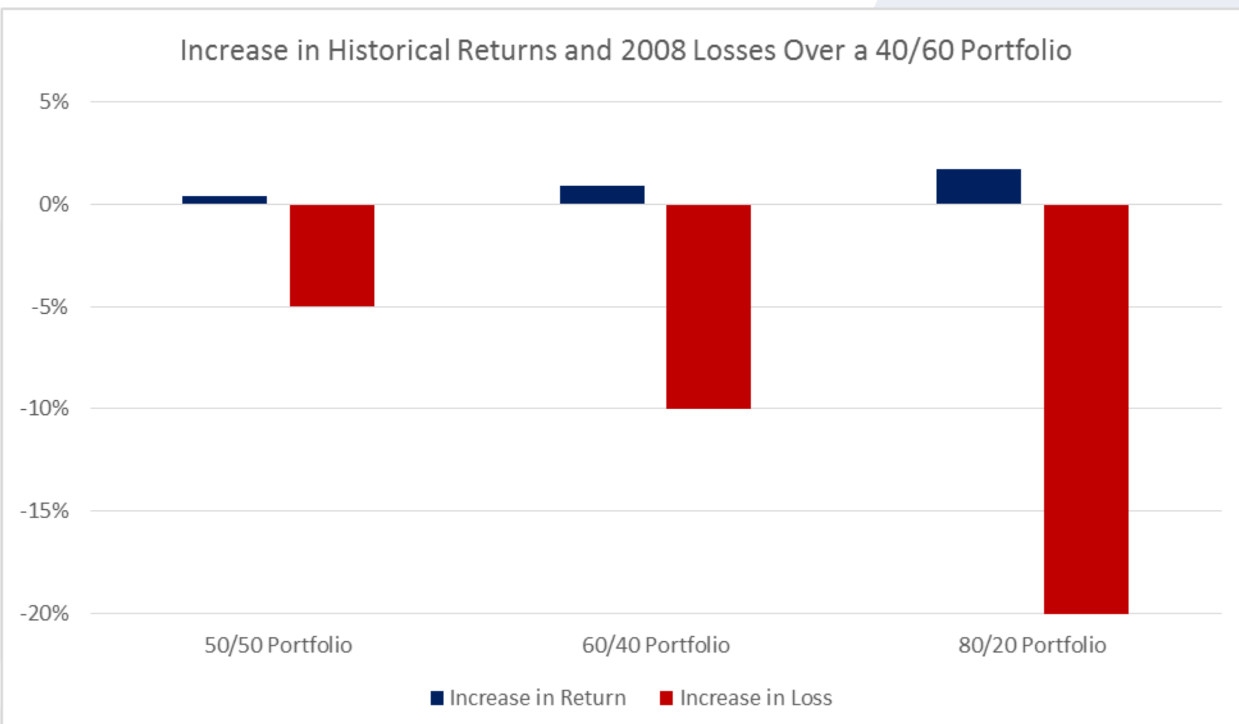
Source: EPFR Global

THE WALL STREET JOURNAL.

According to the Wall Street Journal, investors are dumping more in the stock market right now than at any point over the past 16 years. Investor inflows and outflows are not perfect predictors of stock market performance, but there is a definite correlation which makes this information troubling.

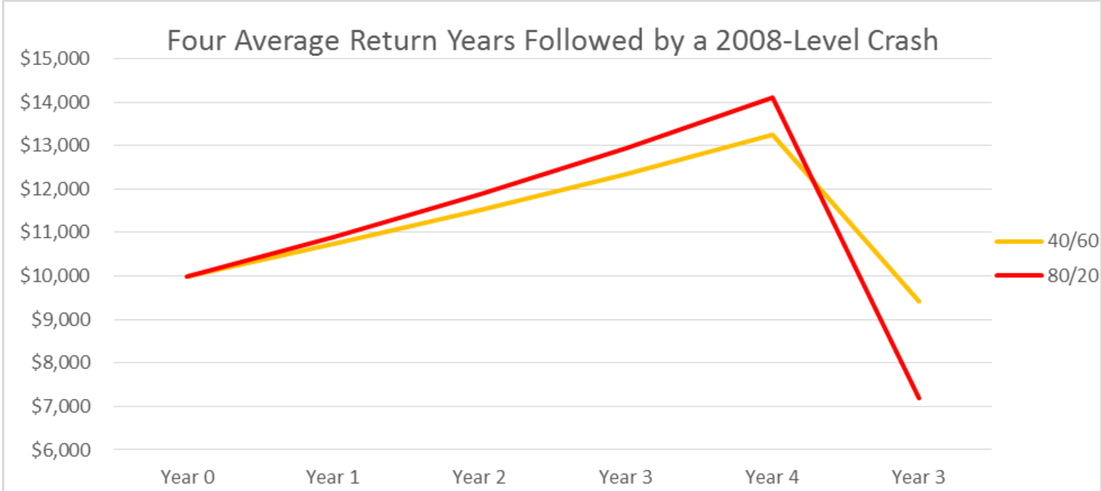
Just based on investors' ability to frequently do the opposite of what they should be doing, though there is an abundance of other data showing a higher level of risk currently in the system, now seems to be a questionable time to get more aggressive. However, ignoring the timing aspect for a moment, what does "getting more aggressive" really mean? For most diversified investors that means selling some conservative investments and buying some more aggressive investments, of course, but how much? How much more aggressive is aggressive enough? For an investor with a 40/60 stock-bond split, is 10% more stock enough? 20%? The problem with getting more aggressive is that in order to make that move pay off, you can't just add a little stock; you have to add a lot, and the problem with adding a lot of stock is that it adds a lot of risk. Believe it or not, adding 5% more stock doesn't do much. Even adding 10% more does less to increase returns than most would assume while also doing more to increase risk than most would assume.

The gain/loss profile on owning stocks is asymmetric, which means the potential losses increase a lot faster than the potential gains as an investor gets more aggressive. For every incremental increase in long-term target return, your potential short-term losses increase more than ten times more. So an increase in long-term target return of 1% results in an increase in short-term downside risk of -10%.



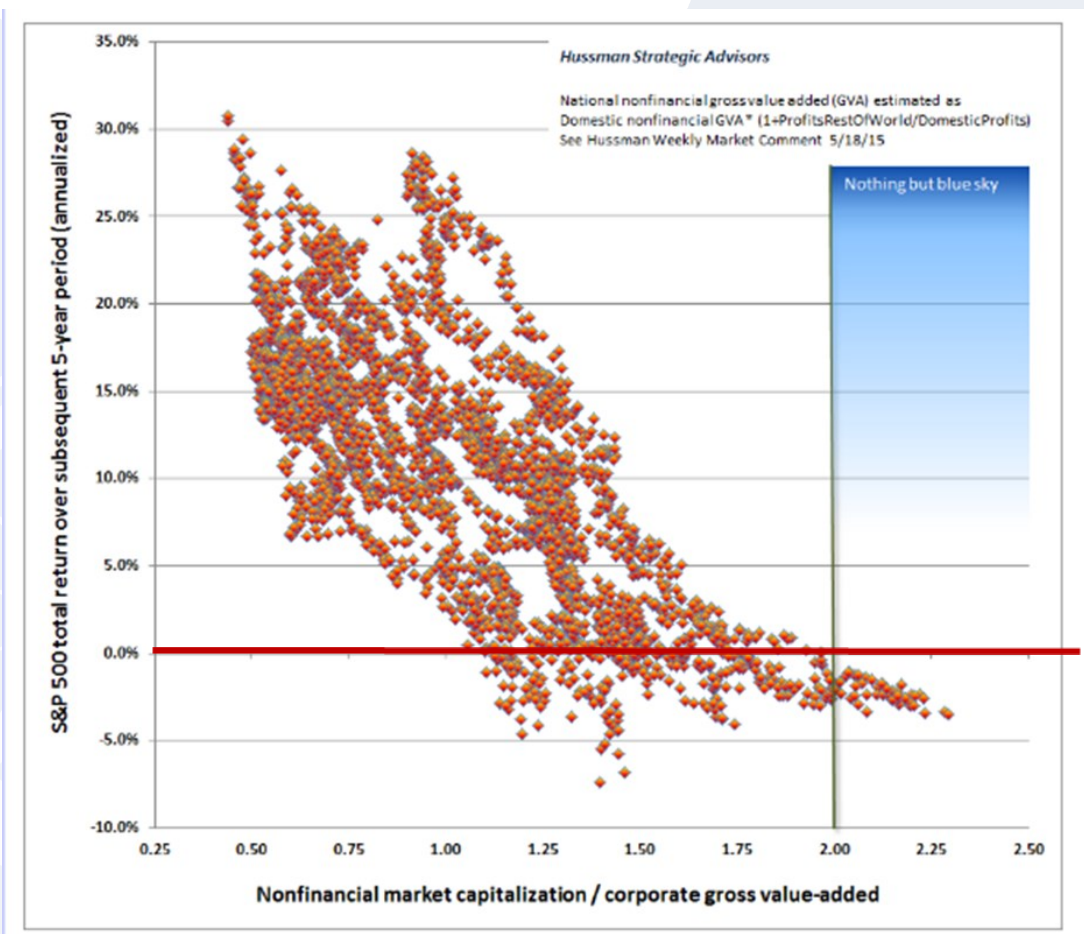
*Historical returns based on portfolios comprised of S&P 500 and 10 Year Treasury returns since 1927.
** Losses based on diversified portfolio returns from 2007 stock market peak through 2009 stock market trough.

What this chart illustrates is, for example, a 50/50 portfolio has averaged 0.4% more in annual return than a 40/60 portfolio over the past 90 years, but would have suffered an estimated -5% greater loss during 2008's financial crisis. Maybe losing -5% more doesn't seem that bad, but consider you're exposing yourself to that much more of a loss for only 0.4% more return per average year. By the time you increase your stock allocation to target a meaningfully higher average annual return, you're increasing your potential losses to a much larger degree. If you bumped your stock allocation up to 80% and as a result earned 1.7% more in annual return (which is the historical average annual difference between a 40% stock and an 80% stock allocation) for four years only to lose -20% more in a market crash, you'd end up with -31% less than had you never changed your allocation:



These are examples of common investor behavior: get complacent about risks, feel like gains are being missed, fail to calculate the potential loss versus the potential gain, and get more aggressive toward the end of a rally. A lot of the work we do with clients is to remind them of how much they can lose at any point in time. We look at a number of data points which we share with clients on a monthly basis. We know it is difficult to remember everything we write, but the bulk of our feelings on how to invest currently have been influenced by an overwhelming amount of data that suggests a large pull-back is likely. We frequently use historical comparisons to help us reach our conclusions, and one we saw recently that strikes us as particularly germane is this one from Hussman Strategic Advisors. Over the past 70 years there hasn't been a single 5 year period where the S&P 500 was positive once the ratio of nonfinancial market capitalization to corporate gross value-added reached where it is today.

We know that "the ratio of nonfinancial market capitalization to corporate gross value-added" gets more confusing each time you read it, and we know the following scatter plot isn't going to clear that up immediately:



*Source: Hussman Funds March 13, 2017: https://www.hussmanfunds.com/wmc/wmc170313.htm

However, it is OK that both "the ratio of nonfinancial market capitalization to corporate gross value-added" and the scatter plot are complicated because fully understanding them matters less than taking away the central point that every single time this ratio has reached where it is today, the S&P 500 has been negative the following five years. This ratio is currently at 2.00 as represented by the green bar running vertically along the right side, and you can see that there are no dots above 0.0%, each dot being a measure of historical five year returns once the ratio has hit a given measurement. Considering before this these conditions have never resulted in a positive stock market the following five years doesn't bode well for the next five years, as do many of the other metrics we use to get a feel for where financial markets are. As a result, we continue to urge caution.

Preaching restraint in a time of booming stock markets is complicated when investors feel like they're missing out, don't quantify the risk of one decision versus another, and have been lulled into complacency by a sustained stock market rally devoid of major losses. Even when the stock market got pretty close to losing -20% in 2011, it took only a little over two months to bottom out and was back to where it started around four months later, so investors really didn't have to relearn the lesson of how low and long market pull-backs can get. Two of the reasons Vanguard estimated advisers add up to 3% in average annual return to their clients' portfolios are because they limit them from deviating from their portfolios (like getting more aggressive at a bad time) and they communicate and coach their clients. According to Vanguard that 3% "extra" return is not added every single year, but bigger chunks get added periodically by helping clients stay the course, especially in the face of a seemingly low-risk, high return environment that could be assumed by many today.

So what does "getting more aggressive" really mean? Without considering timing, it simply means owning more riskier investments and fewer safer investments, but to ignore the timing of the move is foolish. Changing your investment philosophy not based on your needs, but based on your emotional reaction to what seems to be going on in the investment world is a gamble that frequently, if not usually, fails to reap the rewards investors envision. For people who prefer to operate that way, I've got a year 2000 tech stock and a year 2007 investment property I'd love to sell you.

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