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FOCUSED ON WHAT MATTERS MOST.

But I Want It! – The Market's Addiction to Easy Money

The last few months in the financial markets have been nothing if not confusing. Sure stocks and bonds go up and down all the time for a whole host of reasons, but when both stocks and bonds plummet after Federal Reserve Chairman Ben Bernanke suggests that he'll inject a little less money into the system if the economy becomes stronger, that's just a bit strange. Why wouldn't investors be happy about the economy getting stronger? Did they actually think the Fed would or could support the economy forever?

Let's first define what it is that Ben Bernanke and the Federal Reserve have been doing and why before analyzing the market's reaction. The big fear for indebted governments all over the world and their respective central banks is deflation. This is the term used when the circulation of money within an economy or financial system slows down or sits still while prices for goods and services fall. When this happens each dollar becomes more and more valuable over time, which encourages people to hold on to them rather than spend them. That's really bad for the economy and can wreak havoc on government budgets driving up debt over time. In addition, and probably more relevant, deflation favors lenders over debtors, and since governments tend to be debtors, that isn't a good thing. Governments with high debt levels now have less money with which to pay back a fixed amount of debt. This can be the equivalent of a family taking on a $500,000 mortgage at a $200,000 income level only to see that income drop to $100,000 over time. What was manageable at first just became much more burdensome.

So, in an effort to stave off deflation, the Federal Reserve has effectively been pumping money into the system to make sure there's enough to go around. Most recently they've done that through purchasing $85 billion of U.S. Treasury securities and mortgage-backed securities each month. Each time they buy these bonds, the cash that is exchanged for them enters the system for economic use. Money gets lent and spent and voila – the economy begins to take off. Well, it may not be quite that simple. What happens if money's available to be lent, but nobody really wants to borrow? If a family struggling to make ends meet and with a lot of debt gets a call from the bank saying they now have the ability to borrow even more creating a new monthly payment, the offer's likely to get turned down. If it doesn't, the bank's got bigger problems down the road extending credit to that family. Well, in simplistic terms, this is what we're experiencing right now. Borrowing at the household, corporate, and government levels has been fashionable and abundant over the last 20-30 years and it can't go on forever regardless of how cheap credit is or how much money floods the system. Eventually either the focus shifts to paying these debts down or they go bad. Either scenario leads to a slowdown in overall demand for new money and things, which keeps the economy from moving forward in the way we're accustomed to. This is a good old fashioned demand issue that no amount of money can fix.

Given how smart and well educated most of the folks over at the Federal Reserve are, we're guessing they are starting to understand how continuing down the path of easy money will likely do more harm than good. What was much more easily justified in 2008 when we were on the brink of a financial system collapse is becoming detrimental to the health of our country going forward. The excess money in the system is finding its way into financial markets rather than being lent for good productive uses, pushing up asset prices to dangerous levels. The old saying "don't fight the Fed" is being followed almost blindly by speculators and unfortunately more recently retail investors who are simply chasing the returns we've seen as a result. This is how bubbles are created – people (mainly big banks and hedge funds) being forced to do silly things with their money simply because they have too much of it and have to choose the "least bad" option. Sadly, the big smart speculators will most likely be the first to exit markets before they fall, leaving the retail investor/little guy holding the bag. Stuck between a rock and a hard place, the Fed recognizes the risk of market imbalances likely outweighs its ability to heal the economy with continued easing and so has started to communicate a reduction in bond purchases over the coming months. Although they condition the tapering on better economic progress, we think that will be a bit of a moving target. The Fed will need to taper regardless of economic progress. Nervous that the economy isn't quite where it should be, the Fed is more nervous that if it continues down the same path, it will spawn the next bubble creating yet another financial crisis – and so it begins, the very difficult and somewhat painful process of slowing the flow of money from the spigot.

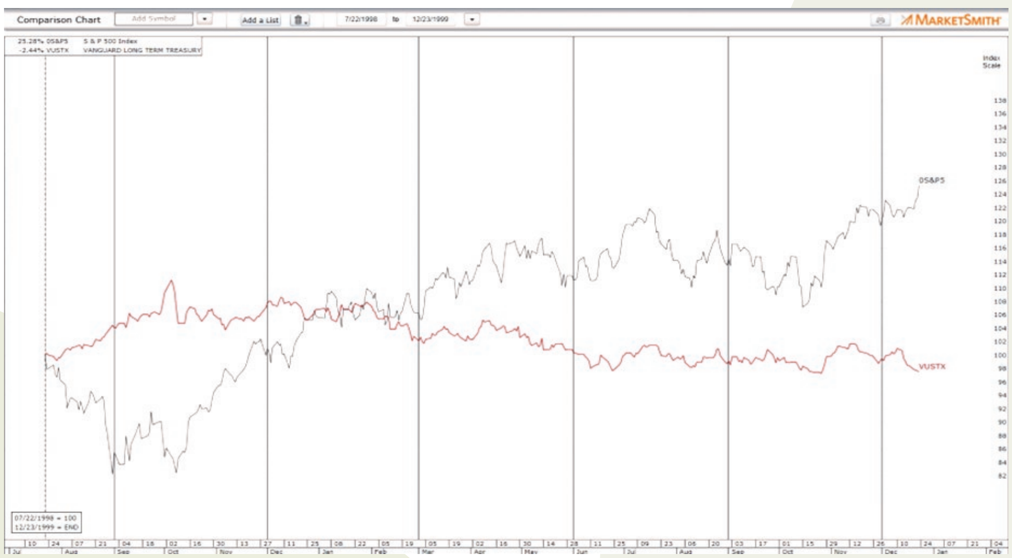
Both stock and bond markets dropped significantly when Bernanke first announced a slowdown in bond purchases. Even though he made it clear that he would only do so if the economy shows strength, markets still chose to focus on the fact that the taper represents a pulling away from the massive accommodation we've become accustomed to. This suggests to us that the recent rise in both stock and bond markets has had more to do with the Fed than the underlying strength of the economy – thus giving us tremendous pause as investment managers. The downturn in stocks over the last couple months was effectively par for the course. We've seen plenty of this and if you've been reading our newsletters, you're well aware that we expect much more of it in the future. In fact, the 7.5% correction since May 22 for the S&P is a mere hiccup compared to what we feel is coming our way. The correction in bonds however was not so typical. Depending on the bond category, we saw hits of anywhere from 3% to 10% in a matter of weeks. This is not normal and is completely reflective of those silly decisions people make when central banks hand them money and expect them to make hay. Bonds were bought with leverage and at the first sign of a major player – the Federal Reserve – backing away from that market, banks and hedge funds unwound some of their bets. Unfortunately the little guy added a bit of fuel to the fire selling their bond holdings after they already took a substantial hit. So, the hit bonds have taken recently we feel is attributable to the imbalances created by easy money rather than a direct result of interest rates going on a sustained long-term rise. Will rates rise? Eventually yes, but not yet. If the global economy weakens as a result of continued global de-leveraging (dealing with excessive debt) and a reduction in central bank support, rates can remain low for longer than we'd think. In fact, if deflation rather than inflation is what we end up battling over the next couple of years, low rates still offer decent and potentially better real return than we've gotten over the last few years. This is one of the reasons interest rates on Japanese Government Bonds were so low for so long. They've experienced persistent deflation since their bubble popped in 1990 making a 1% return on a bond more like 3% net of deflation.

So, bringing it all together, this taper is going to continue to be tricky business for the Fed going forward. Markets that have become accustomed to easy money aren't going to adjust well when it's taken away – we got a glimpse of this after the May 22 and June 19 Bernanke addresses. There are also imbalances in the system that are a direct result of easy money policy which have increased the risk associated with investing and certainly the volatility that we'll experience along the way – in all asset classes. Ultimately, we're more cautious with stocks than bonds. The recent stock market volatility is a taste of what's possible when either the Fed is deemed incapable of heeling the economy or they pull away on their own fruition. The bond market we feel overcorrected due to the unwinding of leveraged bets and is not reflective of the longer term rise in rates that most are talking about. Although we feel this may be coming, it may have to wait until the global economy works through additional de-leveraging and deflationary pressures in the short to medium term. This process would put downward pressure on rates and serve to keep bond prices relatively high until it's worked through. Given this outlook, we're happy to stay very light on our stock allocation while favoring cash and high quality bonds. This is not the time to be chasing returns – in fact it's best to just ignore them and focus on the big picture. So hang in there, the Fed is in a bit of a predicament. It could be a bit of a roller coaster ride as it tries to find a way out. As always, if we plan properly there will always be opportunity.

The Bigger Picture – Historically, Patience May Prevail!

One of the things that makes investing so difficult is that there will always, and we mean always, be a time when your strategy seems like it's not working. When you're more aggressive and positioned for a market rise, the market will inevitably go down for some length of time creating this sinking sense of being caught on the wrong side of things. The same is certainly true when the market's going up – if we're playing more defense than usual, we immediately feel a bit of regret that we're not along for the ride. What's interesting about this psychologically is that the feeling tends to kick in regardless of how aggressive or conservative we think we are as investors. The allure of quick market gains is a very powerful thing that we must be aware of every step of the way. Understanding how powerful and dangerous it can be and being aware of it as it's happening can help us avoid the trap that most investors fall into.

Below are a couple of charts that illustrate the S&P 500 performing a whole lot better than a U.S. Government Bond Fund (the Vanguard Long Term Treasury Fund) over fairly short periods of time – the first from 1998 to 1999 and the other from 2005 to 2007. Take a look and ask yourself this question – How would I feel if I was invested in the Treasury fund over this period of time? Would I be inclined to make the switch? (Obviously this decision would involve knowing your personal goals, objectives, and investment approach, but for now just focus on the emotional side of things. What would you want to do?). Stocks are shown in black and bonds are red.



The above chart shows the time period between July 22, 1998 and December 23, 1999. Stocks are up 25.28% while Treasury Bonds are down 2.44%.

The above chart shows the time period between July 22, 2005 and July 23, 2007. Stocks are up 24.35% and Treasury Bonds 2.35%.

If you answered that you'd be very tempted to jump from bonds to stocks, thanks for being honest. It would be very hard to resist. On the other hand, if you stuck it out in bonds, you'd probably be feeling a bit of doubt, discontent, and regret that you missed out on some growth. Both scenarios take place over one to two years, so just about the right amount of time to start feeling all these emotions pretty intensely. Now let's expand our timeframe a bit and see how our emotions would have served us in the longer run. The first chart now runs from 1998 to 2002 and the second from 2005 to 2009. The question to ask now is, how would you feel had you made the switch to stocks earlier? Had you stuck with your game plan and stayed in bonds, how would you be feeling now?

The above chart shows the time period between July 22, 1998 and December 23, 2002. Stocks are down 21.48% while Treasury Bonds are up 41.11%.

The above chart shows the time period between July 22, 2005 and July 23, 2009. Stocks are down 23.77% while Treasury Bonds are up 19.47%.

With the bigger picture now clearly in front of us, those who stayed true to their more conservative approach would have been very nicely rewarded. They would have seen all of the markets gains they were missing out on earlier completely unravel and turn into losses while their conservative bond investment started performing better. For those who made the last-minute switch from bonds to stocks in order to participate in some of those tasty returns, well, they would have done so just in time for a pretty dramatic free fall in their portfolio. The regret you're now feeling most likely far outweighs the regret you felt from missing out on the short term market returns earlier. What's worse is that you're much less likely to participate in the upcoming recovery since you've just been so badly burned from this crazy, unpredictable market. The stock market in both periods looked very compelling just before very large and devastating crashes. Unfortunately, most investors in those periods decided to put more of their money into stocks just before the crashes – as measured by the amount of money flowing into stock mutual funds versus bond mutual funds.

Hopefully you've found this exercise relevant given that the first set of charts looks very similar to what we're experiencing right now. The bigger picture will play out over time, but it's very important to know based on historical precedent, what it's capable of turning into. Don't be fooled by thinking that the present will continue into the future and that you'll be left behind if you're not a part of it. If you have a sound strategy based on discipline and logic rather than emotion, you'll get that opportunity, and most likely a much better one at that.

2013 Pan-Mass Challenge—August 3rd & 4th

The Pan-Mass Challenge means a lot to us here at Cadence, as it does to many others in the state of Massachusetts. We thought we would share a few facts about the event.

About the PMC:
The Pan-Mass Challenge is an annual bike-a-thon that today raises more money for charity than any other single athletic fundraising event in the country. The PMC was founded in 1980 by Billy Starr, who remains the event's executive director, an annual cyclist, and a fundraiser. The PMC has since raised $375 million for adult and pediatric cancer care and research at Dana-Farber Cancer Institute through the Jimmy Fund. In 2012, the PMC gave a record gift of $37 million. The PMC pioneered the athletic fundraising industry and is today a model of fundraising efficiency. The event donates 100 percent of every rider-raised dollar directly to the cause. In 2012, the PMC generated 52 percent of the Jimmy Fund's annual revenue and was Dana-Farber's single largest contributor. More than 233,000 individual contributions were made to last year's fundraising campaign. In 2013, PMC cyclists will ride with the goal of raising $38 million for Dana-Farber.

The Ride:
The Pan-Mass Challenge is a fully supported bike-a-thon — with food and water stops, mechanical and medical assistance, luggage transportation, and lodging — that runs through 46 towns across Massachusetts. Approximately 5,500 cyclists ride in the event. Cyclists choose from 11 routes of varying mileage designed to cater to all levels of cycling strength and fundraising ability. There are six two-day routes that range from 153 to 190 miles and five one-day rides that range from 25 to 110 miles. Cyclists are required to raise between $500 and $5,000 to ride in the PMC, depending on the chosen route.

When:
The 34th annual PMC is Aug. 3 and 4, 2013. The ride has two starting lines Sturbridge and in Wellesley, and five finish lines in Provincetown (2), Bourne, Wellesley and Foxboro.

Who:
Cyclists travel from 36 states and eight countries to ride in the PMC. Over 350 riders are cancer survivors or current patients. Some PMC cyclists are weekend warriors, others are trained triathletes. Most PMC participants ride in honor of a family member or friend fighting the disease. Cyclists range in age from 13 to 88. The average PMC cyclist is 45 years old, trains for three months, solicits 40 sponsors, and raises more than $6,000. During PMC weekend and throughout the year, more than 3,000 volunteers donate their time, and 200 corporations provide more than $5 million in products and services. The PMC is presented by the Red Sox Foundation and New Balance.

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