ISSUE 5 | VOLUME 11 | NOVEMBER 2022

Cadence clips

FOCUSED ON WHAT MATTERS MOST.

My Portfolio Has Lost Value—Now What?

By Steve DeBoth

When your investments are going up, it's easy to picture how you'll react when they go down because you don't really *feel* it. Not at that moment. In fact, you're feeling pretty good, what with your investments going up and all. It sure is different when the actual down period hits, though, isn't it? We are ten months into this current stock market downturn and a traditional diversified portfolio of half stocks and half bonds is down roughly -18%. Our corresponding portfolios at Cadence are down a fair bit less than that, but more on that later. Ten months into the 2007-2009 crash and this same portfolio was down around -8%, because though stocks were down about the same after the first ten months as they are today, bonds were down a lot less. It's pretty natural, then, to wonder whether or not we should make some kind of strategy change.

Strategy changes at this point in a downturn usually center around getting more conservative to lose less if the downturn continues. I am happy to say that this move is pretty easy to pull off successfully, provided of course you can tell me when the various asset classes will start their recoveries and how aggressively they will do so. Unfortunately, without that information, getting more conservative now, or trying something else to hedge your bets, is far more likely to lock in losses and ultimately cost you more than staying the course.

What are the most common moves investors make when trying to protect themselves further during a downturn?

Going to Cash: The most obvious, and used, strategy when it comes to getting more conservative is to sell assets and keep them in cash until the dust clears. The only way this works is if you get back into whatever you sold at a price lower than when you first sold it. It seems easy to do, but very, very few people are actually able to do that. Because asset prices zig zag on the way up the way they did on the way down, the vast majority of people do not have the confidence to get back into their investments until they believe there is no more downside possible, and that is almost always at a price that is higher than when they sold out of their investments. If any investment you sold loses another -10%, will you have the confidence to buy it back at that point, or will you fear it will continue going even lower and hold off? Most people just end up locking in losses when they go to cash; the current inflationary environment only compounds that. With inflation as high as it is right now, your cash investments will be losing real value to the tune of -8% per year until inflation comes down a fair amount.

If your main motivation for going to cash is to be protective as opposed to considering the current downturn as an opportunity, then the likelihood of your feeling comfortable enough to reinvest in what you sold at the right time is extremely small. If you're feeling uneasy about the stock and bond markets when they're down -15 to -20%, don't think for a moment you'll suddenly feel comfortable investing when they're down more than that. That is why most people who go to cash for protection during a downturn lose.

Going to Bonds: Instead of selling stocks and/or bonds and going to cash, some people opt to sell stocks and increase their bond allocations, figuring their stock investments will lose more than bond investments would and that bonds would be a good place to hide while waiting for the stock market to bottom out. Like the going to cash strategy, this only works if you buy back into stocks later on at a price lower than where you sold them, but this move has the added complexity of also needing your bond investments to hold their value relative to stocks. With cash, you knew what you were getting: pretty much zero growth, but at least it can't go down in price. With bonds, you run the risk they'll go down while stocks go up, which is the opposite of what you want.

One aspect specific to our current downturn is that some bond categories are down just as much as stocks are. How much protection are you getting by selling out of the S&P 500 index, down around -19% on the year, and putting that money into high grade corporate bonds, which are down around -22% on the year? One seemingly more sensible option is to sell out of stock and/or bond positions and put those assets into short-term Treasury Bills yielding around 4% on an annualized basis. But even there, that only works if what you're selling doesn't go up more than that 4% after you make the move. Who is willing to bet high grade corporate bonds can't go up by more than 4% over the next six to twelve months? Again, without that crystal ball telling us when things will bottom out and how quickly they will rebound, you are left having to wait until you feel comfortable switching back out of bonds, and that is almost always at a point that locks in losses.

Betting Against the Market: There are other moves an investor can make to protect their portfolios from further loss that are less mainstream and require a fair bit of experience. Buying protective puts and shorting the stock market are two such moves, though both require varying degrees of up-front expenses and carry asymmetric levels of risk, especially in the case of shorting the market. Once you venture away from the mainstream to get your protection, the more you may be ratcheting up the risks you've been trying to protect yourself from, which is why they're more complicated than just going to cash or loading up on bonds. Buying protective puts that do not pay out just reduces your potential portfolio recovery, and having your market short move against you can carry even worse financial penalties. For investors who are nervous about their portfolio losses and looking for ways to protect themselves going forward, adding elements of increased risk at that point does not really accomplish the goal of reducing risk; it just introduces newer, additional risks.

It is very difficult to time these kinds of market moves because you have to get both directions right: you have to both get out AND back in at good times, and most fearful investors that change strategy mid-crash wait too long to get out, and too long to get back in. People who went to cash for a couple years in the fall of 2008 locked in permanent portfolio losses as high as -20%. It's easy to look back now and say had you done that, you would have gotten out and back in at good times, but it is never as obvious in the moment as it seems in hindsight. It is far better to allocate appropriately before a crash even starts and reduce your losses that way than to try and make a strategy change midway through.

So, where does that leave us?

We Cadence advisors have been concerned about equity valuations and the moves that have been made to keep the economy growing for some time now. As a result, we have tended to recommend more conservative allocations for our clients, as well as incorporating non-traditional assets into those allocations to be both more protective as well as selectively more opportunistic. Our use of alternative investments, like gold and managed futures to name a couple, has helped reduce our exposure to stocks and bonds during their difficult year, and has helped reduce portfolio losses. Our allocation toward energy helped us find a market segment that was actually positive on the year, further reducing portfolio losses. While traditional 50/50 stock/bond portfolios are down close to -20% on the year, our corresponding portfolios are down around half of that, give or take a couple percent.

Were we to try to get even more protective with our portfolios from here, we wouldn't be left with options that actually guarantee we would reduce our chances for loss. Going to cash and allocating even more to bonds may feel safer at the moment because they do not typically lose as much value as quickly as stocks can, though many bond categories this year are down just as much as stocks, but over the longer term you still have to get back into the aggressive investments at the right time to make the move pay off more than trusting your initial strategy. Buying protective puts and shorting the market are additional options that carry their own costs and risks, and both have to be timed right to pay off, just like going to cash.

Having portfolios based on asset valuations and tolerance for loss, as we have been doing for years, does not shield us from all losses, unfortunately, but the assets we own that have lost value to this point in the year have as much potential to rebound quickly as anything we may be tempted to shift into to make up portfolio losses quicker. We will shift portfolios into more protective allocations, as we have done before this year, when valuations and systemic risks call for it. Likewise, we will shift portfolios into more aggressive, opportunistic allocations when valuations and market conditions allow in the future. As a result, the moves investors may feel tempted to make in a moment like this to get more "protective" have already been made and have already reduced losses. It's never fun to see portfolio losses, but these losses do not mean a strategy based on asset valuations isn't working. Trust the process.

Risk and Reward

By Casey Clarke

Highlights:

- Every investment has risk of loss over shorter periods of time, but not every investment offers reward. An unbiased, dispassionate assessment of risk and reward should be conducted periodically to make sure we're invested in the right places and can ride out market volatility when it shows up.

- Traditional stocks and bonds still have a long way to go before the long run return potential (reward) looks compelling and worthy of the shorter-term risk.

- Most commodity asset classes have a favorable risk/reward profile based on their relative valuations as well as being early in their long-term growth cycles. The same is generally true for companies that deal in them.

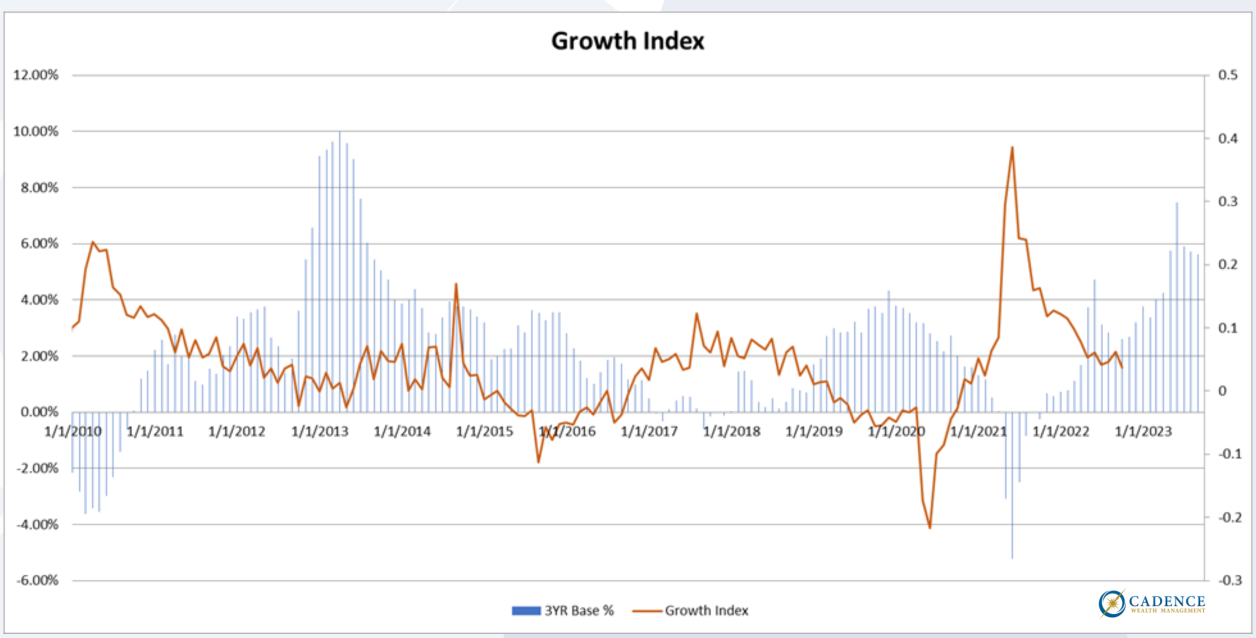
- U.S. Treasury bonds look significantly more attractive with yields over 4% than they did 12-24 months ago.

- In the short run, all asset classes have the potential for losses. Although this is always true, it's especially true now given the chaotic situation markets and the global economy are in. In times like these, it's important to stay focused on the risk and reward elements of investments that are more likely to play out once the dust settles and with the passage of time.

At every point along the investing time continuum, there must be a proper evaluation and reassessment of risk and reward for each existing as well as potential portfolio position. Because financial markets are dynamic, risks can change rapidly and so can the potential reward for an asset class. Despite constant change in an exercise that is more art than science, there is one underlying truth that we stay diligent to never forget – while there's risk in all, there's only reward in some. Many investors and advisors alike have grown to assume that the more risk that's taken, the more return one's entitled to. Nope. Not how it works. In the best multi-decade period for virtually every asset class in financial history maybe, but not over time. Sometimes risks never pay off. Individual investments can and do go to zero and every great investment has a rough patch. So, while risk is everywhere, reward is more elusive. There is no free lunch in investing, as this year has so graciously reminded us of. Because of this, it's crucial to know if the risks we're taking – the inevitable drawdowns and scary moments – are likely to result in reward. So, let's dive into evaluating a little investment risk/reward based on what we're seeing now.

Financial System & Market Risk

Unpleasant market events tend to happen during economic slowdowns. When things aren't growing as quickly, profits fall, lending tightens, and vulnerabilities in markets and the system get exposed. Despite the rhetoric that we're not yet in recession, there's no question that economic activity is slowing. Our index of economic activity below shows a decline from over 9% to less than 2% on a year over year basis – that's significant. In addition, the comparisons coming up over the next few months are getting increasingly difficult to reaccelerate from. Similar to a sprinter after lactic acid builds and fatigue sets in, a surge in one direction tends to lead to a dramatic and sometimes sudden deceleration down the line. In the case of our economy, we are now paying the price for all the factors that contributed to our sustained growth over the last 13 years as well as the particularly rapid growth over the last two.



Low rates for too long

Low interest rates, readily available credit, and generally easy financial conditions have all contributed to the build-up of record amounts of leverage in our financial system. In addition to the run of the mill debt that accompanies every growth cycle, we have the added vulnerability of leverage directly applied to financial instruments to improve returns. Since yields on bonds and other fixed asset classes have been so low for so long, hedge funds, pensions, and other financial institutions have resorted to leverage to buy more of those low yielding assets in an effort to earn more reasonable returns. This works fine so long as those "safe" asset classes don't decline significantly in price, which by the way, they just did. More on that later, but suffice it to say the pension issues in the U.K. we're witnessing at the moment likely have a lot to do with this. We would be naïve to think U.S. pensions are somehow immune to this risk and we fully expect to see headlines announcing hedge fund or pension rescues, restructurings, or outright failures at some point down the line. In summary: An economic slowdown tends to create asset price volatility (downward) that exposes reckless leverage and a general disregard for risk.

Inflation

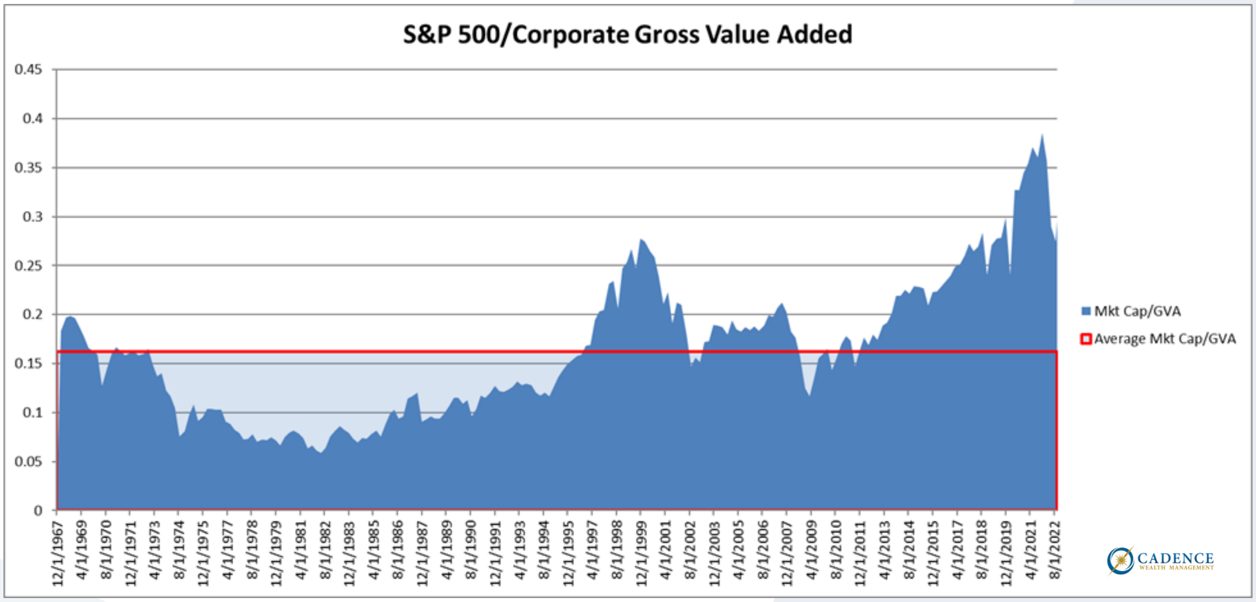
Inflation running at multi-decade-high rates only serves to exacerbate the economic downturn and associated risks. We've discussed how inflation has rendered the Fed powerless to rescue falling markets, but it also impacts markets by quite literally stealing the consumer's purchasing power. Folks buying less leads to reduced corporate profits, which when investor confidence is low, motivates market participants to do more selling than buying. High inflation also increases the risk of bad things happening as it can exacerbate the economic slowdown, exposing recklessness more quickly. Although inflation rates will likely come down over the next few months, the cost of living has still ratcheted up very quickly, and without outright deflation to undo it, those increases will be impacting us for quite some time.

Margin Calls

When investors large or small borrow money to increase their market exposure, and the markets move against them, not only are losses far greater than without the leverage, but those investors run the risk of having to pay back the loan at very inopportune times. As an example, imagine you had $500,000 to invest in XYZ company, but because you felt so strongly about the prospects for the company, you borrowed another $500,000 to add to your investment in XYZ stock. Now imagine the $1,000,000 position dropped in value by 30% to $700,000 and the bank gets nervous that you won't be able to repay the loan and calls the loan in. You're forced to sell the stock, repay the $500,000 loan and are left with $200,000. That's a 60% loss on a stock that's down -30%. There are three market implications to consider here. First, when investors get margin calls and are forced to free up cash to pay back loans, they typically sell what they can rather than what they should. What this means is that good investments during periods of market stress can go down along with more speculative ones even though it would seem that they shouldn't. This is normal, and although it typically doesn't last very long, the duration of it usually corresponds with the intensity of the deleveraging process. The more leverage fueled speculation built up, the greater the potential selling pressure on all assets as leverage is unwound. Second, when markets fall quickly, margin calls can perpetuate the selling for a period of time. We should expect this. Third, imagine that instead of borrowing 1x your portfolio equity, you borrowed three or five times. With the same 30% decline, you'd be wiped out entirely. This is the type of leverage that can send systemic shockwaves through the entire global financial system. Knowing that this leverage exists, and most stock and bond markets have already fallen 20-30%, it's reasonable to expect that fires are being put out behind the scenes as you read this. The extent to which monetary authorities succeed in extinguishing these fires without public knowledge, and the manner in which they do it, will determine the severity of the systemic risks that play out going forward. The potential for chaos is certainly there.

Reversion to the Mean

Even after a -20% decline in the S&P 500 this year, we are still above valuation levels we saw at the height of the tech bubble in March 2000. Should investors decide to pay the average multiple of corporate revenue over that period of time rather than top dollar, the market would need to fall another -45%. Keep in mind that doesn't assume markets fall below the average, and it also assumes that corporate revenues don't fall. In a severe enough economic contraction, both are not only possible, but likely. Valuations at historically elevated levels paired with the potential for a protracted economic slowdown against the backdrop of record financial market leverage presents about as big a risk to stock markets as is possible, convincing bear market rallies notwithstanding.



Potential Rewards

Just as risks can play out over both long and short periods of time, rewards can as well. For the purposes of this assessment, we'll stick with medium to long-term rewards (opportunities), since as we've seen, anything can happen during temporary periods of market turmoil. The more time we have, the greater the likelihood that opportunity pans out. As someone once said, "never let short-term price movement and emotion destroy a long-term plan".

Attractive Yields

With the aggressive action of the Federal Reserve in raising short-term interest rates and the historic decline in bonds prices, the yields on higher quality bonds and cash equivalents are finally somewhat reasonable. CD's can now be found paying more than 4% as can most durations of U.S. Treasury bills, notes, and bonds. The question of course is whether rates will go much higher from here, but the fact is, 4% is significantly more than the 0-2% we've seen over the last 10+ years. It also stands to reason that if economic growth is more tepid going forward as the 40-year trend would imply, that 4% might be viewed as a fair deal in hindsight. Our thinking is that our financial system and economy simply couldn't effectively function at much higher interest rates based on current debt and asset price levels, and so 4% seems a pretty compelling risk/reward for "risk-free" assets. On lower quality instruments such as high yield bonds, REITS, and even utilities, we're not there yet. A severe economic contraction could take any of these investments significantly lower, wiping out any yield one might be collecting.

Buying Low(er)

It annoys me when experts and pundits view falling markets as counterproductive and view those who embrace the concept as pessimists. They must not have children—At least not children they hope will have the same opportunities for investment growth as they do. Perpetually rising markets create a world that only a select few can afford and doesn't necessarily create strong cohesion, unity, and understanding across socioeconomic classes. The good news is that despite the best efforts of the Federal Reserve, fiscally reckless politicians, and a price-indiscriminate passive investing industry that has provided a steady flow of funds into increasingly expensive markets over the last decade plus, stock markets will continue to correct as they always have. It may take longer as we've seen over the last decade, but fragility and market complexity ultimately dictate crashes and downturns. Our belief is that extremes work in both directions as I've alluded to a couple times already. With some asset classes down -30%, we can confidently say that we're closer to fair prices in some things than we were at the beginning of the year; but we're not there yet. In the table below, you'll notice it would take another -40% decline in the S&P before we could expect to earn over 5% annually from buying and holding the S&P 500 over the next 10 years. The math here is simple: After another -40% decline from current levels in the S&P 500, the trip to average valuations 10 years from now would result in a 5% annualized return. Of course, valuations could be either side of average 10 years from now, but the important thing to remember is that investor sentiment, and therefore valuations, tend to cycle from one extreme to another; which means we're probably more likely to see dramatically undervalued stock markets before we get back to seeing super expensive ones. For most stocks, we're moving in the right direction, but we're nowhere near the U.S. stock market representing a compelling long-run opportunity—Certainly not one that offsets the risk of owning it over the medium term. We'll start getting excited, on a long-term buy and hold basis, after another -40% decline. We'll be ready for this when and if it happens.

Market Loss From Here	S&P Value	Implied Return Over 10 Years
-10%	3491.10	0.8%
-20%	3103.20	2.1%
-30%	2715.30	3.6%
-40%	2327.40	5.4%
-50%	1939.50	7.5%
-60%	1551.60	10.3%
CADENCE WEALTH MANAGEMENT -70%	1163.70	14.1%

That said, we'll reiterate that most commodity categories, in particular precious metals, look extremely attractive at current valuations. Rather than reverting downward toward their mean from current levels, most commodities will need to move upward in price to reach average levels that investors paid in the past. With the chaos in markets this year, most commodities with the exception of oil and gas, have given investors another opportunity to buy low.

Let's look at the selling and deleveraging chaos so far this year. As is evident in the chart on the next page, the only major asset class not in the red is the CRB commodity index which is heavily represented by oil and gas. Everything else is negative with U.S. Treasury bonds performing the worst and gold performing the best. As we mentioned before, this historically large drawdown in U.S. Treasuries has resulted in a compelling risk/reward setup from here. Overall, returns have been largely homogeneous, hinting toward margin call and deleveraging pressure that has led to the "good stuff" getting sold along with everything else. This chart illustrates how every investment, no matter how traditionally conservative, has risk and every now and then those risks make an appearance. What doesn't show up in the chart are the risks to each of these asset classes over longer periods of time or the potential rewards to investors for holding them. We'll simplify this assessment of risk and reward by looking at the state of the growth cycle and valuations.

We know from previous economic contractions, and it makes intuitive sense, that high quality bonds and precious metals tend to hold up better than most stock categories. So, if there's more slowdown ahead, which we discussed there likely is, we should be best served in these more defensive categories. In addition, the valuations of these more defensive assets and commodities as a whole are much more attractive, or historically "cheap", than for those of stocks in general. So, beyond the relative appeal provided by the current contractionary growth situation, the longer-term story bodes much better as well. In fact, for a handful of commodity categories, the valuation story is quite literally a mirror image of the mainstream, mass market stock and bonds categories. In last month's Clips we referred to this juxtaposition as the beachball and the brick. Some asset classes have the potential to recover very quickly, while others may have much further to fall. In summary, short-term risk exists across the board so we should expect anything, but medium and longer term, the stocks and bonds most heavily owned by the market and thus overvalued are at greatest risk. In terms of potential reward, over the medium to long run, our view is that those categories most heavily shunned in recent years, and under-owned by investors, provide the heftiest opportunities. This isn't just because those assets are cheap, but because when it comes to commodities, the long, deep bear market they've experienced the last 10 years has set the stage for the next bull market. Underinvestment ultimately translates to a lack of capital expenditure in the production of that commodity, which leads to supply shortage. Shortages lead to high prices, and high prices lead to more capital investment, which ignites the next growth cycle in the commodity market in question. This is the nature of cycles and why they are highly predictable over longer periods of time. With respect to a number of natural resource commodities today, we appear to be at a key turning point in one of these cycles.

For context, on the following page is the period beginning with the tech bubble just after March of 2000. That period of time was very similar to where we stand today in terms of stock markets being expensive and commodity categories being deeply depressed. Notice that early in the market downturn and eventual recession, everything fell together. It wasn't until the latter half of the contraction that gold, silver, and miners began moving higher while stocks continued to fall. By April 2003, there was a noticeable divergence between the assets that were over-owned (tech stocks) and those that came into the period cheap and under-owned (commodities).

We see the same thing throughout the period encapsulating the financial crisis from 2007 to later in 2010. Everything fell together during the worst of the downturn in late 2008, but commodities recovered much quicker, albeit for slightly different reasons. They weren't nearly as cheap then as in prior years, but they were still viewed as a relative safe-haven and a good bet against an overly accommodative Federal Reserve. Most commodities went on to peak in 2011 as stocks and bonds began their epic ascent into the largest bubble in history. More than 10 years later, we find ourselves with a very similar setup to 2000. Cycles will cycle.

In track & field, it's usually a very graceful occasion in a relay race when one runner hands the baton to another, with both runners in full stride. In markets, transition couldn't be sloppier and more confusing. What we're likely going through this year is an extremely messy transition in market leadership from those categories that have served investors so well over the last 12 years to those that have done very poorly by comparison. Old habits die hard. Meta (Facebook) down -70% from it's peak in the last year seems like the deal of a lifetime because we're conditioned to favor companies like Meta that are exciting and have done well recently. Question: How does one lose -85% in Meta? First, she loses -70%, then she loses another -50%. Most people would assume that being down -70% already means that we're almost there, but the math of losses is fickle and doesn't quite work that way. It takes time, and usually far greater losses than one is accustomed to imagining, to change one's viewpoint - to realize that there may be opportunities somewhere else that make more fundamental sense, where the full cycle risks are much less, and the opportunities greater. The adage that comes to mind here in preparing for this eventuality is "you don't invest in what you like today, but rather what you think others will like tomorrow." Assessing where sentiment and preferences will be tomorrow isn't easy, and requires a process. The better that process is, the more accurately one can evaluate the risks and potential rewards that exist in markets.

CADENCE
WEALTH MANAGEMENT