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# Cadence clips

FOCUSED ON WHAT MATTERS MOST.

## Investor or Speculator - Part II

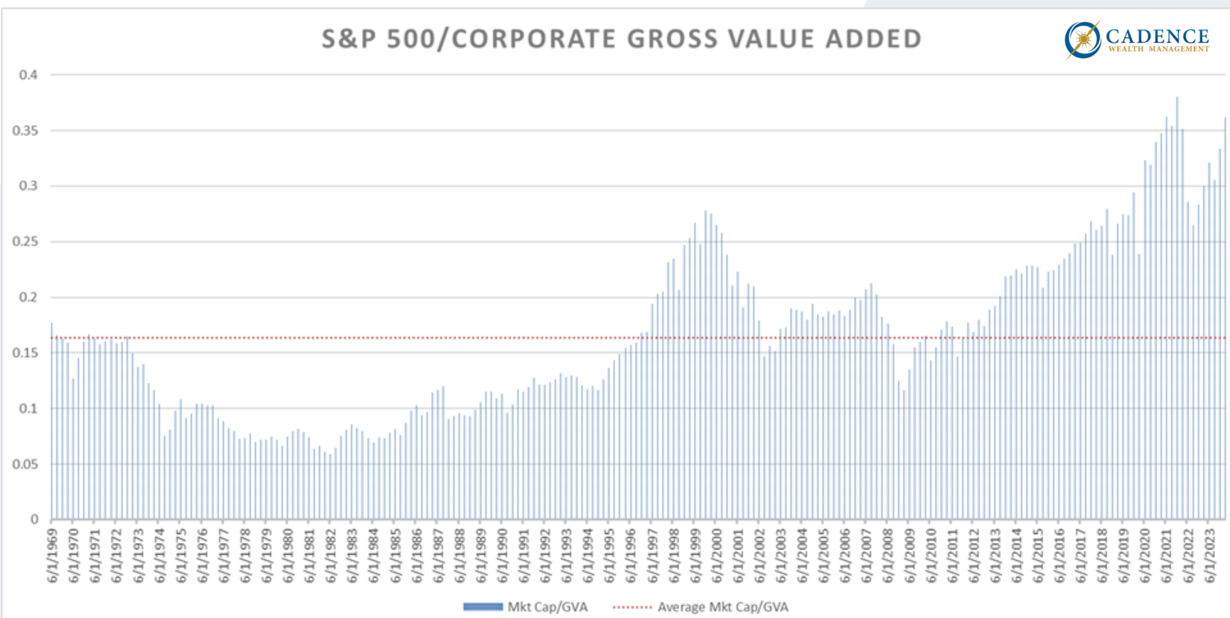
*By Casey Clarke*

If you think about the last time we had widespread social strife and turmoil in the United States in tandem with expensive financial markets, your recollection will probably take you back to the sixties. Between anti-war protests, the civil rights movement, entitlement reform, and a re-tooling of criminal justice policies and laws, there was plenty of fodder for calm, dispassionate chats with friends and family. It's probably no coincidence that this swell of activity came toward the end of a post-World War II economic expansion that brought economic comfort to many and stock markets to rather lofty heights. What followed, in the financial realm, was biting inflation for nearly 20 years, and a stock market that popped and went nowhere from 1968 to 1982. Worse than having the same account balance 14 years later, after accounting for inflation, investors would have lost ~65% of their wealth hanging out in the S&P 500. In many ways, today's circumstances look very similar to those in the late 1960s.

**Lessons For Today**

Overpriced, overhyped markets eventually spawn corrective periods that can last much longer than we'd think, given the long period of positive conditioning leading up to them. These corrective periods can be tremendously destructive financially, especially when coupled with inflation. There are no do-overs when generational bubbles pop. The responsibility falls on each individual to understand the risks inherent in markets, sectors, and asset classes, evaluate them, and take steps to minimize them. In the end, no differently than how we should feel about our own health, we are responsible and accountable for the decisions we make. Nobody cares more about our own situations than we do and our clients know very well that we're not leaning on cues from Wall Street or financial media when it comes to financial markets. There are no bells rung at important moments. In fact, it's quite the contrary. The most important moments often feel the most benign. The combination of positive recency bias, conflicts of interest, and greed make elevated risks extremely hard to see. We see some, however.

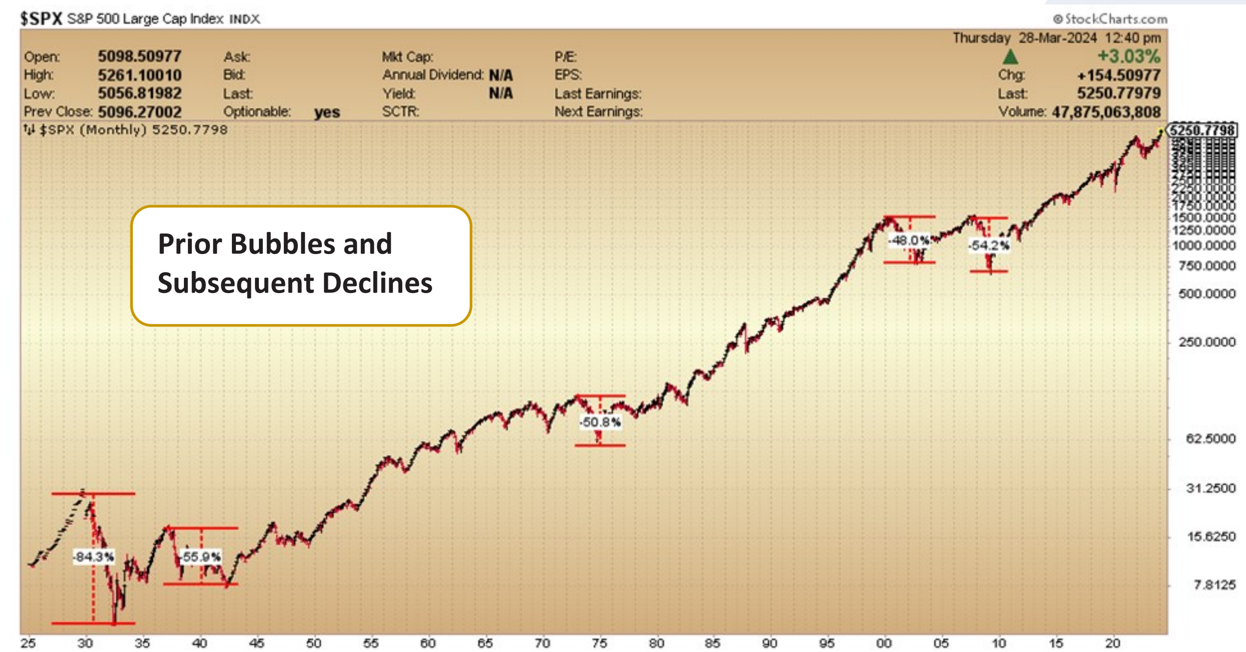
Below is a chart going back to the 1970s of the S&P 500 relative to the level of goods and services produced and sold in the economy. The red line in the chart is the average ratio between the two, and as you can see, the valuation of the stock market has fluctuated around this average. You'll notice that stocks became "cheap" throughout the 1970s after having been expensive in the 1960s (you can't see that in this chart due to data provider limitations, but you'll have to take my word for it). This cheapness led to the best two-decade stretch for stocks throughout the eighties and nineties, which of course morphed into the biggest bubble in U.S. market history at that time - the Tech Bubble. When that popped, Federal Reserve rate cuts gave birth to housing market speculation which precipitated the housing and financial crisis of 2007 and 2008. After stocks dropped more than -50% by March 2009, they were genuinely cheap relative to most economic measures, but not for long. By 2013, we were back up to levels we'd consider expensive based on long-term traditional valuation measures. Where are we now? Off the charts - biggest bubble in U.S. history - and we have been for a while. What this chart should scream to everyone is that risk far outweighs opportunity for returns over time. Could the stock market go up for another week, month, or year? Sure, but eventually it will work its way back through average and to genuinely cheap territory, because that's what valuation cycles do.




## Getting Back to Average

If the level of the S&P 500 was at the red line above (average price relative to economic output) ten years from now, it would be more than -30% lower based on our estimates of economic growth. That's 30% less account value than investors have today. The question we often get from clients is, "When will the stock market be investable again?" On the next page, we can see that it really isn't until the S&P 500 drops -50% that we're back to reasonably expecting returns north of 5% over a ten-year timeframe. We're truly back in business if stocks drop -60% or more from here. This may sound inconceivable, but don't forget that 50% declines are common when stocks get too pricey. We saw this threshold roughly met or outright breached in 1932, 1937, 1974, 2002, and 2009, all declines stemming from bubbles smaller than today's.

| Market Loss From Here | S&P Value | Implied Annual Return Over 10 Years |
|---|---|---|
| -10% | 4725 | -1.2% |
| -20% | 4200 | 0.0% |
| -30% | 3675 | 1.5% |
| -40% | 3150 | 3.2% |
| -50% | 2625 | 5.3% |
| -60% | 2100 | 8.0% |
| -70% | 1575 | 11.6% |

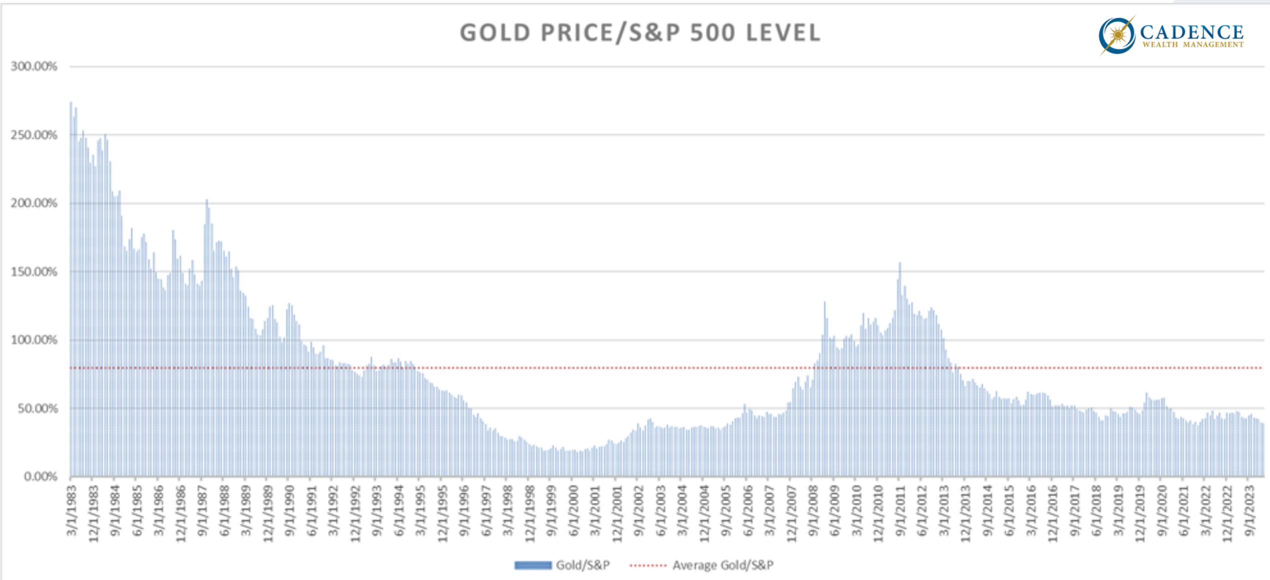



**A Grim Stock Market Reality Doesn't Equal Pessimism**

Our clients know that our current view on financial markets doesn't mean we're not optimistic. There is always an opportunity somewhere. The nature of cycles and the factors that drive them usually means that there is something else out there at another point in its cycle that holds more promise. Speculative bubbles take place because more and more people jump in over time. Good returns garner attention, which leads to more money flowing in, which leads to more returns, and on and on the pattern goes. Success begets success until one day, somebody says, "What the heck am I doing paying five times my annual income for a tulip bulb?" That realization, or a similar small change in behavior by somebody, somewhere is what starts the process of sending the whole thing into reverse.

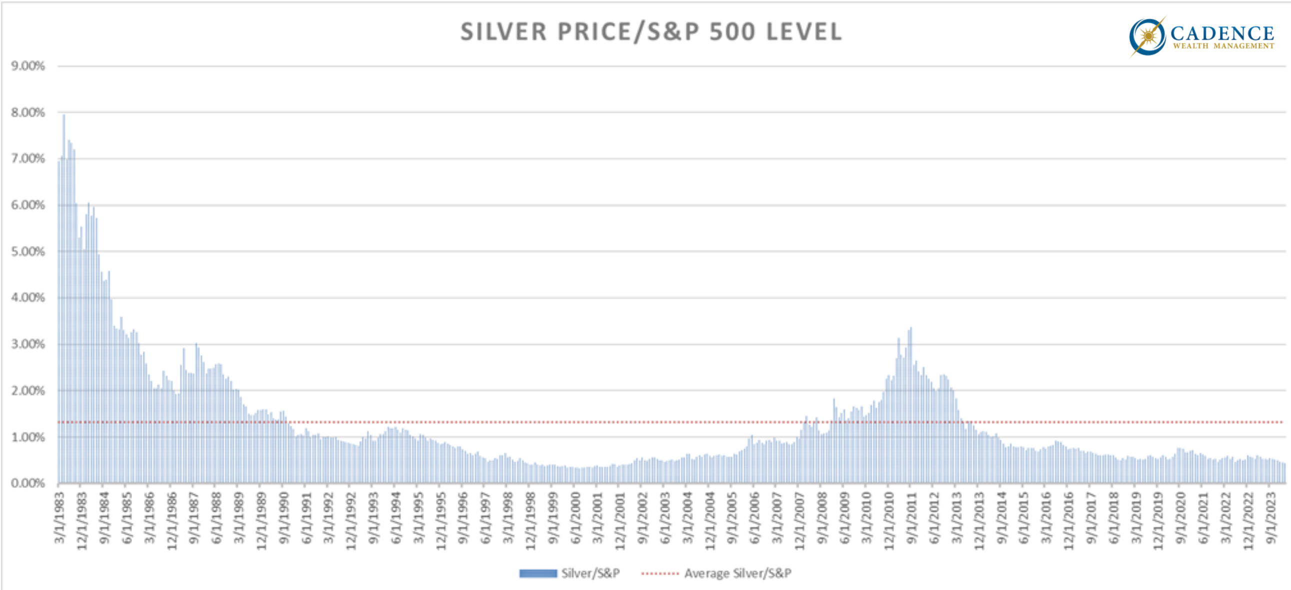
What's happening along the way, as more and more money goes into the shiny, upward-trending speculation, is other classes or groups of assets are being neglected. This neglect leads to subpar returns, which leads to more neglect, etc. An upward speculative cycle in one thing creates an opposite value-creating cycle in another. Real assets, or commodities, are a category of asset that have been left behind throughout this epic run-up in stocks, and they are now at levels that offer very compelling long-term opportunities – similar to those of the early 1970's and early 2000's.

Below is a chart showing the price of gold relative to the S&P 500 going back to the early 1980's. The relationship currently lies well below the average of the last 40 years. Getting back to an average level over the next ten years, given our assumption that stocks go nowhere due to their current lofty levels, would result in a doubling of the gold price.




| Gold Relative to S&P 500 | CADENCE WEALTH MANAGEMENT |
|---|---|
| Avg Price/S&P | 79.83% |
| Estimated 10 Yr S&P Growth Rate | 0.0% |
| S&P In 10 Yrs | $5,248.49 |
| Current Price | 2047.32 |
| Price at Mean Ratio in 10 Yrs | 4189.72 |
| Price Increase Over 10 Yrs | *104.6%* |
| Average Annual Return | 7.4% |

On the following page, we see the same analysis for the price of silver, which is even cheaper than gold relative to its historical relationship to the stock market. Getting back to average with stocks staying static would result in closer to a 200% gain in the price of silver from current levels. Many other commodities share this theme given that they've spent the last 13 years or so going down rather than up. The thing about buying cheap assets that represent good value is that we need to be comfortable buying something that's gone down a lot. This can be extremely hard to do as our human brains compel us to chase the mob that's chasing the shiny thing. Of course, there are things we can try to do to make sure we're not catching a falling knife, but the fact is the portfolio that makes the most sense for the next 5 to 10 years has almost always done far worse than other portfolio mixes looking backward 5 to 10 years. By contrast, the asset classes that have done the best in hindsight will likely do the worst. These are cycles. We don't want to overstay our welcome in them, nor be too late to join a nascent one.




| Silver Relative to S&P 500 | CADENCE WEALTH MANAGEMENT |
|---|---|
| Avg Price/S&P | 1.32% |
| Estimated 10 Yr S&P Growth Rate | 0.0% |
| S&P In 10 Yrs | $5,248.49 |
| Current Price | 22.65 |
| Price at Mean Ratio in 10 Yrs | 69.06 |
| Price Increase Over 10 Yrs | *205.0%* |
| Average Annual Return | 11.8% |

Investors, rather than speculators, who have stuck to this discipline have been tested in recent months. As speculators continue to chase stocks to new highs, other asset classes tend to get knocked around on the ground by scurrying feet. Our view is that most commodity categories have already entered their bull cycles, but this isn't entirely obvious as the flows they receive still pale in comparison to the largest tech stocks. The first couple months of the year were challenging for most commodity categories, but March has seen prices bounce back very aggressively. Investors got a bite at the apple and will likely celebrate their March statements. Patience was rewarded. At cycle turning points, this can feel like the exception rather than the rule, but once money flows change in a meaningful way, from one asset class to another, it becomes more of the rule. Our sense, using history, cycles, financial principles, and a fair amount of logic, is that speculators will soon wish they were investors.

# Even the Pros Get Investment Speculation Wrong

*By Steve DeBoth*

Last month's Cadence Clips article entitled, *"Investor or Speculator – Which Are You?"*, compared two different investor types, and how one of them is much less likely to enjoy long-term success. (Hint: it's the Speculator). Despite the obvious limitations inherent with being a speculator, it is very difficult for many investors to avoid being pulled toward those investments that seem to be in the news, or taking off, or seemingly making others richer quickly. Even professional investors have a difficult time trying to make money off the hot takes of the day.

Consider the Dow Jones Industrial index, known by all as "the Dow". It was first compiled on May 26, 1896, and its longevity is the main reason people still pay attention to it, as it is comprised of only 30 stocks and represents only around 20% of the value of the US stock market as a whole. The index's value is the sum of the price of one share each of the 30 stocks in the index, corrected for certain factors. What makes the index particularly unhelpful is that because its value is the sum of the PRICE of each company's stock, the more expensive the share of stock is, the larger influence that company has over the index.

For example, a share of United Health Group (UNH) is currently priced around $493 per share. Meanwhile, a share of Apple (AAPL) is currently priced around $171 per share. This means the price moves of UNH affect the Dow almost 3 times more than the price moves of Apple, even though Apple as a company has a stock market value 480% larger than UNH. That is incredibly out of whack. As far as the stock market is concerned, Apple is much, much more important than United Health. You can read more about the pros and cons of the various stock market indexes in the August 2018 Cadence Clips article, *"It Pays To Understand The Indexes"*.

How do the 30 stocks make it into the index? Unlike the S&P 500 index's well-defined and rigid requirements for company inclusion that many companies cannot meet, the Dow doesn't have much in the way of requirements for a given company's inclusion, nor guidelines on what would cause a company to be removed from the index. A five-person committee decides which stocks should be added to the index, and which should be removed. These five individuals are all financial professionals, and are either employees of the Wall Street Journal or S&P Global, which owns the index. These are all pros, as you can see, so when they decide to add a company to the index, and when they decide to remove one, they're going to be pretty good at identifying winners and losers, right?

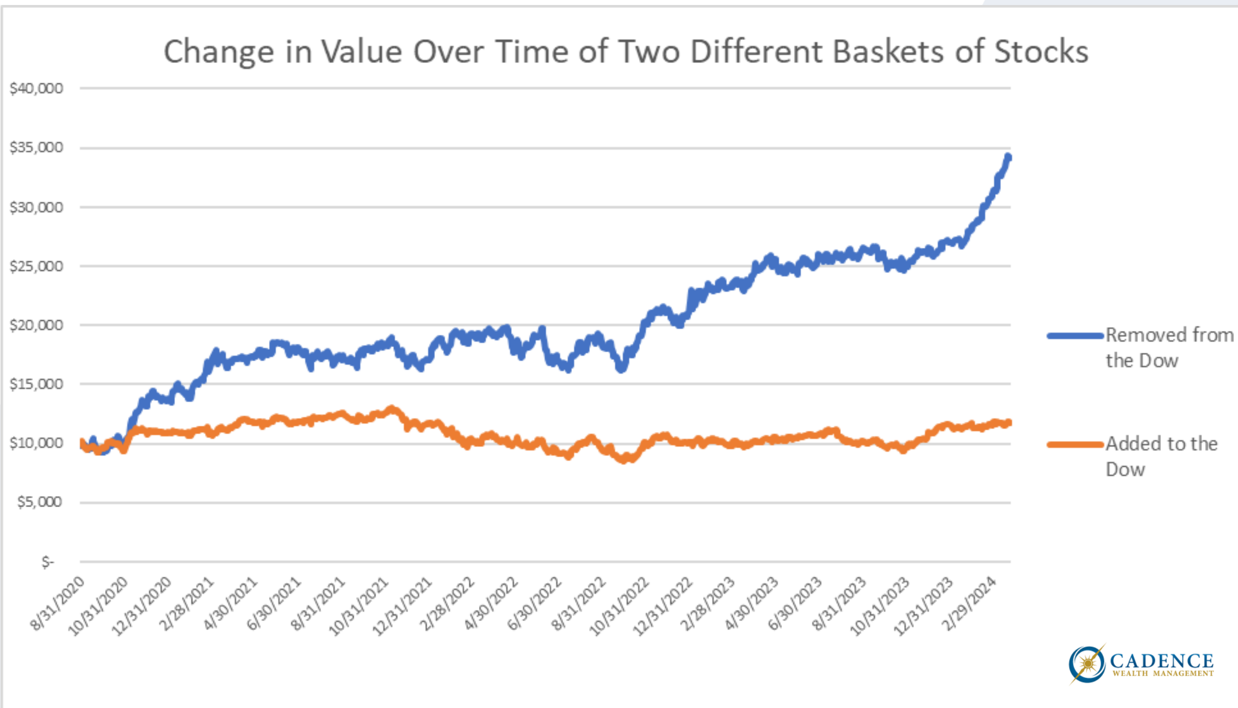
Err, not so much.

Consider three of the most recent swaps into and out of the index:

| Date | Company Added | Company Removed |
|---|---|---|
| June 26, 2018 | Walgreens Boots Alliance (WBA) | General Electric (GE) |
| August 31, 2020 | Salesforce Inc (CRM) | Exxon Mobil (XOM) |
| August 31, 2020 | Honeywell International (HON) | Raytheon Technologies (RTX) |

With five experienced industry pros deciding those additions and subtractions based on factors such as if the company has an excellent reputation, demonstrates sustained growth, and is of interest to a large number of investors, you would think the stocks added would outperform the stocks removed. Let's see how they did with these most recent rounds of additions and subtractions.

Consider two baskets of stocks. One basket is comprised of the 3 stocks added to the index, and the other is comprised of the 3 stocks removed from the index. At the start, each basket is worth $10,000, and that $10,000 is allocated based on the relative prices of all the stocks in the basket, just like how the index is comprised. So for the "Added to the Dow" basket, the starting value of HON is around $5,500 of that $10,000, CRM's is around $3,600, and WBA's is around $900. It's the same allocation methodology for the "Removed from the Dow" basket, with GE's starting value at around $4,450, XOM's around $2,875 and RTX's around $2,675. Using the common time frame starting on August 31, 2020, look at how the values of the two baskets have changed:




After 3 ½ years, the value of the basket of stocks removed from the Dow would have grown to be around 300% larger than the value of the basket of stocks added to the Dow. Since the baskets are constructed the same way the index is constructed, based on the prices of the stocks themselves, this does mean the Dow would have performed better by NOT making the changes advocated by this 5-person panel of professional investors. The final stats show just how much better the companies kicked out of the index did than those that replaced them, as well as the basket of each group of stocks overall:

| Added Co | Starting | Ending | Avg Annual | | Subtracted Co | Starting | Ending | Avg Annual |
|---|---|---|---|---|---|---|---|---|
| WBA | $871 | $564 | -11.5% | | GE | $4,452 | $19,829 | 52.2% |
| HON | $5,498 | $7,064 | 7.3% | | RTX | $2,676 | $4,578 | 16.3% |
| CRM | $3,631 | $4,081 | 3.3% | | XOM | $2,872 | $9,723 | 40.9% |
| Basket | $10,000 | $11,710 | 4.5% | | Basket | $10,000 | $34,130 | 41.2% |

The basket of kicked out stocks grew by over 41% PER YEAR compared to just 4.5% for the basket of stocks that replaced them. To be fair, the committee deciding what companies are in and what companies are out of the Dow does not always get it wrong, in the same way an every day investor doesn't always get it wrong. But this further illustrates that chasing the seemingly hotter stocks of the day, those "of interest to a large number of investors", absolutely does not guarantee success. It is very, very difficult for things to end well when chasing runaway stocks for everyone, regular and professional investors alike. If the five-person committee that decides the stocks in the Dow are not evidence enough, then consider that one in three hedge funds fail within their first three years, and the average lifespan of a hedge fund is only five years. (Source: *Financial Times*) The pros who run hedge funds are seen as the 800lb gorillas of the professional investor world, with the ability to bet for or against almost any investment on the planet at any time. Even they, though EXTREMELY well compensated, have a pretty dismal track record over time of picking winners and losers based on rapid short-term price moves.

Speculating is quite risky. It does pay off for some people some of the time, but continued speculation is like playing a game of musical chairs. At some point, you're going to do the wrong thing at the wrong time. If you can be patient and see that buying under-valued or properly-valued investments, and holding them until they begin to get a bit over-valued is a far easier strategy to execute and profit from than chasing after the hottest stocks of the day. Even the pros prove that.



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