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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Blissful Ignorance

By Casey Clarke

Most tend to think of markets as rational, quasi-sentient beings that move in understandable, predictable ways. They are not. Markets are made up of people, and to the extent that people think and act irrationally, so will markets. To understand markets, we first need to understand people – what they seek, what they avoid, and what compels them to act. One particular facet of human behavior is the concept of blissful ignorance - the act of refusing to think about, learn about, or confront a particular idea or reality. We see this all around us and across a wide range of subject matter. I would argue that at market and societal extremes such as we're experiencing now, we see elevated levels of blissful ignorance; probably the result of both people being increasingly ignorant and more people exercising ignorance. Some might argue that ignorance is a good thing. In fact, I've heard many over the last few years state very clearly that they'd rather not know certain things and be happy than suffer the cognitive dissonance associated with knowing them. I am of the mindset, however, that the only way one can be truly empowered to survive and thrive is to have a firm grasp on reality, and the only way for a society to function successfully and peacefully is for the individuals comprising it to be operating in an informed state. To the extent we can accomplish this, we can better protect ourselves (and others) from risks we shouldn't be taking. Before endeavoring to achieve better awareness and understanding, it's important to explore what compels us to blissful ignorance.

Fear

When we think about why we would invest in something that's far too expensive, whether a stock or a pair of jeans, fear can play a prominent role. The investment world calls it "fear of missing out", but for a retail product such as a car or that classy pair of jeans, it could be a fear of being left out of a developing trend or fear of ridicule if one doesn't act as his or her tribe acts. If there is a perceived cost of addressing a reality (in this case, acknowledging the non-sensical price of an investment or product), the fear of incurring that cost can be a strong factor – even stronger than greed. Ignoring data, an argument, or an actual reality can often times be easier than facing the cognitive and social costs of addressing it.

Greed

This one's fairly simple. When there are financial incentives to maintain a current course, it's easiest not to change it. Toward the end of long-term bull markets in stocks, the inertia of consistent gains takes over despite the increasing risk of those gains turning into losses. "More of the same, please", is a much easier course of thought and action than seriously contemplating a complete 180-degree shift and what comes along with that. This is why markets reach extremes. It's also why most investors lose much of what they made along the way when bear markets finally arrive. Financial incentives can be absolutely blinding.

Comfort

"My smart friend is investing this way". "Lots of people are doing it". "It's consensus". Unfortunately, most people would rather lose money in the company of others than lose it alone investing differently. Again, this is one of the factors that drives markets to extremes and causes investors to ignore risks that are in plain sight. Tangentially, it's also one of the key factors that leads people within society to ignore heterodox viewpoints regardless of how strong they are and the importance of considering them. Most would rather be wrong in the company of others than risk being wrong alone. There is comfort in numbers. Sometimes so much that's it not even about making money, being right, or being wrong. It becomes solely about maintaining the comfort of the group and fitting in.

Change

It's our default state to resist change. Change involves fear of what comes next, takes cognitive re-wiring, and requires effort in that one must subsequently think and move in another direction. If we're content with our current situation, remaining blissfully ignorant of the changing landscape is easiest, and redirecting the established inertia requires a shift in the factors that drive human behavior. A fear of something new rather than the fear of missing out or being different. A shift in incentives possibly. The realization that there are other ways to make money, other investments to choose from. For non-market-related changes in viewpoint, potentially a compensation structure change or a wholesale adjustment in project funding policy. Ultimately, when it's comfortable enough for someone to make a change (cease to ignore something), or when the discomfort associated with changing is reduced enough, they likely will. As others change course, it becomes easier for us as individuals to also change. In markets, this typically comes too late for someone to avoid large losses in the investments that should have been sold long ago, and also too late to experience nice gains in others that should have been considered. The favorable outcomes are usually reserved for those most flexible in their thinking and who adapt early on.

So, in general, we should expect that we're all practicing blissful ignorance – it's human nature. The question really is, to what extent. Finding the answer requires some deep introspection around our current beliefs and biases, emotions with respect to certain issues and topics, group associations, incentives, conflicts, and the level of entrenched inertia around all of this. For example, and with regard to the stock market, an aggressively positioned investor may discover the following about himself:

- I believe the stock market always makes sense for those with time and a tolerance for risk.
- My father taught me this when I was young and I respect him tremendously. Also, I lost a lot of money in bonds and real estate years ago. That memory still haunts me.

- Most of my friends also invest in stocks and those that do are my closest friends. I find it hard to relate to bond investors.
- The market has paid me handsomely. I would like for that to continue.
- This has been my opinion and investment position for quite some time and I see no need to change it.

If this investor chooses to remain blissfully ignorant, he will likely be rewarded tomorrow and the next day due to inertia and prevailing trends. Being in good, supportive company will enforce this. Eventually however, and with respect to a changing market dynamic, he might come to regret not exercising more caution. So long as he and his friends are all suffering financial losses together though, and they're all smart people, it's possible to convince one another that nobody could have seen it coming. Pride allows blissful ignorance to live on. After all, acknowledging the prescience of bond investors isn't an option. They were likely just lucky. Right for the wrong reasons. Stocks are always the better choice.

If, on the other hand, after honest introspection, our investor discovers he may be unconsciously ignoring critical and important information, he has a chance to adapt his thinking and act accordingly. He may look at a market valuation chart that he eschewed earlier and find that current stock market levels really are unprecedentedly excessive. He may take another look at the asset category that failed him years earlier and decide that bonds look much more attractive now than they did – even more attractive than stocks. He may be more willing to suffer ridicule from his investment buddies feeling confident about his position, and more willing to share a coffee with the bond guys. After making a few concessions around his prior viewpoints, he suddenly realizes that Wall Street is heavily incentivized to always promote stocks and wonders why he didn't notice this before. He begins reading new books; realizes that stocks are quite literally one investment choice out of many, rather than the center of the investment universe. Being more aware of the entirety of the situation compels him to change his path, which is always hard, but now worth the effort. Our investor is no longer blissfully ignorant, but consciously aware. The challenge of course is making sure he remains so after building up new experiences, biases, emotions, group associations, incentives, and conflicts. He must always prioritize a clear view of the real rather than a comfortable view of the ideal. If he can do this, he will remain empowered to survive and thrive while minimizing vulnerability to peril. It won't be easy. Nothing worthwhile ever is.

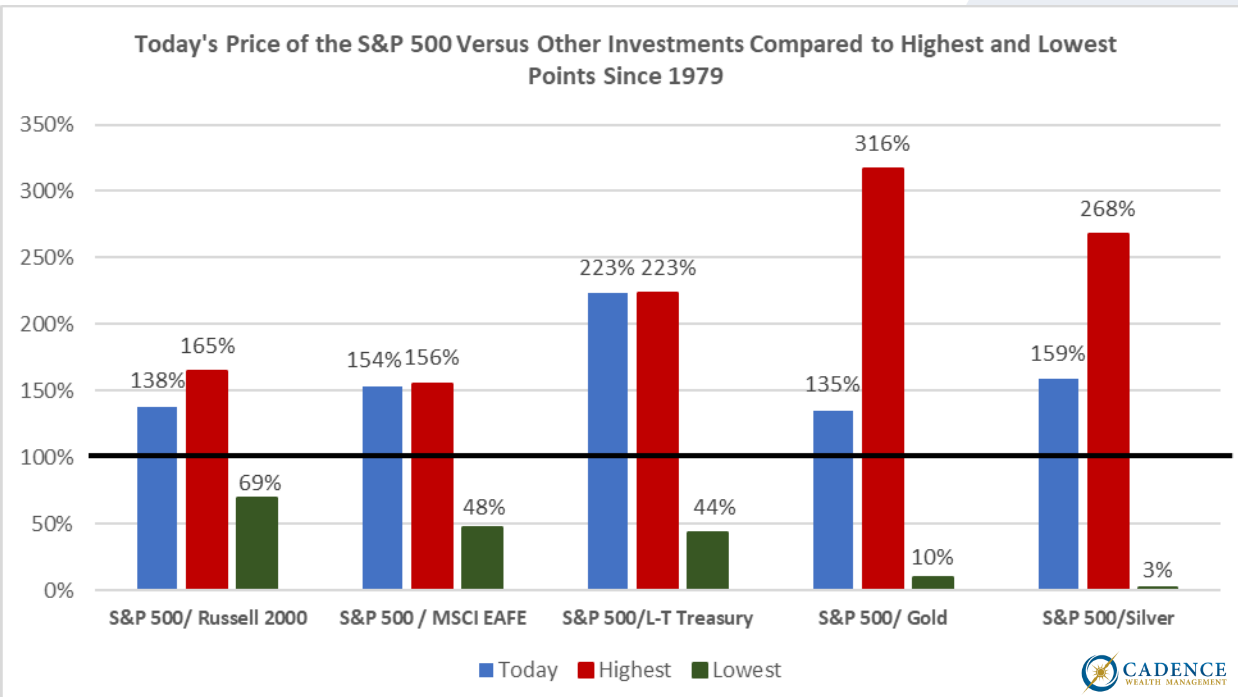
Buy Low, Sell High – Right?

By Steve DeBoth

The three ways an investment may provide you a positive return are through interest, dividends, and price appreciation. Although the majority of an investment's returns can come through interest or dividends, like with bond funds, the one people pay most attention to is price appreciation. It's easy math: is the price today higher than what you paid for it?

"Stocks are expensive". We've been hearing that more and more the past few years, and if that is true, that would make it more difficult to earn a positive return through price appreciation for a share of stock bought today. But, what does it mean for a share of stock to be expensive? I know that a $7 carton of eggs is expensive, but is a $182 share of Amazon expensive? How about a $32 share of Honda? You can't just look at the price of a stock and know if it is expensive or not the way you can with a carton of eggs. That makes the old adage "buy low, sell high" more difficult upon which to execute when considering individual stocks. For individual stocks as well as for indexes, there are ratios that try to translate price into value: PE Ratio, Price to Sales, Price to Book, etc. However, even these ratios can tell the wrong thing at the wrong time and require their own comparison to what is happening in the economy.

One simple exercise that helps to compare whether or not one investment is cheaper or more expensive than another is to compare their price movements over time to each other. This works better for diversified investments like stock and bond funds and indexes as they are not as subject to the extremely violent moves that can happen in individual investments. Large cap US stocks have been seen to be expensive relative to other investments for a while now, but just how expensive are they? I compared the price of the S&P 500 with the prices of small US stocks, large foreign stocks, long-term US government bonds, gold, and silver since 1979. If I want to buy low, sell high, then I am looking for the S&P 500 to be cheap relative to others which is a buying signal, or expensive relative to the others which is a selling signal.



The blue bars represent the price of the S&P 500 divided by the other indexes today expressed as a percentage of each ratio's long-term average. So, the ratio S&P 500/Russell 2000 at 138% means the S&P 500 index is 38% higher today relative to small cap stocks than average over the past 44 ½ years. The highest that ratio has been is 165%, and the lowest it has been is 69%. The price of the S&P 500 compared to small cap stocks today is much closer to its all-time high than it is to its all-time low. There haven't been too many times it's been more favorable to buy small cap stocks instead of large cap stocks over the past nearly 45 years. So, with just this as your trading signal, you would sell large cap stocks and buy small cap stocks.

Compared to foreign stocks represented by the EAFE index, and long-term treasury bonds, large cap stocks are more expensive relative to them today than at almost every point since 1979, so it looks much more favorable to buy either of them than the S&P 500. Rounding it all out, the price of large cap stocks relative to gold and silver prices are also expensive by about the same amount above average as small and foreign stocks, though we're not nearly as close to the all-time highs.

In the chart, if a blue bar is higher than the black line, it means large US stocks are more expensive on average than to what they're being compared, and in this case, that's everything. This is an example of what is meant by "stocks are expensive" when discussing large cap US stocks. Small and foreign stocks are cheap by comparison, as are the rest. We may look back on right now as the best time ever to buy long-term US treasuries and foreign stocks compared to the S&P 500, with small cap stocks not far behind. We use a lot more data to determine what and when to buy and sell for our clients than just dividing one price by another, but this simple exercise is a good way to test other market indicators, and like them, this one is telling a similar story: large US stocks look expensive. When trying to determine what to buy low and what to sell high, now might be the time to sell overweight large-cap US stock positions in favor of buying other assets on the lower side of their price histories.

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