



► RISK HIDES IN COMPLACENCY.....1-3



► QUESTIONING CONVENTIONAL WISDOM – LIMITLESS MARKET GROWTH4-8

Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

Risk Hides in Complacency

By Steve DeBoth

We humans aren't great at evaluating risk. Take the person who habitually texts while driving. We all know that's a risk, but we have a way of rationalizing behavior like that. Texting on a country road doesn't carry the risk of texting in front of a school, and texting while driving alone doesn't carry the risk of texting with children in the car, for example. Our brains find ways to give us permission, and I'm sure the person texting with kids in the car WHILE driving through a school zone also finds a way to give themselves the permission to run that elevated level of risk.

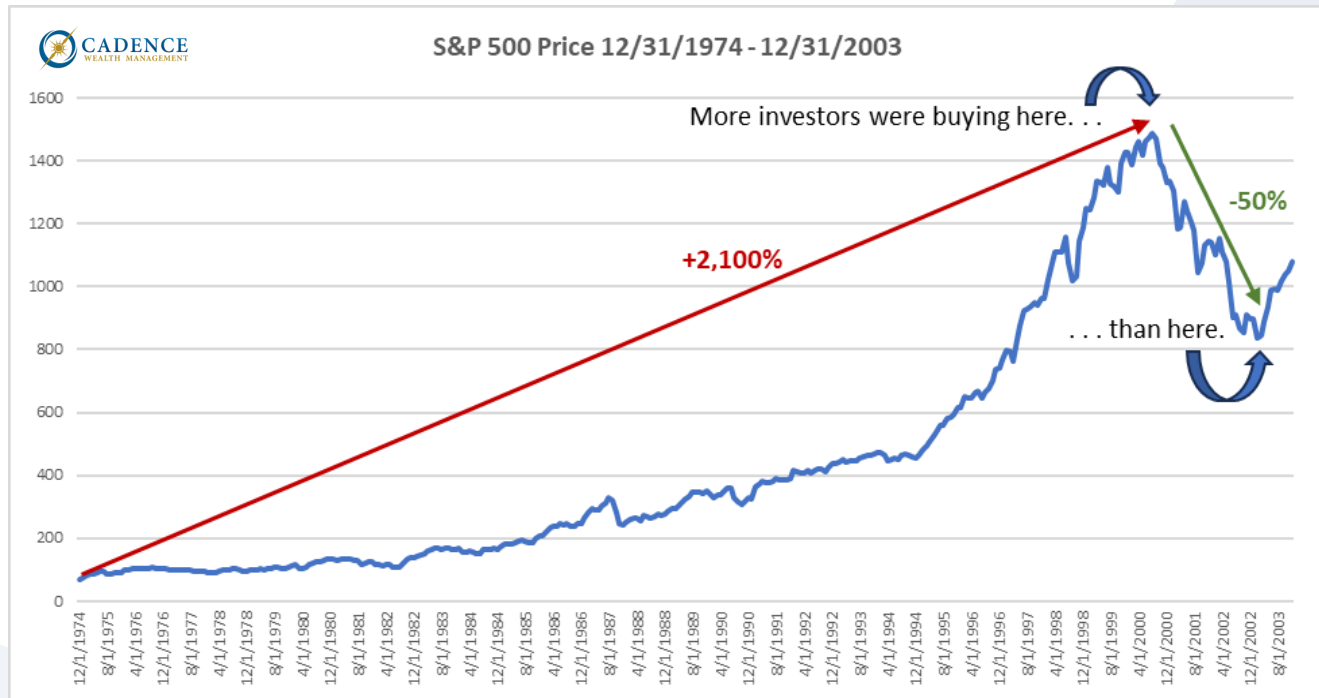
We tend to evaluate risk based on emotion and experience as opposed to logic and reason. Because nothing bad has ever happened while we've been texting and driving, we begin to overestimate our abilities and underestimate the risks involved. The people crashing while texting must be worse at it than we are. What were they even thinking? The fact that they've crashed and we haven't means, at least to us, that the risk of our doing it is much lower than theirs. But there's nothing true in that, of course. The risk someone runs while texting and driving the 100th time is the

same as the 1st time. In fact, the risk might even be higher as they may now have a false sense of security brought on by the 99 times they texted and didn't crash, so are now even less careful.

When it comes to financial risk, we are frequently just as illogical. For some reason, we see less risk in buying stocks that have already appreciated a lot than in buying those that have gone on sale. When it comes to sweaters, we're happy shopping the sale; when it comes to stocks, we are less comfortable. With individual stocks that can make sense in some cases, as when a company's stock is decreasing in price because the company itself is struggling, there is real risk the company could fail and the investment falls to \$0. However, with a diversified mutual fund or exchange-traded fund, the risk of the share price going to \$0 is nearly non-existent.

Consider the price moves of the S&P 500 index in early 2000 as the internet bubble was bursting. Between 1996 and 2013, which are the years covered by the data I sourced, more funds were flowing into the S&P 500

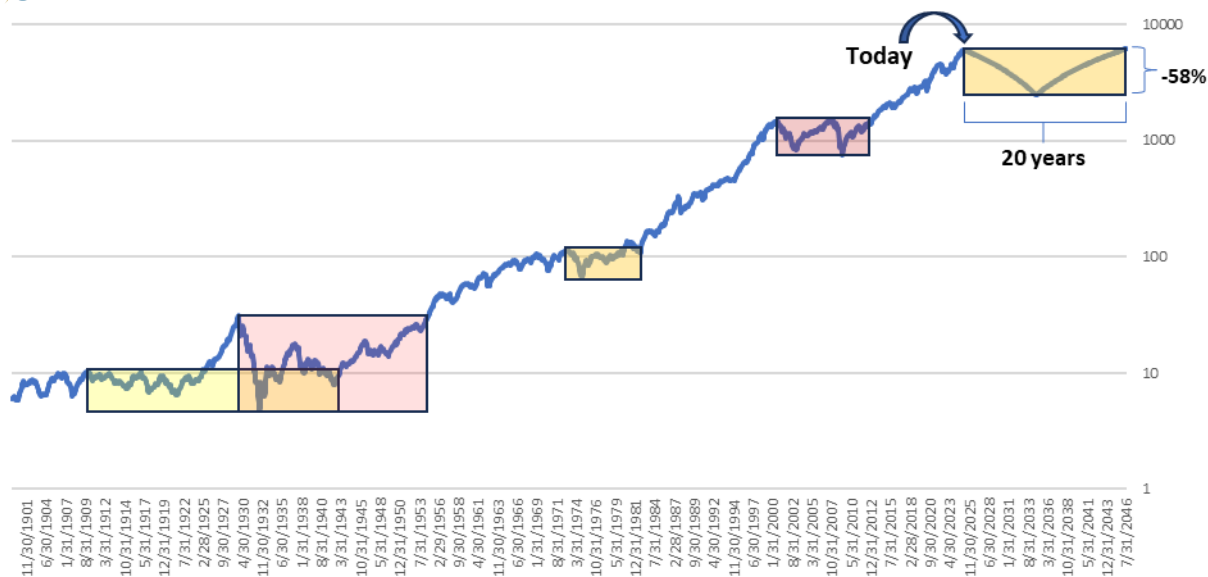
index around the time the index was peaking than at any other time in that span. Investors were pouring money into an index that had been almost only going up for over 26 years. At that peak, the price of the S&P 500 had increased over 2,100% since its December 1974 lows. Anyone buying the S&P 500 at that point would not see a positive price return for 13 years. Meanwhile, when the S&P 500's price was bottoming out for good in early March 2003 after losing nearly -50% of its value, many more people were still selling stocks than buying them.



In other words, to the human brain, buying after a price increase of 2,100% is much more attractive than buying after a price decrease of -50%. Would you go out and buy a sweater that had a price mark-up of 2,100% over one that had a price reduction of -50%? Well, sure, how ugly are the sweaters, but in this case IT'S THE SAME SWEATER.

And here we've reached that false sense of security again, like texting while driving for the 100th time. If an equity investment is getting more expensive, it must be safe; if an equity investment is getting less expensive, it must be risky, or so we feel. Of course, it is frequently the opposite, especially long into a bull market. Frankly, and obviously, much of the risk is out of a diversified investment once its price has declined -50%. There is risk in NOT investing in growth-oriented assets to be sure, but overriding the complacency that comes with a long bull market to lighten up on equities and reduce your risk, and overriding the emotion that comes with a major stock market crash to increase your equity holdings at an opportune time is a proper way of evaluating and acting on equity investment risk.

Where does the market go from where it is today? Over the short term, no one knows, but we have not seen the last of the major crashes, and we are once again in a position where US stocks are historically expensive by many measures. If the S&P 500 index were to peak now, lose the average amount of value of the last four major crashes since 1899, and take as long to fall and rise back to where it started as those crashes, it would lose -58% and take 20 years to grow back:



If a 20 year sideways move for the US stock market seems improbable, know that it has happened before, and that foreign stocks just recently completed a 22 1/2 year sideways move a few years ago. If foreign stocks fall -33% from where they are today, then that sideways move gets extended past 25 years. It does happen, it can happen, and it will happen again.

If there is any silver lining in buying after a 2,100% increase and then selling after a -50% decrease, were someone to time it perfectly wrong, then at least there is 50% of the investment left. In the case of the risks we carry in terms of dying prematurely, becoming too disabled to work, or needing skilled nursing care at some point in the future, there is no real silver lining. Ignoring those particular risks completely until something happens and then trying to shift some of the financial risk to an insurer, or trying to save extra to build up higher asset reserves, means being too late. Like all forms of insurance, when you could actually use the benefits is when it is impossible to qualify for the benefits. If you want to cover those particular risks, you absolutely have to take care of it ahead of time. Life is inherently risky, which is why life, disability, long-term care, health, auto, home, fire, and flood insurance exists.

The way to combat the risks present in the US stock market, while still also owning some US stock market positions, is to diversify into the areas that are not as historically expensive, and therefore may be carrying less risk. Bonds and foreign stocks seem to be carrying less risk today than US stocks, and many precious metal and natural resource assets seem to be historically cheap relative to the US stock market. Diversifying across these other asset classes may not have delivered the eye-popping returns that having 100% of your assets in US stocks the past decade could have delivered, but they also stand a better chance of not losing as much as the US stock market were a historical crash to start tomorrow.

“Because I haven’t died yet is proof I don’t need life insurance” is about as logical as “because stocks have been going up for so long means they can’t lose a lot.” It may seem obvious when you read it, but our brains make those rationalizations constantly. Justifying any risk you take by thinking, “Because nothing bad has happened yet. . .” is both completely human and as completely foolish as thinking it can’t rain today because it didn’t yesterday. Batten down every hatch you can. Be realistic about how much you can afford to lose, and what the financial effects of something happening to you physically would mean to you and those dependent on you. Those risks can all be addressed. We know, because we help clients do it every day. Bad financial outcomes happen to everyone at some point. Do not underestimate the financial risks present in every day life, especially when you can do something about them before it is too late.

Questioning Conventional Wisdom – Limitless Market Growth

By Casey Clarke

If you read our letters fairly regularly, you've probably picked up on the fact that we like to question the conventional, especially when our observations don't confirm it, and even more so when embedded conflicts and incentives provide support for that convention. Take for example the notion that stocks can somehow return double digits even though the economy is growing at a substantially slower rate. How is this possible? Don't think and just accept, some might say. Thinking only delays your ability and dampens your enthusiasm to invest blindly in something that is good for the goose. And as we all know, what's good for the goose...

Let's brainstorm a bit on this, shall we? Because the answer is really important when it comes to investing for our future – critically important, in fact. We don't have all the answers—nobody ever does. But we do have lots of questions and a genuine curiosity to understand how things really work. As we've written about before, rarely do we get answers that we're 100% certain of, but we can get a general sense of things, oftentimes with a reasonably high probability of being correct, which is almost always enough. Waiting for certainty makes one indecisive. Being certain makes one foolish. So, how is it that stocks can go up at a faster rate than the general economy over a long period of time? To answer this question, we first need to simplify the picture some to eliminate the effect of noisy, inaccurate data.

Gross Domestic Product, the official measure of economic growth, can be problematic. First, it has four components - consumption, investment, government spending, and net exports. Within each of these categories, there are subcategories that are tracked in various ways – some of which are estimates that ultimately get revised to closer estimates. In addition, you could have a situation where a large portion of GDP comes from government sector spending being directed toward horribly inefficient purposes, which would not accurately reflect the true condition of the economy. Rather, the state of the banking system and its ability and willingness to extend credit might be a better way to assess economic growth. The economist Richard Werner, author of “Princes of the Yen”, has studied extensively the banks' roles in “creating” money within the financial system through the extension of credit. Contrary to popular belief, Richard argues that it's not the Fed that creates money, but the banking system. If banks are lending for productive purposes, then the economy can grow. The more money there is available in the system, the more growth can be achieved. This makes good intuitive and logical sense as we already know that the Fed can really only encourage member banks to lend by increasing their reserves, but can't force them to. We also know that previous historical incidents of banks tightening credit or failing outright was never good, and sometimes led to dire economic outcomes. Think Great Depression. If banks are lending money into existence productively, at scale, there is growth. If they aren't, there is stagnation—or worse. So, the growth in bank credit seems a logical proxy for economic growth.

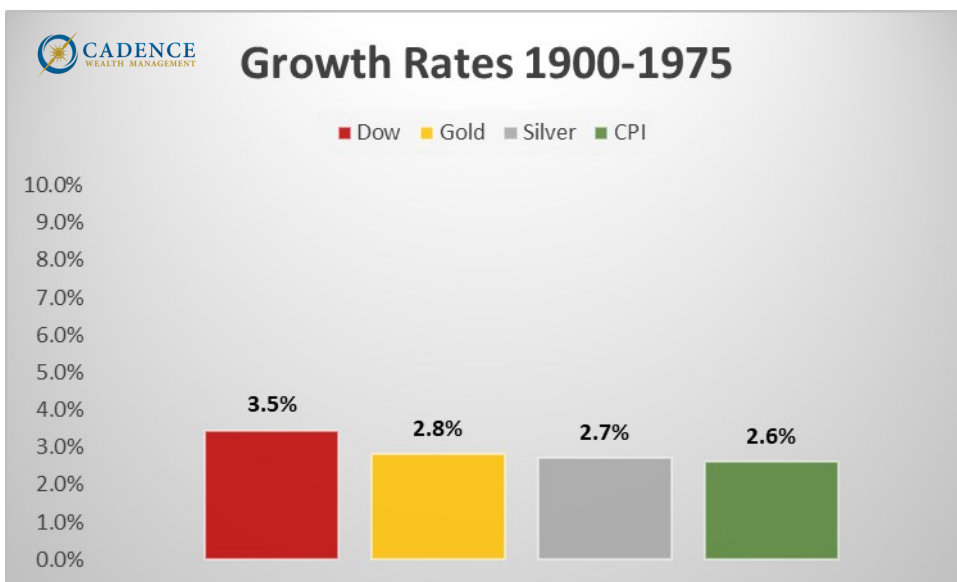
The next step is to think about whether corporations should be growing faster than this growth in credit. At the individual company level, sure. There are always new innovations and products that sell like hotcakes for some period of time. However, at the index or market-wide level, it doesn't make sense that companies, over long periods of time, would be able to grow profits faster than the supply of money is growing within the system. This might be possible over shorter periods of time through efficiencies, profit-margin improvements, salary reductions, right-sizing, etc., but eventually these tactics are exhausted and become counter-productive, resulting in poor product quality, poor customer service, and disenfranchised employees, for example.

So, it seems reasonable to think that the broad stock market should grow at roughly the same rate as the supply of money within the economy - over time. Speaking of money, it's also helpful to think of what asset or currency is most reflective of that supply of money within the system. Governments with a proclivity to spend at perpetually increasing rates would have us believe that their respective fiat (paper) currencies are "money", but as we are all well aware, those paper currencies lose value to inflation every year. Real money should not lose value. And that brings us to the one asset that has served as money for thousands of years that today's central banks and sovereign governments around the world are gobbling up for just this purpose - gold. If bank credit creates money, and this money drives economic growth, then gold should roughly reflect that economic inflation over time.

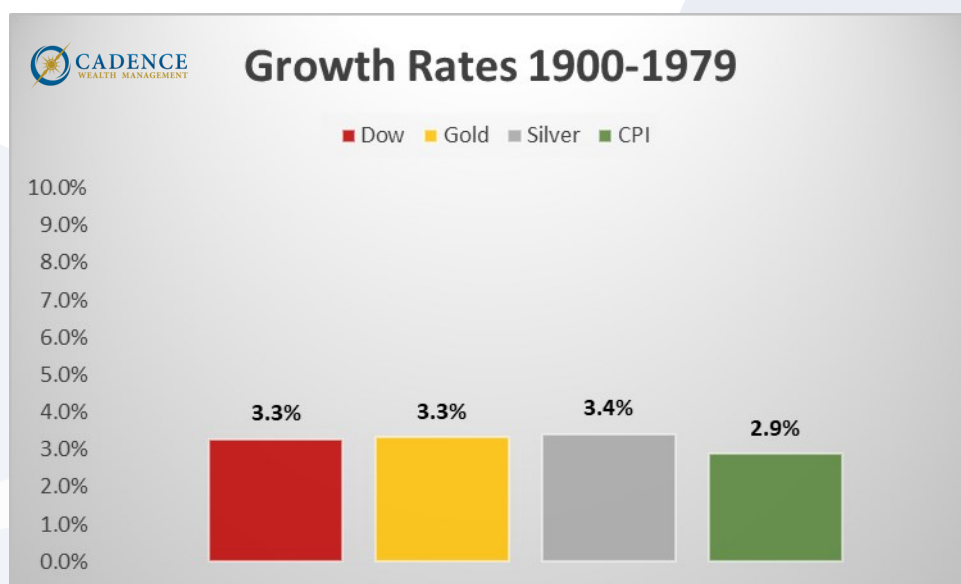
The final distinction to make before looking at the data is that of total economic and asset inflation versus consumer or price inflation. The official CPI numbers that the government has put out for years have averaged anywhere from double digits in the 1970's and 1980's, down to 2% more recently. Inflation tends to average between 3% and 4% most years. However, similar to GDP, the complexity of the CPI calculation is laughable. In addition, there have been changes over the years to make inflation appear lower than it actually is. Most would strongly object to the official annual inflation rate of 2.7%, and argue that their spending has risen much quicker than that over the last year. Therefore, it's reasonable to believe that true consumer price inflation actually runs much more closely to the economic rate of growth than most think. There's no question that televisions and refrigerators cost less now than they used to. Price deflation through innovation and efficiency is real, but for each one of these items, we have medical insurance, steak, eggs, and other costs that seem to grow much more closely with the overall money supply, or put another way, the decline of our paper currency. If consumer inflation is closer to broad economic or monetary inflation, we should be able to see that through hard assets that serve as true money, and have for quite some time.

In looking at the historical data, we need to account for the fact that almost every Wall Street investment rule of thumb that most operate by today is based on the last forty years of market data. The reason is two-fold: First, financial markets awoke from their malaise in the early 1980's and have since experienced some of the best returns in history, and second; this gave birth to the financial services industry as we know it today – the same players who benefit from investors being excited to invest. The result of this is effectively two financial market periods with two vastly distinct realities, the first of which is almost entirely forgotten, and the second period fueling most investment decisions being made today. Since no trends last forever, it's our view that we absolutely must look at the first period for full perspective. We somewhat arbitrarily chose the period of 1900 to 1975 as the first, long-term period to look at, and 1975 to current as the second.

What we notice in looking at the 75 years since 1900 is that the Dow Jones stock market index rose at an annual rate of 3.5%, while gold, silver, and the CPI measure of inflation rose at 2.8%, 2.7%, and 2.6%, respectively. These figures are eerily close to one another. Since we don't have bank credit data for this period, we have to look at gold, and to a lesser degree, silver, as proxies for money supply. What's important to note, however, is that the price of gold was fixed at \$20.67 per ounce under the Gold Standard Act from 1900 to 1934, then at \$35 under the Gold Reserve Act from 1934 until 1971 when Nixon removed the gold backing of the U.S. dollar, at which point it proceeded to climb rather dramatically for the next 10 years. Part of this rise could have been the market's attempt to find equilibrium - a level that reflected the supply of money in the system, while it's likely the latter part of the rise was attributable to speculation.



The next chart shows how these four rates changed over the course of 79 years, through 1979. By adding four more years to our analysis below, we can see that the growth rates on the three assets are nearly equal over 79 years, with the official government measure of inflation, CPI, being not too much lower.

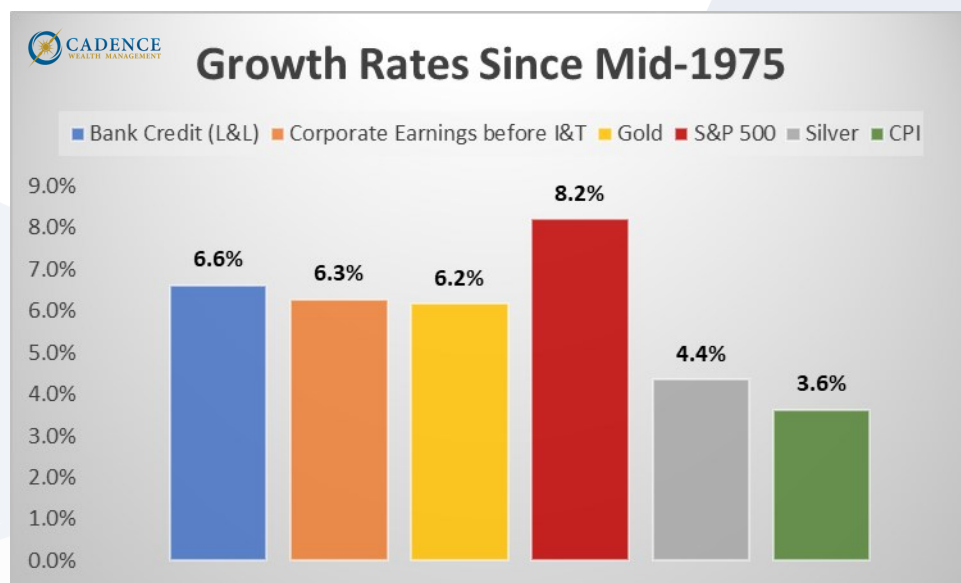


When we shift to looking at growth rates since 1975, we find very similar growth trajectories for bank credit (money supply), corporate earnings, and gold. This makes very good sense, as all three should similarly reflect the supply of money within the system. However, we notice that silver, as opposed to returning somewhere around 6%, returned in the mid-4% range. This could reflect silver being an industrial metal as opposed to more purely a monetary one, but it more likely reflects the fact that silver is simply underpriced right now relative to other assets. The fact that silver performed nearly identically to gold over the 79 years since 1900, along with the fact that copper, a less precious and arguably more industrial metal than silver performed better since 1975, further supports the notion that this anomaly reflects a valuation discrepancy. CPI growing at 3.6% likely reflects some genuine disin-

flation through globalization and technological efficiencies, as well as some formula chicanery to make the figure appear lower than it is. As we saw in the 75 and 79-year periods above, the true inflation figure is likely much closer to the growth rates of bank credit, corporate earnings, and gold.

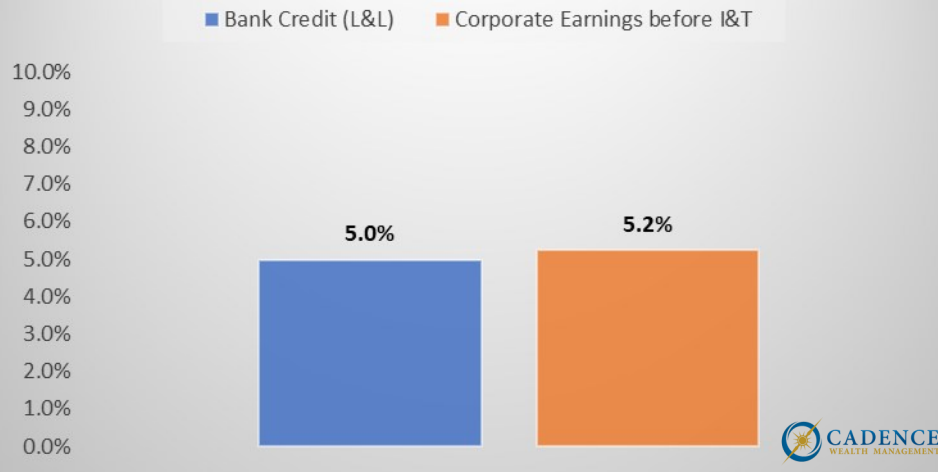
The giant stand-out in the chart below is the growth rate of the S&P 500, and just how far it is from all the others. If logic, as well as the 79-year period we just looked at suggests that stock returns should approximate the growth in the money supply, then how can we explain this ~2.5% higher annual growth rate for stocks? According to Werner and others, too much of the supply of new money went directly into financial markets and speculation as opposed to productive ventures. Throughout history, every time we've had a financial asset bubble, it was due to speculation through the use of leverage, which by definition is new money supply going toward pushing asset prices up rather than creating new, sustainable wealth.

The question is, if in the end, say after a few more years, the stock market growth rate reflects the bank credit (money supply), corporate earnings, and gold growth rates, then what would that mean for the S&P 500? Four years from now, that would mean the S&P 500 would need to be at **2869, down -55%** from where it is today. On the other hand, if silver closes the gap in the next few years to where it reflects the same return as gold (6.2%), as it did in the 79 years since 1900, it would trade at **\$114, up ~200%** from today's price.



Can an increase in money supply growth catch up to stock market valuations and justify their existence? That's unlikely. As the chart on the following page shows, money supply growth has decelerated in the last ten years from its 50-year average – 5%, down from 6.6%. This deceleration is likely due to a limited ability of borrowers to service additional debt, along with fewer credit-worthy borrowers in general. In short, if banks don't feel they can make good money on loans, they won't lend. We seem to be at a bit of a dead-end on this front. Homes, cars, and just about everything else are too expensive. Something's gotta give.

Credit & Profit Growth Last 10 Yrs



So, can we continue to expect 10% long-term stock market returns if the money supply and economy are only growing at 5%? Probably not. As opposed to being a convenient magic trick that just is, this discrepancy is most likely the result of a number of factors leading to the speculative misallocation of capital that's been persistent enough to fool almost everyone. If, in the end, stock returns are similar to economic growth, money supply, and gold, then we have some pretty serious downward adjusting to do. The 79 years since 1900 support it, logic supports it, and a whole lot of mean reversion math based on a host of valuation metrics argues for it. Probably not coincidentally, the numbers all agree fairly well – at least half of the stock market is most likely ephemeral, temporary wealth, that will vanish from retirement accounts at some point. The world will feel very different at S&P 2869. If our definition of wealth depends on the level of the stock market, this won't be a welcome change. If we define wealth more broadly, in terms of sustainability, happiness, and depth of human experience, then it may be a necessary, albeit unpleasant, first step toward actually achieving it.

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