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Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

Choose Your Risk Carefully

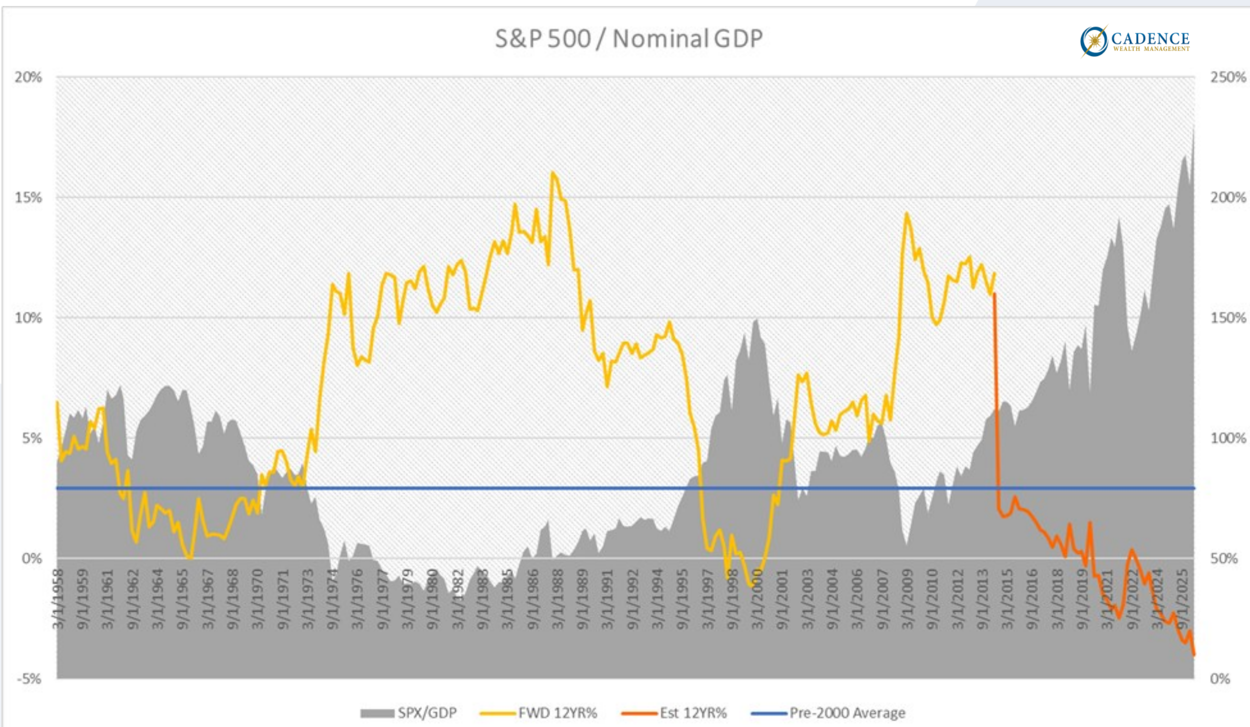
By Casey Clarke

When it comes to investing, most people tend to think about risk as the stock market, with everything else being some degree less risky. For most, that risk is acceptable given the assumption that the stock market always trends higher over time, averages about 10%, and never stays down for long. When you stop and think about it, that doesn't sound too risky at all, which is why most investors usually aren't very concerned about stock market risk. If you have a reasonable investment time frame and can tolerate some ups and downs, the stock market actually sounds like a pretty low-risk bet, with everything else being far too conservative and devoid of return potential—right? Not exactly. We would argue, as we have many times in these letters, that the assumptions investors are making – in large part based on what they are led to believe by the industry – are wrong. There are in fact periods in history when stocks go down and stay down for much longer than investors can afford, where returns are far less than 10% annually, and where fortunes get wiped out in short order. Nothing in investing, or life for that matter, is risk-free—so, we should always be aware of what the risks are across a host of potential choices so that we can make the most informed decisions possible.

Stocks

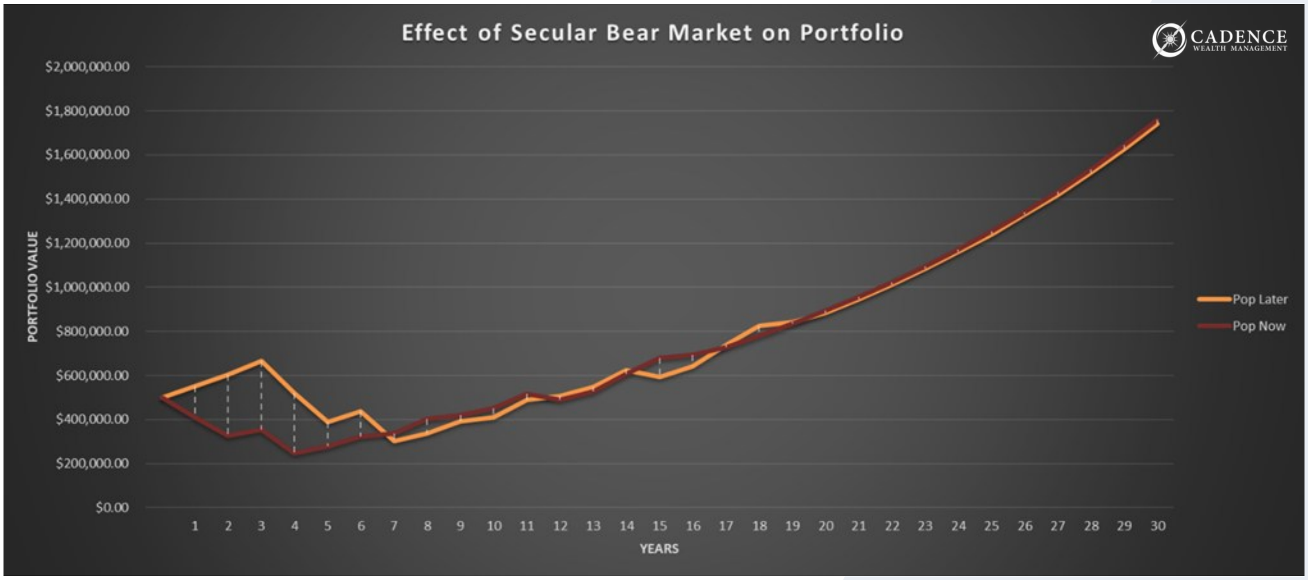
Both stocks and corporate credit (bonds) tend to move in cycles. These cycles can be long-term secular cycles that are related to broad, slow-moving trends like demographics, government policy, and technological innovations, or shorter-term cycles driven more by business and credit conditions. Picture two sine curves, with one spanning roughly 40 years from peak to peak and the other consisting of a 5 to 10-year period from peak to peak. Market cycles aren't as regular and predictable as the four New England seasons, but they are there nonetheless, and where one invests along these cycles determines the risk they are taking on. Contrary to how it might feel at the time, if one invests at the bottom of a stock market cycle, the risk of subpar returns going forward, over a reasonable length of time, is minimal. By contrast, if one invests at the top of a cycle, particularly if it's one of the long, slow-moving ones that ends in a bubble, the risk of getting horrible returns over a long period of time is very high. This is precisely where stocks are now, and very few are aware of it. To drive that point home: The likelihood of a decade or more of zero returns, based on how late in the valuation cycle stocks are, is extremely high for those overly exposed to the stock market. This is a risk very few can afford to take.

The chart below shows the valuation of the S&P 500 (the level of the S&P 500 divided by the size of the economy) over 65 years (gray shaded area). We can clearly see by the yellow line that the average annual return one gets over a 12-year period of time is directly related to where they invest along this big secular stock market cycle. The orange line on the right side of the chart is an estimate of what investors will eventually average over 12 years as valuations cycle back down to earth, as they have always done throughout history. The point is that given where we are in the cycle, expecting the standard 10% per year from stocks going forward isn't at all likely—quite the contrary. Risk of loss and poor returns has literally never been greater.

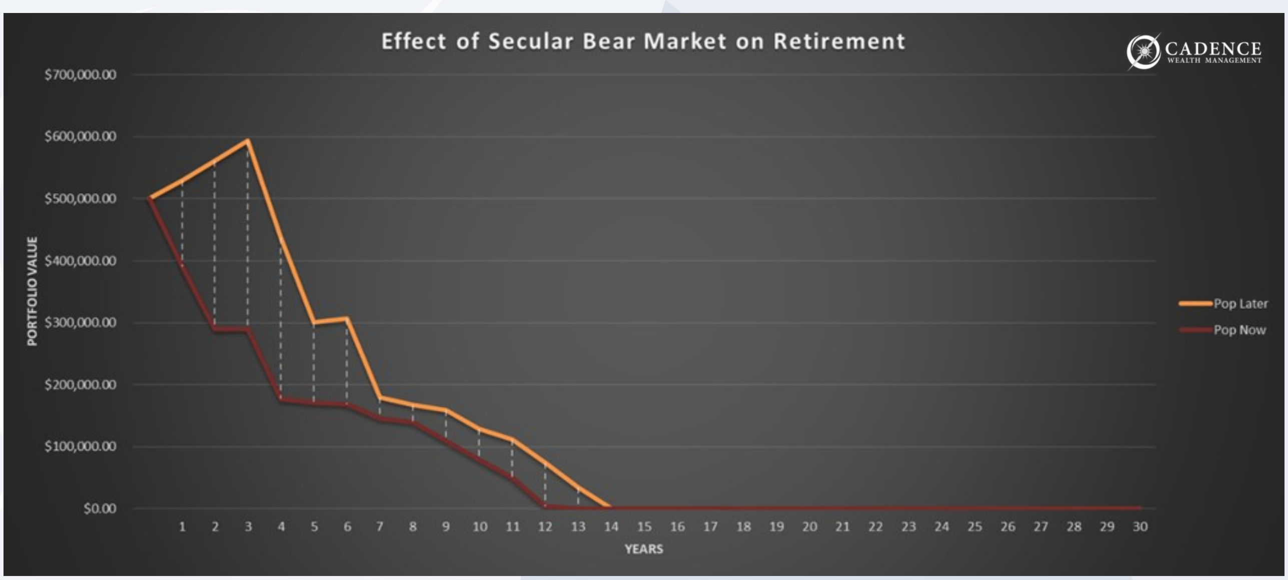


Once We Decide, We Move On

The hardest part of deciding not to invest in a late-cycle bubble is watching it continue to go up and enrich others while not being a part of it ourselves. That positive price momentum that ultimately increased risk is likely to continue further, in some cases for much longer than we would think. This is hard, and for most, impossible to resist. The important thing to keep in mind here is that regardless of how much longer a valuation bubble persists, and how many months or years one has to lament about not being a part of it, when it pops, all those gains are usually wiped away. If the fundamentals underpinning stock valuations haven't kept up with the price increases on stocks themselves, the gains are ephemeral. And since it's impossible to sell at the top with any consistency, we have to assume that had we been a part of the final phase of a stock market bubble, we would have lost those gains anyway. Thus, and almost every market bubble in history confirms this, it's almost always better to leave the party early and wish everyone else the best of luck. The chart below shows how a stock portfolio might be affected given valuations today and what history suggests forward returns might be as a result. The red line shows a relatively standard -50% decline beginning today followed by recovery, while the orange line shows what happens if the bubble continues for another 3 years before popping. Ultimately, the portfolio ends up in roughly the same place given that the decline has to be bigger to compensate for the bubble continuing to inflate further. Again, this phenomenon can be observed in the first chart showing 65 years of valuations and subsequent returns. (The scenario below assumes a steady 7% return after the 12-year valuation adjustment plays out). Bottom line, we're looking at roughly 12 years of the portfolio going nowhere, regardless of when the bubble "pops".



Our biggest concern at the moment is for retirees who are heavily exposed to the stock market and taking income from their portfolios to supplement fixed income. For our clients and readers who are in their 50's and 60's now, the last lost decade from 2000 until 2012 might not have left too visible a mark, since you continued working and saving throughout those years. The next lost decade would be a completely different ball game given your closer proximity to retirement and potential distributions from your portfolio. Below, we show how the above chart would change if one was taking $20,000 per year (fixed income of $40k, expenses of $60k) from their $500k portfolio with inflation running at 3% annually. In this case, the bubble popping three years later buys them a couple extra years before running out of money – 14 rather than 12 – but in both cases, it's a rather quick trip to zero.



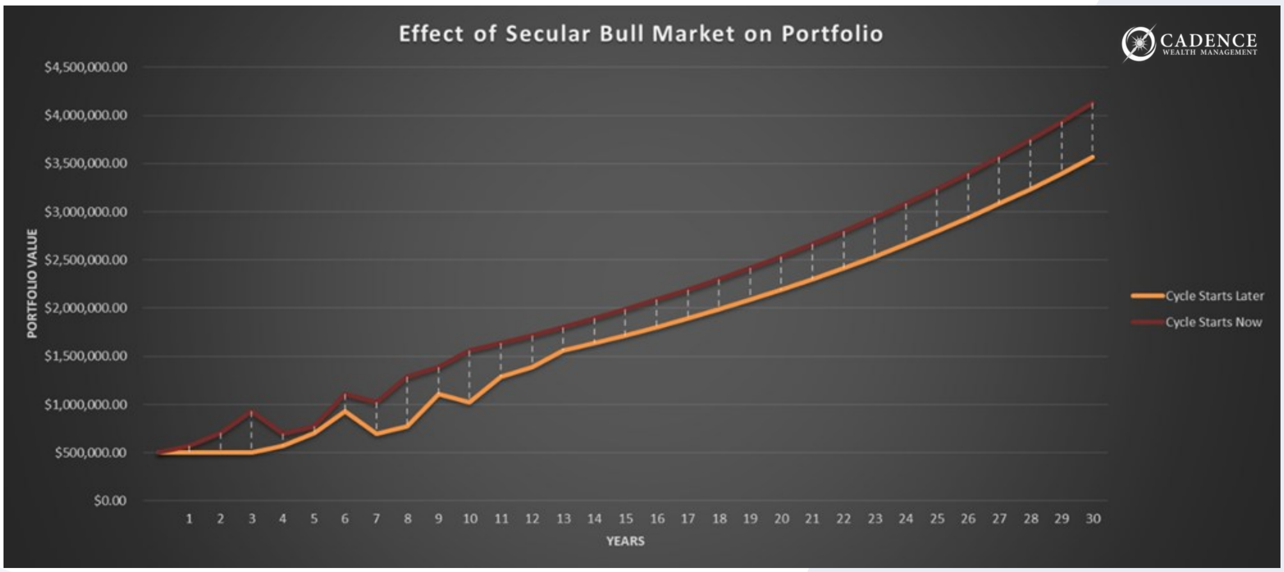
Inflation Risk – Too Much Cash

For those who understand the true risk of investing in stocks and bonds at the wrong point in the cycle, the alternative is typically some form of cash; money market, CD's, etc. If interest rates are high and inflation low, that could be a very smart alternative. But that's a rare scenario. Usually when stock valuations are high, so is inflation, which can very quickly eat up any returns generated by the safer cash alternatives. The term "losing money safely" accurately describes inflation eating away at the small interest payments received on cash investments, incrementally and predictably, without any big surprises along the way. The risk in leaning too heavily on "safer" cash investments is shown in the chart below, which like the one above, reflects the retiree with $500k, a $20k income gap, and inflation running at 3% in one scenario and 5% in another. We also assume a fixed 3% annual return on cash. As is clear, under both inflation scenarios, the portfolio is ultimately depleted, with the 5% inflation scenario shaving 3 years off the portfolio's productive life. Inflation can be a huge, huge problem for a retiree playing it too safe. The silent assassin.

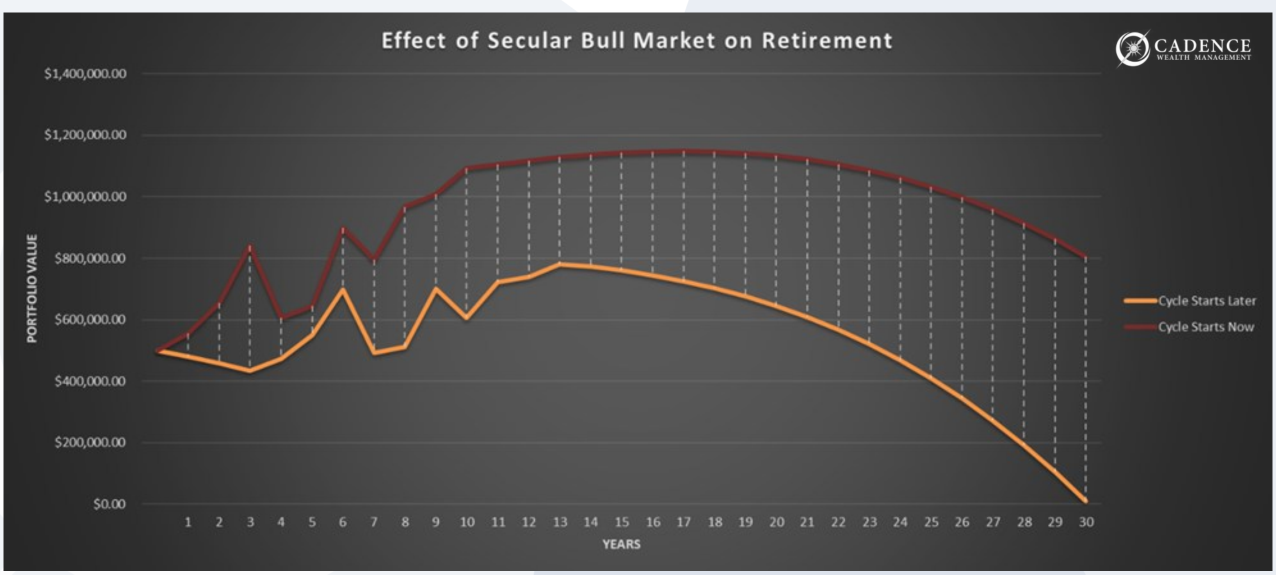
Bottom of Cycle Investing

So, if stocks at or near the top of the cycle are too risky and cash losing money safely to inflation every year also poses excessive risk to our portfolio and long-term planning, then what's left? The answer is, we have to attempt to seek out investments that are near the bottom of their long or short-term cycles – ideally long-term. The interesting thing about financial markets, to me anyway, is the human behavior underpinning them. Humans are very predictable. They will always be driven by fear and greed and have a tendency to seek out the safety of a crowd or "tribe". This behavior ultimately drives the repetition of many cycles throughout human history, and to the extent we're familiar with this dynamic, we can more effectively assess and navigate contemporary trends. When it comes to investing, humans chase the shiny thing until some combination of events materializes to change their minds. The complexity of today's financial markets and system, as well as the motivation of influential humans to perpetuate the trends, has served to extend this cycle for much longer than has historically been the case. This has certainly made things more difficult and confusing, but we're still talking about cycles that are driven by human participation. The interesting thing about humans is that when they're focused so heavily on one thing, they're usually neglecting another. This neglect over time results in an inverse cycle to that which is popular. We've discussed frequently how natural resources tend to run contrary to most stock and bond (financial) assets because of this tendency for humans to focus on one over the other at any point in time. All of this is to say that there is usually something near the bottom of its cycle when something else is at the top, giving investors a viable alternative.

The chart below shows a hypothetical scenario where one invests in something near the bottom of its cycle. Both the red and orange line assume a 12-year average annual return of ~11% from the beginning of the cycle, which our first valuation chart in the beginning of this letter shows is typical. The only difference between the two lines is that the orange line assumes we're early to the party and receive zero growth for the first three years. Note that even with no growth for three years, investing near the bottom of a nascent cycle is still far superior to investing near the top of a cycle in our earlier chart – even the scenario where we receive 10% for three more years before the cycle finally gives way. Moral of the story: We'd rather be standing still letting others continue to make money, than risk being caught up in the eventual unwinding of a bubble. Over time, we'll be much farther ahead.



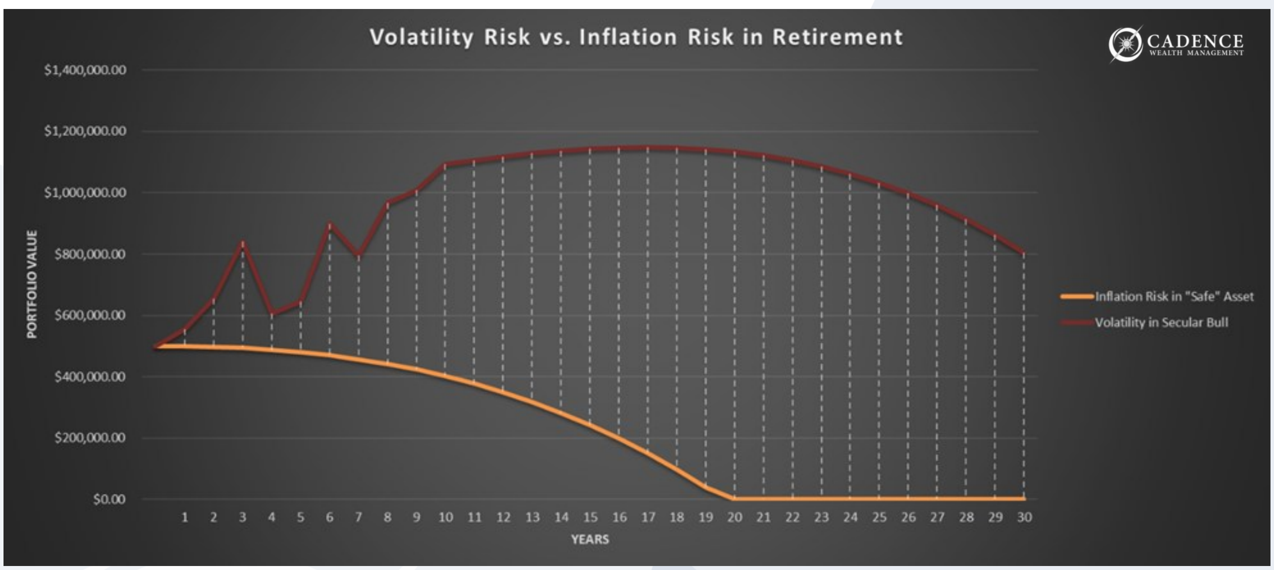
The below chart shows how our retiree fares investing in the early cycle asset rather than late. Here we can see that standing still (earning nothing) for three years has more of a consequence when taking withdrawals, but the portfolio still stretches a full 30 years rather than being depleted in half the time.



The Reasonable Choices

There are undoubtedly other investment-related risks to consider. Credit risk, company-specific risk, default risk at both the corporate and government level, market liquidity risk, etc. We think about and consider them all, but assuming that we're always investing in a diversified fashion - never all our eggs in one basket from both a company and asset class standpoint – usually risk really does come down to the broad cycle and inflation risks we're discussing here. Further, as far as we're concerned, the only two worth taking on to any meaningful degree are early cycle risks and inflation risk. The biggest risks associated with early-cycle investing are being early and having to wait for performance to show up, and the typical short-term volatility and risk of drawdown associated with any investment moving along a path from point A to point B. The risk to cash investments is well known. Inflation will eat into our purchasing power slowly, but there is always a need for some level of cash, be it for purchases or tactical purposes.

The chart below plots out the difference between the two for our hypothetical retiree. For most with a long-term perspective, the temporary losses incurred in the volatile investment are well worth enduring as having too much in cash is a much worse longer-term scenario. But that doesn't mean that having nothing in cash is smart either. As a general rule, the more diversified our early cycle investment portfolio is, the less we'll need to have in cash, whereas, the fewer options we have that are reasonably valued and early cycle, the more we'd want to have in cash to offset that lack of diversification.



In the end, it's about balancing different types of acceptable risk – asset class risk, volatility risk, inflation risk – while largely avoiding the unacceptable risks like late-stage cycle risk. To the extent we can do that effectively, the likelihood of goal-achieving returns goes up while the probability of a lost decade that wreaks havoc on financial goals goes way down. Risk can't be avoided – we just need to make sure we're taking on the right types at the right time.

If you're a client and have made it to this point in the letter, most of this probably sounds very familiar to you – our focus within our client portfolios has been to lean heavily, yet prudently, into those asset classes that are cheaper from a valuation perspective and much more likely to be earlier in their investment cycles. We have also accepted small amounts of inflation risk in lower growth, "safer" investments, so that we can be prepared for short-term bouts of volatility that are par for any investment course. There will be periods of time when good investments that we own go down for no good reason – such has been the case over the last few months. That's to be expected; especially after a good run. If we're confident in our process and the choices we've made, then we wait it out. If we're fortunate enough to have idle cash to invest a bit more at lower prices, all the better. Volatility can be our friend rather than foe if we've done the work up front.

The world is highly uncertain at the moment. More on that in next month's letter. In the meantime, we'll expend energy controlling the things we can by preparing for the things we cannot.

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