



Ruminations on the Market

An article I wrote in May of 2006, is interesting now in light of what subsequently happened in the markets. Here it is verbatim:

As you may have noticed there has been some turmoil in the markets lately and I wanted to let you know my thoughts. I think most (all?) of our clients trust us implicitly and don't need detailed explanations of what is going on, but we always want to err on the side of over-communicating. If you take the position that you pay us to worry about your investments so you don't have to, feel free to ignore this.

Over the past few years returns have been so good and volatility so low that we are no longer accustomed to even the minor (from a historical perspective) volatility we have seen recently and some folks might understandably be anxious.

As you know, our focus is long-term and we don't attempt to time the markets, but rather to maintain appropriate long-term allocations. We believe history has shown that is a superior strategy to attempting to predict market moves. At the same time however, we have certainly recognized for some time that wherever we looked investment opportunities appeared at least fully valued and we have attempted to set expectations knowing that corrections were not unlikely. To quote from a recent letter [April 2006] to our clients:

I am running out of ways to say "we are doing well but please keep expectations low." Many commentators have been predicting the end of the small and value outperformance, but it continues apace, rewarding our relatively large exposures to those areas. Real estate continued to do well also...

In spite of all this good news in returns, we continue to maintain prudent allocations to short-term, high-quality fixed income as protection against possible downturns. Alan Greenspan expressed it perfectly (though in his typical inscrutable manner) in a speech to economists back on August 26th [2005]:

"[T]his vast increase in the market value of asset claims is in part the indirect result of investors accepting lower compensation for risk. Such an increase in market value is too often viewed by market participants as structural and permanent. To some extent, those higher values may be reflecting the increased flexibility and resilience of our economy. But what they perceive as newly abundant liquidity can readily disappear. Any onset of increased investor caution elevates risk premiums and, as a consequence, lowers asset values and promotes the liquidation of the debt that supported higher asset prices. **This is the reason that history has not dealt kindly with the aftermath of protracted periods of low risk premiums.**" [emphasis mine]

In other words high current prices imply lower future returns. People are willing to accept low returns on assets; therefore it may be that people now consider these traditionally risky areas safe. Historically, that has been unwise.

In light of this situation, for some time we have been directing clients to the more conservative choices where they could afford potentially lower returns. Of course, we also have maintained very broad diversification.

I want to explain further *why* we don't attempt to market time (get in and out of the market on a short-term basis). One of the primary problems with attempting market timing with traditional investments – even assuming some people have skill – they don't get to exercise it often enough. To illustrate, suppose I have a coin that has a 60% chance of coming up heads and a 40% chance of coming up tails. Would you bet \$1,000,000 on one coin flip that it would be heads? If you win you get \$1,000,000; if you lose, you pay \$1,000,000. The expected return is $(\$1,000,000 \times 0.6) - (\$1,000,000 \times 0.4) = \$200,000$. I assume the answer would be no, even though on *average* you would win \$200,000. However, you would almost certainly be willing to bet \$1 on that coin flip and do so 1,000,000 times, even though the expected return is the same. The difference is the outcome becomes practically guaranteed because of the volume of wagers. You will almost certainly have a profit of close to \$200,000 at the end. Even presupposing superior skill, many transactions are necessary to eliminate bad luck and evidence that skill with high certainty.

In addition, knowing investments are overvalued (or undervalued) isn't enough. As John Maynard Keynes remarked, "Markets can remain irrational longer than you can remain solvent." Assume for a moment that we recognize that a particular investment is "too high". If there are other investments that appear more reasonably priced we could sell the one that appears expensive and purchase the ones that appears more fairly valued or even cheap (we do this on an ongoing basis in your portfolio by maintaining tilts to value stocks and away from growth stocks and rebalancing to the target allocation for example). That isn't what we have seen lately. We have seen investments across the board *all* appear expensive (or at least what we would call "fully valued"). In light of that, what could we do?

That is not a rhetorical question, but rather one we have thought through and revisited frequently. Recognize that even if investments are "too high" that doesn't necessarily imply a crash or even a correction. It probably means that returns in the future will be lower, but *how* we get those lower returns is unknown. For example, suppose an investment would be fairly valued today at \$5 and given its growth rate and fundamentals is expected to be worth a fair value of \$10 in 10 years. That is about a 7% annual growth rate. Let us further suppose we have perfect knowledge and we *know* that it will be *exactly* \$10 in 10 years. Now suppose the investment is currently valued at \$7. Given our analysis we would determine that it is "too high" and overvalued by \$2 (since it is really worth \$5). We have three options, 1) sell it because it is overvalued, 2) hold it but realize that we will probably only earn just over 3.6% per year (as it grows to the \$10 fair value), 3) recognize the risk and trim back a little, but continue to hold it to some extent.

Which is the superior strategy? Well, as with most things in financial planning, it depends. The investment *could* crash tomorrow to its \$5 "fair" value (or even go lower as markets frequently overshoot – in both directions). However, there is another possibility. The investment *could* shoot up to \$10 immediately. There is nothing that says that an overvalued investment can't get even more overvalued – remember not only what Lord Keynes said (above) but also the late 1990's! Markets can and do go from overvalued right on to "irrationally exuberant". If you sold your investment at \$7 and it went up to \$10 and stayed there for the next 10 years, you would have given away a decade of returns (admittedly low returns, but returns nonetheless) from attempting to profit in the short run.

Thus our dilemma is that even if we know the distant future, we would also have to know the short term path to successfully trade. In light of the uncertainties, we continue to counsel broad diversification, relatively conservative allocations (“conservative” is different for different situations obviously), and focusing on things we *can* control like transaction costs, advisory fees (ours are lower than most), diversification, taxes, saving and spending, etc.

As we observed several years ago, to reach any goal there are only four fundamental things you can do:

- 1) Lower the cost of the goal (retire on less income; send the kids to State rather than Harvard, etc.)
- 2) Put the goal off until a later time (retire at 65 instead of 62 for example)
- 3) Save more to reach the goal
- 4) Get a higher rate of return

Notice that the first three of these are *completely* controllable while the last is largely not (while you can have a more aggressive or conservative portfolio you don't really get to pick the return). In spite of this people spend about 90% (my estimate) of their efforts trying to impact the one factor they have the least control over!

So, as we have noted before, much of what you need to know about financial planning you can learn from the serenity prayer:

*Lord, grant me the serenity to accept the things I cannot change,
[such as the stock market's performance]
The courage to change the things I can,
[such as the amount and timing of my saving and spending, and the level of risk I am taking]
And the wisdom to know the difference.*

Notes:

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