September 2009

A Season of Change

Some families would sell out for nearly nothing and move away. And it never failed that during the dry years the people forgot about the rich years, and during the wet years they lost all memory of the dry years. It was always that way.

~John Steinbeck, East of Eden

It has now been a year since the collapse of Lehman Brothers which, in some respects, triggered the meltdown in the financial and other markets that we all experienced last fall and winter. The virtual gun was already loaded with some pretty toxic stuff, but the Lehman collapse will likely be remembered as the loudest shot.

I'm taking this "anniversary" as an opportunity to discuss some thoughts with you in the context of the events surrounding the last year or so. This is intended to be one of our friendly newsletters, but there may be some difficulties reconciling last fall with the idea of being friendly. But, here goes:

From early September 2008 through early March 2009 (about six months) the stock market (S&P 500) declined by something like 48%. The market reactions and avalanche of uncomfortable financial news was scary – particularly in September and early October. We took the position at that time that restoring equities (stocks) to their intended allocation was not a prudent decision – we "froze" purchases of equities for a few weeks.

By late October 2008 the information suggested that the world economies were not permanently frozen and/or destined for collapse – only to be replaced by who knows what. Rather, stock prices seemed to have had something of an overreaction to the very bad, but not Armageddon-like, news and events. Because we were necessarily working on a "seems like" basis, we determined to begin restoring client portfolios to their target or intended equity-to-bonds mix over the four months from November thru February.

The equity markets continued to decline in November (a brief respite to the positive side in December), January and February (2009). The bad news was that the markets were declining; the good news was that our clients were calling to seek information and ascertain their "stomach" for the risk that manifested itself during this scary period. A few clients determined to reduce their equity (stock) proportions in their portfolios and a few decided to liquidate all their stock holdings and reallocate their investments to less volatile asset classes (bonds, cash, etc.).

We went to school. The precipitous declines in the equity markets essentially wiped out the modest gains of the previous ten or so years. This market meltdown, coupled with the also scary declines in 2000 thru 2002, brought into question the concepts of buy and hold as well as the very essence of equity investing. We sought reconciliation of theory versus experience.

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We have chronicled some of our educational efforts and work in past newsletters and mailings, but let's suffice it to say that 2008 and early 2009 provided information not heretofore available. In response to this newfound knowledge we initiated some changes in the way we view the financial markets and our clients' portfolios. We began with the addition of an additional asset class (absolute return), a more active approach to investing in satellite strategies, and a pressure valve to allow for adjustments to the total equity allocation as measurable conditions indicate. The phone continued to ring with folks understandably concerned about the future of our economies and the security of their portfolios.

In response to the phone calls and visits and in an attempt to put some structure around the decisions some deemed necessary, we published a "Financial Crisis Decision Matrix" to help sort out the ramifications of decisions about overall allocations between equity and fixed income holdings in our clients' portfolios.

Our educational efforts and deepening understanding of the metrics conflicted somewhat with the emotional response of our clients – this then is the essence of our message. The first week in March 2009 was perhaps the worst week of my career in managing portfolios - not because conditions worsened, but because a number of our clients had turned to a panic-like mode. More clients determined to exit the equity market than in the entire history of TD Capital's work on behalf of our clients. The clients were losing sleep because of the continuing declines in the equity markets. I was losing sleep because I was unable to turn the emotions into rational decision-making.

The story continues as you would suspect. Somewhere around March 6 the equity markets reached the bottom of the cycle (as of this writing) and began an almost incredible increase of something like 58% over the ensuing 6 months or so. So, a number of our clients sold equities at the virtual bottom of the market cycle because their emotions took control of the process. I was unable to present a case that the markets were so cheap that selling at those prices was not indicated.

The phones didn't ring much for several months as those who maintained their long-term asset allocation strategies enjoyed the rising equity (and bond) markets. Those who sold out of equities appear to have been frozen by their experiences and concern for a repeat of the scary times. We continued our educational efforts and determined to add a tactical element to the liquidity (bond) side of our portfolios. We instituted that methodology in June.

The phones have begun to ring again. This time it seems to be dominated by folks who sold out or reduced their equity exposures and feel better now. The preponderance of calls suggests a desire to re-enter (buy) the equity markets. We are in a similar dilemma to March. Stock (equity) prices have increased by an almost astonishing 58% and now folks want to buy. We're, however, watching our indicators for information suggesting we reduce equity exposures.

By the addition of tactical elements to both the equity (prospect) and bond (liquidity) side of our clients' portfolios, we have taken on the responsibility of massaging the allocations as our work and metrics suggest. We have not taken to short-term trading or market timing. We have developed a series of metrics and charts and studied history to give us an informed view on the times when the markets seem to be significantly over and/or under priced. These viewpoints do not suggest knee jerk type reactions, but rather suggest subtle asset allocation changes from time to time. As examples – our equity pressure-valve remains at full throttle (for now); our fixed income (or liquidity) tact was to purchase significant interest in a high-grade, liquid, corporate (credit) bond fund in June (which we very intentionally still hold).

These tactical aspects of our work do not suggest that we should abandon diversification as an extremely important element of all portfolios. Further, they do not suggest complete abandonment of long-term investing and the dominance of equity (prospect-based) allocations in most portfolios. And, they certainly do not remove the essential concept of funding anticipated cash-flow needs with reasonably low volatility (liquidity) holdings.

The flexibility suggested by our tactical elements does allow us to lean our portfolios in the directions indicated by the measurements and analyses. Our timing will likely not be perfect. We are trying to manage risk, not create more of it. We will not be making one move on Tuesday and another on Thursday – these tactics will be instituted in quarters and years, not days and weeks.

So what are these measurements or metrics? On the equity side, we are particularly interested in something called the "Q" ratio (developed by James Tobin at Yale), and sometimes referred to as Tobin's Q. This ratio compares the stock market's valuations to the aggregate appraised value of corporate assets. Another measurement that considers equity values is the "Cyclically Adjusted Price-Earnings" ratio (CAPE) developed by Robert Shiller (also at Yale). This fraction looks at the relationship between aggregate stock prices and company earnings. And, we look at the yield (interest rate) differential between three-month Treasury bonds and ten-year Treasury bonds – this indicator gives us an idea of expectations of future economic activity.

On the liquidity side we look at a number of indicators, but maybe most notably we compare the current yields (interest rates) of various segments of the bond markets (as determined by yield-to-maturity calculations) seeking variations from historical norms. Additionally, we look at the expected or "implied" inflation rate as indicated by the difference in yields on traditional Treasury bonds versus the yields on Treasury Inflation Protected bonds.

I will not go into other important but obscure and obtuse metrics, but invite you to visit us for as much of this as you can stand.

Finally, here's the point: Investing and portfolio management is at its essence the management of a very precarious relationship between return (or expected return) and risk (including variability). The application of the appropriate amount of variability to any portfolio is the primary determinant of return over time. That determination is a function of you and your situation.

Beyond our work described above, we have been very diligently working on new approaches to help make the right long-term allocation decisions. Please come see us to discuss and see these approaches and their implications for you and your portfolios.

May God bless you and yours,

Doug

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