4Q 2019 Market Insights
Never Forget Rule #1!
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Integrated|Capital|Management

"Rule No. 1: Never lose money. Rule No. 2: Never forget rule No.1" – Warren Buffett

When you think about your investment portfolio, what does risk mean to you? I suppose it means something different to each of us. For me, my job is to be unemotional, scientific, if you will, about risk. In that sense, risk means expecting an outcome and, in statistical terms, the degree to which you missed your mark, either above or below that outcome. This is what we refer to as standard deviation. It is a measure that is used in statistics to quantify dispersion. It matters greatly in investing, but not in the manner that I suspect would be the first guess for many of us. It matters because volatility impacts how our wealth compounds.

For most of us, however, I suspect that risk relates to the fear of loss. Humbly I admit that aside from our jobs at iCM, where we are quite good at being scientific, we are also people, and all people have their maximum pain thresholds regarding personal investments, hard-earned dollars, as well as hopes and dreams. In that regard, we can relate to the anxiety caused by wild gyrations in investment values, albeit with an informed perspective that many don't have the luxury of sharing. I would also suspect that for most, what causes the greatest anxiety are spectacular crashes that can appear at a moment's notice and occur in the short-term. These are events that are sensationalized by the media, further compounding the fear in each of us. I don't want to suggest that they don't matter, because they do. Anything that keeps our clients up at night matters. However, the manner that these events matter has very little to do with disrupting your long-term plan, if your plan is sound. Where these short-term events matter is in influencing behavior, or if your plan isn't sound.

The title of this quarter's Market Insights is obviously a tongue in cheek play on a famous Warren Buffet quote *"Rule No. 1: Never lose money. Rule No. 2: Never forget rule No.1."* Funny, yes, but in the short-term a virtual impossibility for most to generate a return sufficient to meet any long-term goal and, at the same time, never experience a loss. No matter what you do, with even the most diligently crafted portfolio and strategy, there will be ups and downs in the short-term. What I want to address has nothing to do with the short-term and everything to do with the long-term, which we will define as a ten-plus year investment horizon.

What if I told you that normally sound advice, scratch that, great advice to be a buy and hold, long-term investor can backfire? It can, in a big way. It has backfired before on several occasions and we have every reason to believe that we may be staring at another one of those occasions right now. To us, the greatest risk to a portfolio is the risk of a permanent impairment of capital by buying, owning, and diligently holding any asset that is meaningfully overvalued…a bubble. The consequences to investment portfolios are not only disruptive, but can be devastating, depending on the size of the position and the length of time required just to recover your principal.

Do the Ups & Downs Matter?

Before we get into the meat of our topic, allow me to speak briefly on volatility. Most of us know that bad investor behavior, such as performance chasing and market timing, is destructive. I will show you momentarily how the opposite, buy and hold, can be equally destructive in certain cases. But what about run of the mill everyday volatility? Is that unimportant? That is, can I just ride out the ups and downs to the same end? The answer is unfortunately, no. At least not without some consequence. Volatility does matter for all investors and certainly matters for those portfolios with an assigned liability (i.e. those in retirement drawing an income, a defined benefit pension plan, etc.). You see, while hardly intuitive, volatility has a destructive effect on wealth creation. Take a simple example. Over a two-year period, a non-interest-bearing account would produce a zero percent rate of return. A portfolio that increased by 20% then declined by 20% would also have an average zero percent rate of return, yet it would grow to $120 then fall to $96 -- $4 less then where we started. How is it that two portfolios with identical rates of return end at different dollar values? The reason…volatility. The first portfolio had zero return with zero volatility. The second also had an average rate of return that was zero, but fluctuated by 20% each year, causing the $4 deficit. Mathematically, given two identical performing portfolios, the one with the lower risk will compound to the higher ending value. So, is all volatility bad? The answer is no, only uncompensated volatility. That is, wild gyrations without commensurate return. It's the combination that is important to the compounding of wealth.

What Goes Up, Must Come Down!

Since the mid-1970's, the late Jack Bogle and the folks at Vanguard have suggested that, for most, it's best to simply buy the market and let it ride. Is that false? No. It's mostly true with one very important exception…when markets experience asset price or speculative bubbles. Most of us don't have a time horizon that's long enough to ride them out without meaningful consequences. For those who are unfamiliar, an asset price or speculative bubble is one where the price of an asset becomes detached from its underlying fundamentals. For example, in the 1600's the world experienced its first ever (or at least first documented) asset price bubble: the period known as Tulip Mania. The circumstances regarding this, or any speculative bubble for that matter, are truly mesmerizing. In the early part of the 17th century, a formal futures exchange was formed in the Dutch Republic. In particular, tulips were a popular futures contract where one could speculate on the price gain or loss of a tulip bulb. At the time, tulips had become an exceptionally popular luxury item, especially with the French. By 1637, tulips became the fourth leading export of the Netherlands, with the price of a single tulip bulb eclipsing ten times the annual income of a "skilled craftsman." As with most bubbles, this ended quite badly.

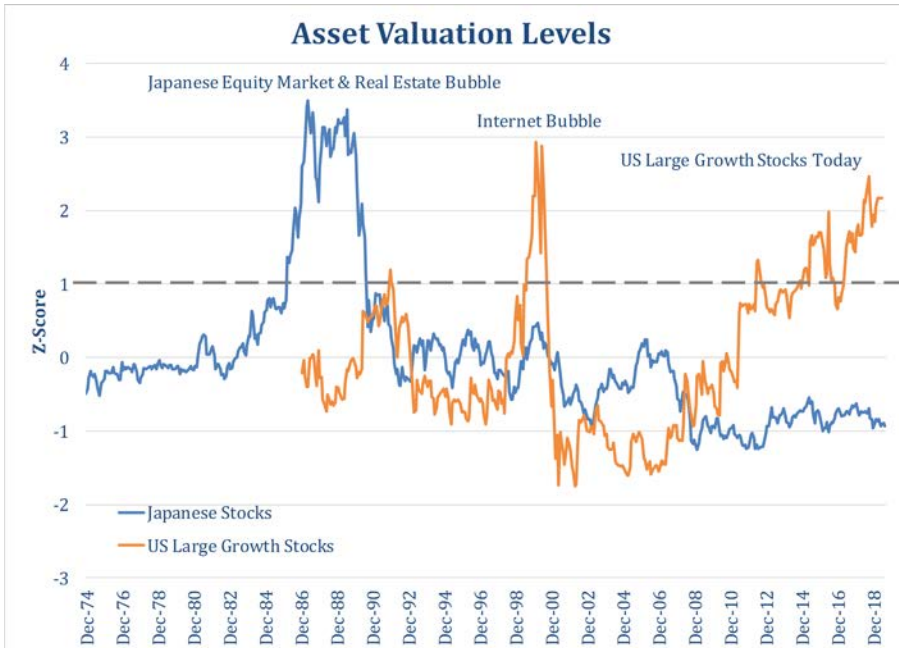
The point, as it relates to permanent capital impairment…was it ever reasonable for a single bulb to trade at a price equal to ten times the annual wage of a skilled craftsman? Of course not. So, if you were among those who bought at or near the market peak, can you simply buy and hold and expect to get your money back? Probably not, since the bulbs had no business trading at that price to begin with. With today's asset price bubbles, the manifestation of a bubble is much less obvious, but the point is the same. Buying overvalued assets is perhaps the greatest risk that any investor can take.

What do asset price bubbles look like today? I'll give two well-seasoned examples, the Japanese equity market of the late 1980's, as well as the Nasdaq at the peak of the internet bubble. During the 1970's and 1980's, Japan came to embrace miniaturization of both technology and machinery, in part because of the oil crisis occurring during this time. For investors, this was the heyday of the Japanese equity market. Beginning in 1971, the Japanese equity market gained an annualized 25% per year over the proceeding 19 years. Within that time period the market gained 40% or more in 6 of those years, during 2 of which markets gained 99.72% and 126.93% in a single year! Stocks, however, weren't the only hot investment of the day, as Japan simultaneously experienced a real estate boom for the ages. At the peak of the market, the emperor's palace was rumored to be worth more than all of the real estate in the state of California combined. Today, as I lay out the facts, it becomes almost comical that anyone could be lured in. But hindsight is 20/20. For those who have lived through asset price bubbles, the story that supports them can be quite compelling.

Sadly, this story, like many others, would soon prove to be too good for too long and would soon come back to bite those who were late to, or stayed too long, at the party, as valuations stretched to epic proportions. The aftermath was so devastating that a buy and hold investor in December of 1989 would not have recovered their initial investment until October of 2015, nearly 26 years later! Imagine how this might impact your financial plan if this were a meaningful portion of your portfolio? Now some might say, I would never own Japan or any other non-US asset as a primary position. This may be true, but what if this were the US market? Aren't we hearing about US domination today?

A similar story could be told about the Nasdaq. Beginning in 1993, with the release of the Mosaic web browser. Access to the internet went from obscure to mainstream in a matter of years. By 1997, 35% of US households were online. As investors grasped for a piece of this new digital frontier and its limitless potential, companies came to market demanding premium valuations and sparking demand for even more high-priced IPOs. Some, who got in early became instant millionaires (sound familiar Bitcoin investors???). Between 1995 and 2000 the Nasdaq appreciated by more than 400%, reaching a peak price-to-earnings multiple of 189x earnings in March of 2000. While it's not all that uncommon for niche markets to reach bubble status, the large market capitalization of many of these companies caused a crossover effect into the broader US equity market, which itself traded at 28x earnings, nearly double its historical average.

Bubble Brewing?



Asset price bubbles form for a variety of reasons, all of which seem compelling as they inflate. The consequences of owning bubble assets can be devastating. Those who owned the Japanese equity market at its top waited 26 years to recover peak value. Similarly, those who owned the NASDAQ at its peak waited 15 years.

Data Sources: MSCI, Russell Investments Group

As the bubble burst, the trickle over effect was much more prevalent in terms of its economic impact. In total, an investor in the Nasdaq in March of 2000 would not have recovered their initial principal, if they were disciplined enough to stay invested, a big if, until January 2015, 15 years later. For the broader S&P 500, while there would be a few brief instances of recovery prior to 2008, it would not be until August of 2011 that an investor in the S&P 500 at its peak would recover their initial principal without looking back. Let me ask two very important questions? How many believe that they truly would have had the staying power to own those assets long enough, without selling, to recover their initial investment? If this occurred for someone in their 40's or 50's what type of an impact might this have on your financial plan?

The Curse of Being the Best House in a Bad Neighborhood

What does this or should this mean to each one of us? With few exceptions among investors, most of us are vulnerable to this today, with striking similarities to the March 2000 debacle. I'm speaking of course about US growth stocks and, in turn, their impact on the broader US equity market. On the growth side of the house, on every valuation metric, P/E, forward P/E, price-to-book value, 5, 7, 10-year CAPE, adjusted P/E and price-to-peak earnings, US large growth stocks are overvalued by an average of 40%. Numerically, this may seem enormous, but statistically this is a fairly run of the mill 1 standard deviation event vs. their own historical valuation levels. Where the valuation overhang becomes particularly apparent, is when you start to make comparisons to other assets that you can acquire at much more reasonable prices, e.g. US value stocks. The broader US large cap market, with an average over-valuation across all the aforementioned metrics at 28%, is a bit better than growth. For both, US large cap growth and the broader US market, those valuation measures that we have found to be the most reliable, unfortunately, show the greatest levels of overvaluation, easily adding 10% to my prior estimates. So, if the point is to not put ourselves in a position of permanently impairing our portfolios by owning overvalued assets that may take upwards of a decade to just get back to where we are today, why do so many of us feel compelled to do it? I suspect that the answer is that most don't realize the risk. For those investment professionals who do, I also hope that they realize that they are in fact juggling dynamite with their clients' long-term goals and life's work in many cases.

As I began this letter, I spoke to something that to some degree affects all of us. The fear of not meeting financial goals. This is more than numbers. This is not paying for a wedding, a college education, or a retirement that most of us work our entire lives to achieve. Asset price bubbles are difficult to spot because the supporting narrative is usually compelling, until you march one seemingly logical step at a time to a completely unreasonable destination. When you don't march along with the crowd, it's easy to be dismissed as simply overlooking something new…. it's different this time. For us, and for our clients we subscribe to two rules. The first rule is to protect portfolios by being cautious when caution is warranted. The second rule is to never forget rule number one. Thank you for your trust and confidence.

Sources: Wikipedia, Tulip Mania, Japanese Economic Miracle, Dotcom Bubble

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