July 2015

"Predicting rain doesn't count. Building arks does."
-Warren Buffett

A Rainy Day

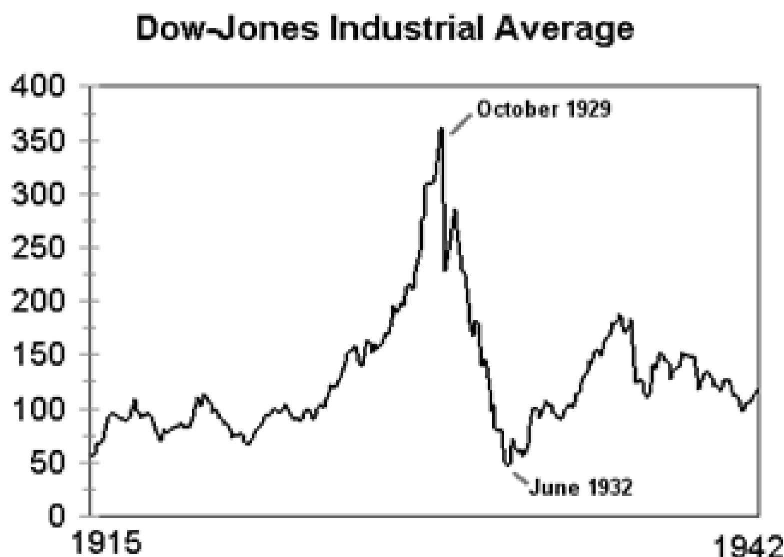
Never is a long time.

When I was growing up, my grandmother constantly used to remind me to keep some money aside for a "rainy day."

My grandparents, having lived through the Depression, had experienced an investor's worst nightmare: the price of virtually everything they owned -- from real estate to their stock portfolio -- collapsed and liquidity quickly disappeared. With a scarcity of buyers in the marketplace, no matter the price, investors who had borrowed money to take advantage of "opportunities" were quickly wiped out.

Those who were fortunate to still have a job (my grandfather was a dentist) were able to survive the crash and make back at least some of their losses. Many others were not so lucky.

From August 1921 until the crash of 1929, the Dow Jones Index rose about six-fold, an annualized return of almost 30%. During that time, the U.S. economy was growing at a brisk pace, aided by the expansion of consumer credit for the purchase of homes, cars and durable goods. As the bull market continued, euphoria took hold, and investors increasingly relied on borrowed funds to buy stocks. They had grown accustomed to a market that only moved in one direction. Even the esteemed Irving Fisher, one of the most influential and highly regarded economists at the time, made the following (now famous) bullish comment just days before the crash: "…***stock prices have reached what looks like a permanently high plateau***." (The New York Times, October, 1929)



source: The Econ Review

Trees do not grow to the sky

At the time of the crash, investors were carrying a record amount of margin debt (money borrowed to invest in securities). When brokerage firms called the loans, clients were forced to sell their shares, regardless of price. Needless to say, many fortunes were quickly lost. Fisher himself lost most of his wealth.

And so goes the history of asset bubbles. As asset prices rise for extended periods of time, memories begin to fade and investors -- with seemingly incurable amnesia -- once again start to believe they have discovered an easy path to generating wealth.

Much of investing is psychological. Is it any wonder why the public buys the most at the top of the market and the least at the bottom?

The only winners during bubbles are those who did not overextend themselves with debt and maintained a healthy balance in their portfolios. Those who buy assets at inflated prices on the way up, usually have no cash on the sidelines to take advantage of steep declines.

A bubble in stocks or real estate?

While we believe the current signposts do not point to an imminent bubble, valuations are substantially higher today than several years ago and there are a number of risks that could cause a market sell-off. The usual suspects include: a Fed rate increase, slowdown in emerging markets, Greece, sovereign debt, valuation levels and the impact of the strong U.S. dollar, to name a few. Canada, in particular, is also starting to feel the impact of the commodity meltdown.

History is usually a good teacher. Past bubbles, be it the Depression, the dot-com collapse or the financial crisis, teach us that investors who maintain some balance and keep some powder dry when risks become elevated, are best able to preserve capital and benefit from a decline. Simply put, they pack an umbrella, just in case it rains.

Going “all in,” as they say in poker, can become an expensive lesson, leaving investors with only feelings of regret and a promise to act differently next time (by adopting a far more balanced asset allocation).

Asset Allocation

When the majority of investors and investment professionals consider their asset allocation, they tend to use a general rule of thumb (such as using your age to determine your allocation to bonds) or select a fixed balance between stocks and bonds at a moment in time (such as the classic 60/40 portfolio). Once chosen, it is often maintained as the status quo for many years without a second thought.

Yet if you think about it, such an approach does not account for the relative valuation among asset classes or changes in interest rates. It is a strategy that essentially assumes everything remains static. As we all know, in the real world, stock prices often move independently from bonds. Therefore, there are times when stocks become far more attractive, both compared with historical valuations, as well as relative to other asset classes. Additionally, as markets become increasingly expensive or at times of heightened risk, cash becomes more attractive.

The most intelligent piece we have ever read on how to navigate asset allocation comes from Benjamin Graham, (Warren Buffett's mentor and college professor) who wrote about the subject in his book “The Intelligent Investor.” Graham advocates that which is seemingly obvious, but his advice is ignored by much of the investment industry, as it goes against the very human nature that produces market bubbles in the first place. To paraphrase, Graham suggests using a balanced allocation as a baseline and to shift the allocation (within a range) to match changing

market conditions and capitalize on fluctuations. That is to say, as an asset class becomes relatively more expensive, investors should shift their weighting toward other asset classes. After all, why should investors force themselves to hold a fixed allocation of an asset class that has become far less attractive than others?

This is referred to as dynamic (or tactical) asset allocation. By always maintaining *some* balance in an investment portfolio, one can tilt the allocation toward asset classes that represent better value. For example, in the current environment of rising equity markets and elevated risk, it makes sense to maintain some liquidity.

That said, many investors do not like holding cash or lower yielding investments in a rising stock market. The pain of potentially missing out on greater returns is too high. How often did we hear from clients in the late 1990s that we should have bought Nortel, notwithstanding the absurd valuation? More times than we care to remember. Yet in every cycle, too many investors forget the lessons of the past and repeat the same mistakes.

High Yield Bonds

A review of the high yield bond market and our high yield fund is available here: High Yield Quarterly.

Final Thoughts

The recent meltdown of the commodity sector probably reflects not just weaker Chinese demand, but also an unwinding of speculative positions. This is an indication of how quickly investor sentiment can shift. It was only a few years ago that the major Wall Street firms were predicting that oil was in a long-term bull market, with analysts producing the usual charts to support that thesis. Many pension funds concluded that they had to include an increased weighting to commodities in their asset allocation.

In this low yield environment, the allure of being fully invested in equities is powerful. However, history teaches us that one should always maintain some discipline. A prudent approach to asset allocation should always involve monitoring and rebalancing a portfolio to suit market conditions.

Given the level of risk and steep valuations in the current market environment, an asset allocation that includes some level of cash and/or bonds is warranted. My grandmother would have agreed.

As always, we welcome the opportunity to discuss our outlook and investments with you.

Sincerely,

Lorne Steinberg
President

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