



INVESTOR INSIGHTS – THIRD QUARTER 2017

Think Twice

If you go to the dictionary to get an understanding of the term “Think Twice”, you will find these definitions,

- To consider carefully whether one should do something.
- To be cautious about doing something.
- To weigh something carefully.
- To review one’s options.

In his book *Think Twice*, Michael J. Mauboussin argues that it is human nature to simplify problems, preventing us from making sound judgments when confronted with complex problems. Investing is a complex problem, and from where we sit, the biggest mistake investors make is framing investment decisions in an unreasonable timetable. So, even when we consider our options carefully, when we are cautious, we can still miss the mark if our timetable is off.

You may be familiar with The Capital Group, a California investment firm founded in 1931 with 28 offices in 16 countries. They manage a group of funds called the American Funds and are one of the largest investment firms in the world. They have a new ad campaign with a powerful message to investors. It says, “Some people hope for a good year, American Funds prefers good decades.”

We agree, decades are reasonable timeframes for measuring investment advice, but there is a problem with using decades as the proper timeframe, namely, clients. All our clients want updates more frequently. Investors today have access to more data, get more sound bites and more information than they ever have so convincing investors that annual, 6-month, or sometimes even 3-month time frames are way too short can be a difficult task. But you must ask yourself realistically, “thinking twice” about it, what you can deliver to clients; you cannot deliver excess returns consistently within short time periods.

The history of our markets reflects the instincts of investors to follow whatever the current trend might be, and markets historically have gotten dramatically overpriced and underpriced based on investor sentiment. In the 1990’s tech did well, and then in the late 1990’s, 1998 and 1999, tech controlled the market. In 1998 the top 12 stocks contributed all the return of the S&P500. In other words, the S&P500 was up 28.6% while the S&P488 was flat. We thought that performance couldn’t be sustained until we saw what happened in 1999 when the total return of the S&P500 came from the top 7 stocks.

Unfortunately, this is normal behavior after long rises in stock prices. The same phenomenon existed in the later 1960’s and early 1970’s with a group of stocks called the Nifty Fifty. These were supposed to be one-decision investments; one could safely hold them for decades. The problem was that 1973 and 1974 saw the

Nifty Fifty fall more than the market, just as the top 12 and 7 stocks from 1998 and 1999 fell in the 2000-2002 period.

The poster child stock for this one-decision investing phenomenon in the 1998-1999 period was Microsoft, a great company. Our job, though, is not to identify great companies but great investments. If one bought Microsoft on the first trading day of 1998, the price was \$16 per share, and by the end of the next year, 1999, the price was \$48. Investors were euphoric, but here is the problem. Microsoft peaked at the end of 1999 at \$48 and one had to wait until September 30, 2015 for the price of Microsoft to reach \$48 again. This was 15 years and 9 months of no appreciation. Even if one bought that stock at \$16 on the first trading day of 1998 and calculated the total return after tripling the investment when the stock hit \$48 on September 30, 2015, the annualized return was 6.38%, not the worst return possible but certainly not reflective of a thoughtful investment thesis.

**Thinking twice and considering reasonable timeframes are critical to investment success.
So why do investors get caught up in the wrong timeframe?**

The amount of information, or at least investment sound bites, people hear confuses them and who can blame them? When they hear that their 6% or 7% or 8% return for the first six months of 2017 could have been 14% just by investing in EAFE, they feel as if they missed out. They hear about someone who made the shift from the S&P500 to EAFE at the beginning of the year and, whether any prognosticator did or did not make this recommendation, some will say they did. Being deterred from their investment goals by short term “wins” can be a costly distraction in the long run. Our job is to help investors see beyond the fever of the moment to best achieve their long-term investment goals.

There are two biases that investors can have that lead to bad investment decisions. The first is called historical bias, which is a way of rewriting history by believing whatever trauma occurred was not as bad as it really was. Over the last 17 years there have been two dramatic declines in stock prices. From 2000 to 2002, the S&P500 fell -37% and from November 2007 to February of 2009, the S&P500 fell -50.9%. We can say with certainty that we have not forgotten either of these declines in spite of providing clients with significant outperformance during both periods. But, 15 years after the first decline and 8 years after the second, many investors fall victim to recalling those periods as less painful than they were.

The second bias goes hand-in-hand with historical bias and is called present bias. Present bias is the belief that the good things we are experiencing today will continue for an extended period. So, envision the mindset of investors who remember 2000-2002 and 2008 as really not so bad. Then, if we combine that reference with a belief that the good things we have today will be with us as far as the eye can see, we have a problematic combination that leads to unrealistic optimism without any thought of other possibilities. No thinking twice!

Today we hear that low inflation, low interest rates and high PEs will be with us for the foreseeable future. Maybe they will, but what if things change? What if rates rise or inflation rises or PEs decline? What will happen to your portfolios? Have we assured our investors that we are “thinking twice”? Have we educated our investors on the importance of doing so?

**So, what about our recommendations?
Have we thought through them twice?**

Let's review them by asset class.

Our equity strategy focuses on high and rising income in the form of dividends. You have seen our analysis of the Jeremy Seigel study structuring the 500 based on which companies contributed the most dollars to the dividends of the S&P500. The results show two things. First, since the inception of the S&P500 this methodology would provide 22% higher return than the index. Second, it shows that the S&P500 has long periods of outperformance of this dividend-based strategy but, over time, the dividend strategy prevails.

We use a variation on this theme employing world-class managers to implement our strategy. We have underperformed the very high return periods, outperformed the low and negative return periods, and over the last 17½ years achieved a return of 8.3% versus the S&P500 of 4.8% with up capture of 90% and down capture of 75%.

Today we have high PEs, and our strategy underperformed the S&P500 in 2013-2015. While we have no way of knowing if the chasing of high PE stocks that led to our underperformance in those years will continue, we do know that every time that happens it ends poorly. We also know that high quality, growing dividends stocks outperform over time and especially in difficult markets. So, we are very comfortable that we have thought this through twice.

Our fixed income strategy focuses on the very low current yields in the bond markets. History provides us with a good guide for this period. The last time rates were this low was the 1940's, and the total return of the 10-Year Treasury for that decade was 2.4% annually. This was followed by the 1950's when the 10-year period showed an annualized return of 0.8%. The annualized return of the total 20-year period was less than 2%.

This is where we are headed, not opinion but a fact. The opinion is when, and we do not pretend to know the answer to that question. But ask yourself the same question we ask: Can you solve your client's investment needs with these types of returns? We think not, so this is our logic for thinking through our recommendation to dramatically reduce your exposure to fixed income, and yes, we think this is thinking through the fixed income question twice.

Our Alternatives recommendation focuses on firms who manage broadly diversified ETFs invested in stocks, bonds, commodities, hard assets, real estate and currencies. These portfolios have achieved standard deviations of 7% or 8% depending on the period studied. This level of volatility is higher than the bond market, so we recommend replacing bond exposure as well as equity exposure to add this asset class, 2/3 from bonds and 1/3 from stocks.

We have confidence these managers will deliver on the level of vol, so the question is what will the returns be? Although we are very optimistic that we will get an attractive return, we do not know. But it is most reasonable to assume they will be higher than the future returns from bonds, and that is our logic for "thinking twice" about Alternatives.

Investing is Tough

Yes, it is true that investing is a difficult business, and anyone looking for certainty will be sorely disappointed. In addition, there are all kinds of absurd ideas being passed off as good investment theory, and they are simply explanations of what is working today. Good investing requires a thoughtful, long-term approach, but that does not mean that living through periods when that thoughtful approach is underperforming is easy. It may be part of everyone's investment life, but it is tough. And, that is why we need to "think twice".

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