GVA Newsletter

October 2019

Whipsaw

"The four most dangerous word in investing are: This time it's different." Sir John Templeton

A recent article in *Barron's* October 11th issue caught our eye titled "Harvard and Yale Missed the Stock Market Rally and Here's Why." To us this article stands out for three reasons: first it highlights the tendency toward the end of bull markets to chase returns and in this market in particular to emphasize investing in passive strategies. Second it highlights the need for financial publications to come up with content, that critical or negative content gets more readers, and magazines and papers avoid criticizing their biggest advertisers, which are mutual fund and ETF companies. So, Harvard and Yale which invest in less traditional assets are easy game. Lastly, it completely misses the central point of what is going on in the financial world today and what these endowments are trying to achieve for their constituents. We have been here before.

In 1980 pension managers maintained very low market exposure because the major averages made no progress for the previous 14 years, 1966-1980, and there was a question about whether investing in stocks at all was in keeping with a fiduciary standard. Twenty years later, after a record run in stocks, the emphasis was on investing in stocks, particularly tech stocks, just before the tech heavy Nasdaq fell 80%. Alan Greenspan at the time declared that we were in a "New Economy" that called for changing the way we value companies and those arguing for diversification were looked at as missing the boat. In 2007 we were told that real estate was different and were not subject to wide scale declines. Equities had recovered all their losses from 2002 and it was "obvious that everyone should just buy and hold". Ben Bernanke told us that "subprime lending was contained" just before Bear Stearns unraveled and we experienced the "Great Recession" of 2008.

Now here we sit after years of trying to stimulate the global economy through printing debt and we have not generated meaningful growth in the economy. Global Central Banks have created $22 trillion in new government debt since 2003, global corporate debt is up by $35 trillion, a 92% explosion since 2007, we have had a massive tax cut for corporations and yet we can't get GDP growth to move past 2.7%. Through aggressive central bank policies, we have inflated prices in stocks and real estate, but we have more failing IPO's than 2000. Global stock markets are at or near all-time highs, unemployment is at record lows and yet the Fed is cutting interest rates and engaging in more stimulus. Why after 10 years is it still necessary to stimulate? While all of this is going on it feels like investors are thinking about what returns they may have missed by not owning more stocks and are looking to the favorite growth plays and passive index strategies.

The smart money, such as high net worth investors, endowments, and storied value manager Warren Buffett, are raising cash. Buffett's firm has a record $122 billion in cash, 60% of the value of his publicly traded securities portfolio, according to *Markets Insider*.

There is no way to know for sure when the market will top or when the next recession will begin. But there is plenty of evidence that risk is high and that investing in equities will not likely be the surest path to reach your goals over the next 7 -12 years using today as the starting point.

Rather than worrying about beating an arbitrary benchmark which has had two 50% declines in the last two decades, we think it makes more sense to understand the needs and goals of the institution or individual. Those who chase returns after a ten-year bull market because they fear having underperformed, will likely feel even greater pain in the next, inevitable down cycle. Please read on as we share some background to the issues we have highlighted.

Given the amount of content we have to share we are going to focus this letter on equity markets and the next newsletter on updating the debt and interest rate markets.

Thank you for reading,

Matt and Tom

Executive Summary

Invest Looking Forward Not Backward:

- GMO's 7 year forecast and a little background on their track record and experience from 1999.
- John Hussman's forecast. In 1999 Hussman forecast an 80% decline in the Nasdaq. Today he expects a 50-65% decline in the S&P 500 if markets don't overshoot on the downside.

Low Interest Rates Don't Justify High PE's - Perhaps one of the most misleading arguments for equities.

The Value of Cash - When every asset is distorted by debt, cash has optionality. A report form Financial Times shows that High Net Worth Investors' largest position right now is cash. It is also the largest position of Warren Buffett's Berkshire Hathaway.

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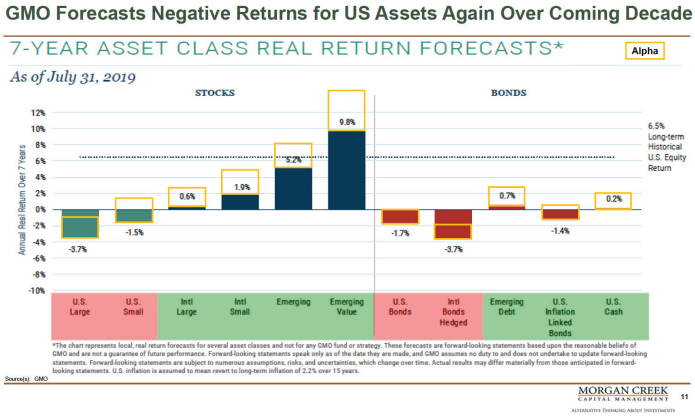
Whipsaw

Invest Looking Forward Not Backward

Below is the updated Seven Year Asset Class Real Return Forecast from GMO. GMO makes this forecast based on valuation metrics that have proven over time to be good estimators of future returns. As Warren Buffett likes to say, in the short run the market is a voting machine, but in the long run it is a weighing machine:



What you may notice is that their expectation is for U.S. stocks (and U.S. bonds) to lose money for the next seven years.

To provide some historical context, below is a chart based on the forecast GMO published in 1999 and the results ten years later, because at that time they published a ten-year forecast.

2000 GMO Forecasts Reflected US Valuation Stupidity, Negative Returns…

Exhibit 1
Performance of GMO Asset Class Forecasts for the Decade Dec. 31, 1999 to Dec. 31, 2009

Asset Class	Estimated Rank	GMO 10-Yr Forecast Dec-31-99 (% Real Return/Yr)	Actual 10-Yr Return*	Actual Rank
U.S. REITs	1	10.0	7.4	3
Emerging Market Equities	2	7.8	8.1	1
Emerging Country Debt	3	6.1	7.5	2
U.S. TIPS	4	4.3	4.9	4
Barclays Capital U.S. Gov't. Debt	5	3.8	3.5	6
International Small Cap	6	3.4	3.5	7
Foreign Bonds	7	3.0	3.9	5
U.S. Small	8	2.5	2.3	8
U.S. T-Bills	9	2.1	0.3	9
EAFE	10	0.4	-1.4	10
S&P 500	11	-1.9	-3.5	11

Correlation of rank order: 93.6%
Probability of picking same or better rank order randomly: 1 in 550,000

* Actual compound annual real returns are for the period 12/31/99 to 12/31/09.

The accuracy of past predictions does not guarantee that current or future predictions will be accurate either with respect to the ranking of asset classes over a 10-year period, the absolute levels of return, or results over shorter time periods. The accuracy of the forecast rankings and returns in the asset class forecasts generally varies from period to period.

Source: GMO

Source(s): GMO

MORGAN CREEK CAPITAL MANAGEMENT
ALTERNATIVE THINKING ABOUT INVESTMENTS
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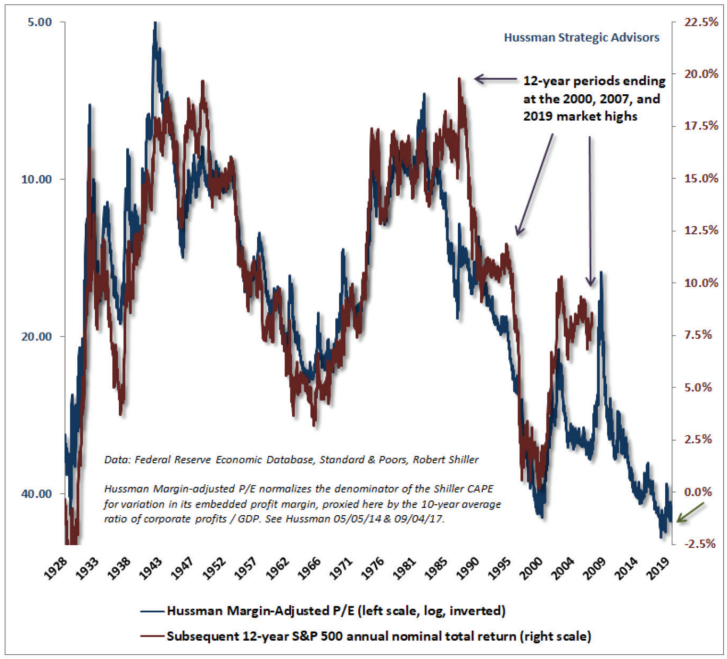
There are several things that make this interesting. One is the accuracy with which they ranked various asset returns, a 93.6% correlation with the rank order, and the footnote that points out a 1 in 550,000 chance of picking that order randomly. GMO has maintained over time a remarkable ability to forecast returns of various asset classes over time.

What is also remarkable is the amount of pressure they were under. In 1999 few investors wanted to hear that investing in stocks was a bad idea. Everyone wanted more of what had just done really well. GMO was not giving them the news they wanted to hear and the firm watched 50% of the their assets under management leave. Jeremy Grantham somewhat famously said at the time "I would rather have 50% of my client's assets leave than loose 50% of the value of my clients' assets."

Mark Yusko at that time was sharing this information with the Board responsible for managing University of North Carolina's endowment. They did not want to hear it. He was advocating for the reduction of equities and the inclusion of more alternatives, such as hedge funds.

Look again at the chart. The forecast was for U.S. Large Cap Stocks to lose 1.7% per year for the next 10 years. The actual performance was a loss of 3.5% per year for 10 years which included two declines of roughly 50% in the S&P 500. Today their forecast is for a loss of 3.7% per year for the next 7 years. We think this is worth paying attention to.

John Hussman's forecast is also worth noting. Similar to GMO Hussman forecasts returns over long periods of time. The chart below shows a remarkable correlation between the data he uses to forecast returns and what has actually happened. Currently his methodology forecast negative returns for the S&P 500 for the next 12 years:



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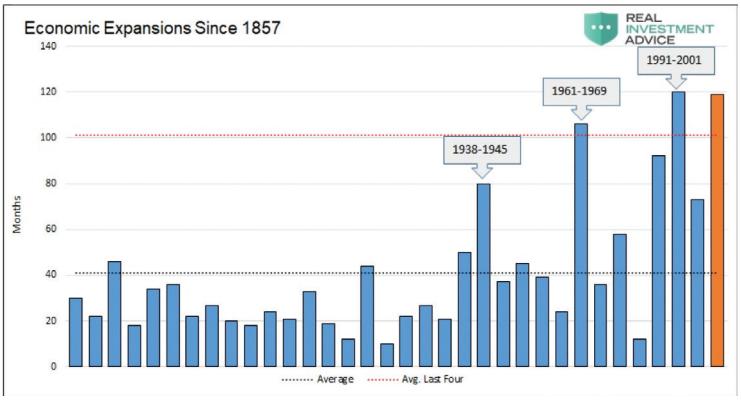
Economic Expansions and Market Patterns

It has been a long time since the market lows of 2009. We are experiencing a weak recovery, but the longest recovery just surpassing the 1991-2001 recovery. The longest previous recovery was 1961-1969. Both were followed by more than 10 years of no progress in equity markets.



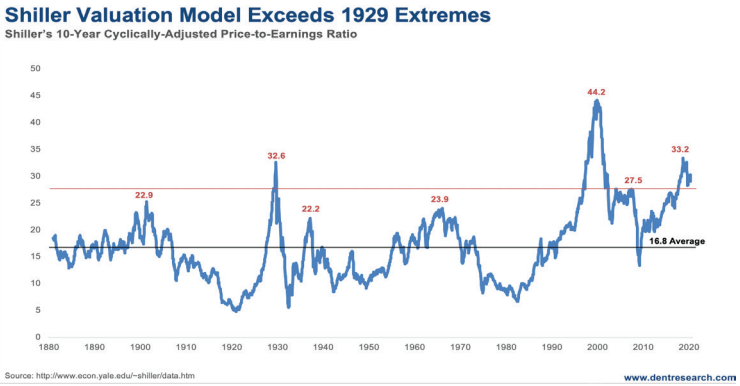
If we look closer at the performance of the S&P 500 since January 2018, we see a market that has essentially stopped making real progress with a series of slightly higher highs and lower lows creating what, in the technical analysis world, is referred to as a megaphone pattern:

Some investors use breakouts to new highs or breakdown to new lows as confirmation of a trend. In this environment this can create whipsaw – the experience of having a market reverse just after giving a confirmation signal. As we write this, we still maintain that we don't know where and when markets will top, but we could imagine a scenario where markets go down below last December's low. That would be a 27% decline. We could also imagine a rally from there back near or above current highs. That would be another "tradable rally". But the ultimate resolution of this market seems likelier, given historical precedent, to be a decline of greater than 50% in the major market averages. For those close to retirement, or for pensions and endowments, that would be a devastating experience.

If we look back to the 1966-1974 experience, it was the third and final decline that had the greatest impact on investors and market psychology. Of course, perhaps this time it's different.

Low Interest Rates Don't Justify High PE's

There is a theory being pushed out there that stocks are not expensive because interest rates are low. But by all historical measurements stocks are still expensive. The Shiller 10 -Year Cyclically-Adjusted-PE is at 28.95, 71% above its long-term average of 16.9. It recently exceeded its 1929 peak. Given that we have been above average since the 1990's except for a brief period in 2008, it is likely that we will go below that average and stay there for a long time to return to the mean. Unless this time is different of course. Take a moment to think about what that would look like. For us it is not that hard to imagine the market completing its long-overvalued cycle much the same way it did in the 1970's and spend some time trading below its historical average – just as it did in the late 70's and early 80's.



But back to the interest rate conversation, here is how Gary Shilling puts it in his most recent newsletter "Vulnerable Consumer Spending" dated October 2019:

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"So, don't rest easy, believing that low interest rates make stocks cheap. Quite the contrary, low yields are probably foretelling economic weakness and possible deflation that will dramatically slash corporate earnings and P/Es."

And John Hussman puts it this way:

"Low interest rates aren't your friends: Proposition: Low interest rates don't "justify" elevated stock market valuations. Rather the combination of low interest rates and high valuations simply implies that both are priced to produce similarly low future returns."

Perhaps this is why Harvard and Yale endowments have low exposure to traditional assets such as publicly traded stocks and bonds. Again, we would refer back to the GMO forecast that suggests both U.S. stocks and bonds lose money over the next seven years.

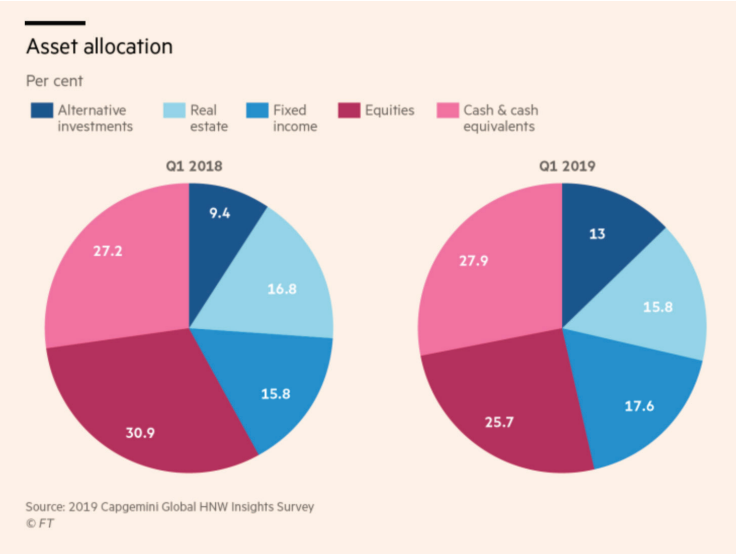
The possibility of a continued rise in stocks remains. We could see a return to the kind of overvaluation we saw in 2000. But that does not make stocks a good investment as much as an avenue for continued speculation. In our estimation, it would just make the downside that much bigger.

High Net Worth Cash Holdings

Alan Greenspan has stated recently that he sees two bubbles: stocks and bonds. Seeing this concern of elevated stock and bond prices, high net worth investors have been opting for cash. Now in some places in the world, like Europe and Japan where clients are being charged negative interest rates to hold cash, this is a pretty extreme decision. But if you refer back to the GMO chart, cash does not look like such a bad asset to hold.

As we mentioned in our introduction, Warren Buffett currently holds $122 billion in cash – 60% of the value of his publicly traded securities portfolio - *Market Insider* August 19, 2019. Now that is a big cash position. I always find it interesting that he will advocate that most people just buy index funds while he focuses on value investing and is willing to hold 60% in cash in an investment portfolio.

High net worth investors – defined as investors with greater than $1 Million in investable assets are currently allocating an average of 28% of their portfolios to cash. Below is a chart for the 2019 Capgemini Global HNW Insights survey as published in the *Financial Times*:



Notice that the breakdown includes 15.8% to real estate, 13% to alternatives, 17.6% fixed income, 25.7% equities and 27.9 % to cash. We think that this is a reasonable allocation, in general, given the state of markets today. It is not "run for the hills and stock up on canned goods." It is simple prudence.

For our part we continue to look for and find opportunities in this market and we hope to spend more time talking about those. Demographic trends continue to suggest that certain areas in real estate can continue to deliver relatively reliable yields in apartments and health care real estate. Energy transformation is currently emphasizing natural gas but is moving quickly toward renewable energy on a much larger scale. Demand for infrastructure improvements in the U.S. and beyond are huge and a likely focus of future efforts to stimulate the economy. Innovation will continue and areas such as AI, electronic vehicles, 5G and others exciting developments will provide great growth opportunities.

Being aware of the larger risks and the cycles that we are find ourselves in does not have to preclude the understanding that economies do tend toward growth and change, with disruptions along the way.

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Create Your Own Economy Corner - Living Through the Toxic Environment

"I like things to happen and if they don't happen, I like to make them happen. " - Winston Churchill

It's a little kooky out there right now. But think about what it was like when Winston Churchill was leading Great Britain against the onslaught of German aggression in WWII as you read the quote above.

One of the biggest obstacles to reaching our goals is distraction. When we feel like we are being distracted from our important goals, we feel stress. When the source of the distraction is also stressful, we feel doubly stressed.

It used to be that if you liked sports, you read the sports page in the morning, got caught up with the major stories and stats, and then put it down until the next day. It took your mind off of work and gave you something to discuss with people at the water cooler or the bar after work that was uncontroversial. But now even sports information is being updated constantly throughout the day on our TVs, laptops and cellphones. And for some it's not just information for fun, it's gambling on DraftKings and/or Fanduel. So, we have 24hr access to data and gambling, an absolute field day for ADHD and addiction prone kids and adults.

But what is more broadly taxing our population currently is the 24hr cable news cycle that has the rhetoric turned up to 11. Deepak Chopra defines stress as "The perception of threat." Whichever side of the political spectrum you find yourself on, we are being told that if the other side wins then life as we know it is over. We all feel it. But how do we deal with it?

I am a believer that an engaged, informed populace is key to a functioning democratic republic. But I also believe that overconsuming news is a distraction from the achievement of your goals, so it has to be managed and put into context.

When we grow, our influence grows, and it is natural to think in larger circles. We start with ourselves, then our families, then our communities and then what we think of as our community expands. It may be that what bothers you in the current environment is that you are not doing enough to impact something that is important to you.

Ignoring the reality of our time may not be the solution. Rather, managing what you are focused on and differentiating between taking powerful action toward your most important goals or just being in distraction can help reduce stress. Put another way, if the world of politics is bothering you maybe you should turn off the TV, or maybe you should join a campaign and do something about it. That is for you to decide in the context of your personal goals.

Daniel P. Keating PhD. writes in Psychology Today that the three ways to reduce the negative impacts of stress are to focus on connection, consciousness and control. Connection means social connection, having mutual support through family or other means. Consciousness is about being mindful and present. Recognizing the nature of the environment and what is creating the stress and taking time away through meditation, a walk in the woods or whatever works for you. Control is about taking action. When we take positive action toward our goals we feel more in control of our lives.

"I know of no more encouraging fact than the unquestionable ability of man to elevate his life through conscious endeavor." Henry David Thoreau

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