Monday, February 22, 2016

LESSONS LEARNED
(HOMAGE TO THIRTY SIX YEARS OF KNOWING MORE THAN ALL OF US)

- It is very difficult to beat the market over the long term. Not just very difficult, but extremely so. You overlook this lesson at your own peril.
- You may find that you can't resist trying to beat the market. If so, indulge your compulsion without risking your entire portfolio in the process.
- The best you can hope for is beating the stock market by an annualized average of just a few percentage points, but given the risk associated with doing so you might as well not even try.
- The last timeless lesson I want to leave you with is that short term performance is mostly noise.

Once upon a time, we published a financial newsletter that focused on the ranking of and the building of model portfolios of mutual funds. We eventually decided to spend all of our time managing our client's money. Honestly, managing money is more fun. But the publishing business was missed, because I was competitive. As a money manager, our regulators do not allow us to tout or brag about returns or market calls. But in the newsletter, it's out there for everyone to see. And that spoke to our competitive spirits. And we were able to check ourselves against peers every month in the Hulbert Financial Digest, a newsletter that tracked financial newsletters.

I was young, and eager to showboat. It was, at that time, easy to do so; but only because everyone compares returns to the large cap US stocks that make up the S&P 500 index. Back then small caps and international stocks were beating the S&P 500, so being overweight in those areas juiced relative performance. It's easy to beat the market when 1) the market is defined by the S&P 500, and at the same time 2) the S&P 500 is underperforming so many other asset classes. But, like I said, I was young. In short time, we came to learn important lessons; lessons that the revered Mr. Hulbert recites not as opinion, but as immutable fact.

The publisher, Mr. Mark Hulbert, did more than just run the numbers. He observed. I guess you can say he ran the numbers on the observations. After 36 years he recently published his last HFD. Thirty six years of not just any ole observation of the markets, but observation of hundreds of money managers posting their returns, strategies, comments, opinions, etcetera, by way of financial newsletters. Mr. Hulbert has tracked more advisors longer than anybody. ***He knows more than most of us when it comes to lessons about managing money. In his final newsletter, he shared these lessons, and we should all heed them.***

Mr. Hulbert writes "I am devoting this issue's lead article to summarizing the timeless lessons that have emerged from the 36 years the HFD has been tracking the investment advisers. I am confident that, even if the HFD were to continue publishing for another 36 years, these lessons would remain just as true."

Lesson #1

"The first, and perhaps most important, lesson to draw from the HFD's database is that it is very difficult to beat the market over the long term. Not just very difficult, but extremely so.

I am hardly the first to draw this lesson, of course. Nor is this issue of the HFD the first time that I have drawn it for you. So you may be tempted to downplay this lesson's significance or even to overlook it altogether. But regardless of whether this lesson is boring or earth-shattering, it remains overwhelmingly true. You overlook it at your peril."

Lesson #2

"The reason to deviate from a long-term buy-and-hold is as much psychological as statistical. You may find that you can't resist trying to beat the market, for example. If so, the psychologically realistic thing to do is indulge your compulsion without risking your entire portfolio in the process."

Lesson #3

"The best you can hope for is beating the stock market by an annualized average of just a few percentage points. This is crucial since it defines the risks and rewards of trying to beat the market. You might conclude, for example, that even though beating the market over the long term is not impossible, you might as well not even try—since what you gain if you win is too small to justify the risk of the bigger losses you will incur if you're wrong."

Lesson #4

"The last timeless lesson I want to leave you with is that short term performance is mostly noise. That means, when choosing an adviser, you should barely pay any attention to recent performance and focus instead on returns produced over many, many years."

BMM'S BOTTOM LINE TO THE HFD'S LESSONS LEARNED

We're all long-term investors until we see short-term losses. It is then that emotion more than creeps in; it floods our brains and makes the rational investor irrational. The goal to investing isn't beating the market's performance every year, or even most years. The goal is to stick to a long-term plan, and only working to mitigate (hopefully avoid) the largest of the stock market shocks, those associated with US recessions. Corrections associated with non-recessions are painful at times, gut-wrenching at other times. But no tools exist to time them. So if we wish to be exposed to the potential long-term returns of the stock market, we have to be exposed to the potential short-term shocks of the stock market.

The Stock Market Has Called Nine of the Last Five Recessions

- There has been much fearful talk that the troubled financial markets are signaling a recession.
- The only thing "calling" a recession is the stock market. Other often used signals of impending recession are not even flashing yellow.

We've heard a lot of fearful talk that the troubled financial markets are signaling a recession. And much of that talk occurred over two days last week by politicians grilling Federal Reserve Chairwoman Janet Yellen on Capitol Hill. The ominous tone from concerned politicians was pervasive, all of them citing recent stock market declines as a seemingly definitive prediction of a looming recession.

Well, apparently they did not read our 2016 Economic Outlook where we wrote:

> *"…for whatever the reason du jour the media assigns to the event, once every three-and-a-half years the stock market will correct by twenty percent. The last time the stock market corrected that much (actually, it was about 19%) was in 2011, so you could argue that we're "due" a pretty big drop. And given that the Fed will be raising rates in 2016 and that we will be confronted with a Presidential election, a drop of the twenty percent magnitude really shouldn't be ruled out. "*

Yeah, I know. Then the argument is "why didn't you get out of the market?" I could copy-and-paste all that rationale from the aforementioned 2016 Economic Outlook, but I'll let you re-read it (but for one thing, the timing is impossible – we speculated/guessed/threw-the-dice and said maybe it would happen after the Presidential candidates were chosen, maybe as late as July. Like I said, the timing is impossible.) The point is that stock market corrections are normal. I'm not saying it's comfortable, I'm just saying it's normal. But it's only normal because there is no recession. For clients, we raised significant cash for 2002 and 2008 because of US recessions, and even a moderate amount of cash in 2011 due to recessionary concerns in some European nations.

We're all for putting on the breaks for stock market declines associated with recessions. But right now, the only thing "calling" a recession is the stock market. The reaction is mostly emotional, but there has been some argument that the "wealth effect" whereby US consumers will buy less goods and services because of lower stock prices given that US stock capitalization has declined some $2 trillion . This is true, but not terribly impactful because a) household assets in stocks and mutual funds rose $12 trillion between 2009 and 2015, putting them $5 trillion above prerecession levels, b) the value of an owner's home have more impact on consumer spending than stocks and according to the Federal Reserve Bank of St. Louis, the median price for new houses sold in March 2007 was $262,500,$205,100 in March 2009 and in December 2015 it was $288,900, and c) consumers' real disposable income is growing and both financial-obligations and debt-service ratios are at multi-decade lows.

So the world is worried that the stock market is calling a recession. However, other often used signals of impending recession are not even flashing yellow. Unemployment insurance claims are extraordinarily low, the unemployment rate is falling and not rising as it does prior to recessions, consumer confidence remains resilient, the bond yield curve remains firmly positive, and energy prices have declined tremendously rather than the spiking that often is the cause for a recession.

But I understand, you want to know when the pain will stop, as do I. There are two theories to this. One theory is that the pain will stop when the final investor gives in to emotion and capitulates (which likely ranges anywhere from literally today to about 1,710-1,760 on the S&P 500, not much lower than recent market lows). The other theory is that the pain will stop when oil prices stabilize. The plunge in oil prices is the proximate catalyst for the stock market selloff. The reasons for that include weakness in emerging markets with whom we trade, regional US weakness where oil is produced, and the decline of the stocks and bonds of energy companies.

Locating stabilization in the oil market is unpredictable, to say the least. Saudi Arabia has been accepting the pain of lower prices and pumping out oil, the thought being that if they can stand the pain long enough it will drive out of business the competing higher-cost oil producers in the rest of the world, including in the U.S. However, it's not just Saudi Arabia that is creating the oversupply. Globally energy companies have been continuing to pump oil, hoping to hold onto market share and praying prices will rise. But now oil prices are well below the average long-run global cost of production, about $32 per barrel of oil. (The average North American shale producer can break even at $68, but as low as $42 in the most productive Eagle Ford region in Texas. In comparison, Saudi Arabia can break even in a range of $10 to $20.) Bankruptcies, mergers, and acquisitions are coming, and production cuts should soon follow. This should be the basis for more stable oil prices as well as more stable financial markets in the first half of 2016.

BOTTOM LINE

We're all for putting on the breaks for stock market declines associated with recessions. But right now, the only thing "calling" a recession is the stock market. Other often used signals of impending recession are not even flashing yellow. Unemployment insurance claims are extraordinarily low, the unemployment rate is falling and not rising as it does prior to recessions, consumer confidence remains resilient, the bond yield curve remains firmly positive, and energy prices have declined tremendously rather than the spiking that often is the cause for a recession.

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DOW

The Dow Jones Industrial Average (NYSE: DJI, also called the DJIA, Dow 30, INDP, or informally the Dow Jones or The Dow) is one of several stock market indices, created by nineteenth-century Wall Street Journal editor and Dow Jones & Company co-founder Charles Dow. The Dow average is computed from the stock prices of 30 of the largest and most widely held public companies in the United States. Clients of BMM may have portfolios that differ substantially from the composition of the DOW and therefore, their performance may vary significantly from that of the Dow. The Dow is used for illustrative purposes only, as one indicator of the overall US economy, and its past, present, or future performance should not be viewed as an indicator or comparison point for BMM client performance.

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For our affiliates' everyday business purposes— information about your transactions and experiences	NO	WE DO NOT SHARE
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Questions?	Call 888-232-6072 or go to www.berkshiremm.com

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