Real life needs active management

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E.Q Trendwatch™

Wise to fear heights

"Bubbles for the most part, are invisible to those trapped inside the bubble."
–Jim Stack, founder, InvesTech Research

November was another strong month for equities. The S&P 500 is now up an incredible 32% (!) in just the last 12 months since the Fed promised to go all in on Quantitative Easing in November 2012. The rebound from the 2009 low, 56 months ago, has been 170% for the US market, making this cyclical bull now stronger than the average bull market since 1932 that gained 164% over 57 months. For those holding balanced portfolios that are not 100% invested in stocks today, it is easy to feel like an underachiever.

But here is a pop quiz question for our readers: <u>how much would the S&P 500 now have to decline in the next cyclical bear market in order to wipe out all the capital gains seen in equities since the secular bear began in 2000?</u>

<u>The answer is that a decline of 25% would wipe out all the capital gains in US equities since 1999</u> and place equity hares far behind cash and fixed income tortoises once more. A decline of 36% would wipe out all of capital gains <u>as well as all dividends received</u>: rendering <u>negative</u> nominal returns <u>for 15 years</u> of risk.

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Hard to believe? Let's do the numbers: Let's start with $1,000,000 of savings invested in the greatly celebrated S&P 500 Index since 1999. (The Canadian TSX has performed worse than the S&P since 2009, having recovered just 79% of its 2008 decline, so we'll use the S&P numbers here as a best returns scenario).

This table shows that the gross gain of remaining perpetually invested through each up and down cycle (*not missing out on any of it!)* over the past 14 years has in fact been drum roll…. **3.2% a year including dividends *(but before any investment costs*).** Moreover, as noted in the bottom 5 rows on this table, **a bear market from here of -36%**would take back all capital gains and dividend income all the way back to 1999.** How confident will all those boasting of their investment prowess today appear then we ask?

	S&P 500 annual return % dividends incl.		Cash impact starting with $1,000,000	
2000	-9.1		909,000	
2001	-11.9		800,829	
2002	-22.1		623,845	
2003	28.7		802,889	
2004	10.9		890,404	
2005	4.9		934,034	
2006	15.8		1,081,611	
2007	5.5		1,141,100	
2008	-37		718,893	
2009	26.5		909,399	*
2010	15.1		1,046,719	
2011	2.1		1,068,700	
2012	16		1,239,692	
2013 YTD	26		1,562,011	
compound annual return	(2000- 2013)			
over 14 years before any fees: 3.2%				
2014/15	-25%	?	1,171,508	
bear market	-30%	?	1,093,407	
	-36%	?	999,687	**
	-40%	?	937,206	
	-50%	?	781,055	

** Note after 9 long years, the starting 1m was worth just 909K by 2009.*

Sure, but how likely is it that we will see a cyclical bear market of -25 to -36% you may ask? The answer: highly likely.

Below is a summary of the cyclical declines with every S&P 500 bear market since 1929. The average bear market decline over the past 84 years has been 40%. The average decline during secular bear phases is greater than 40%, where stocks start from historically high valuations like today: Shiller PE at 25 (56% above mean), Price to Revenue at 1.6 (100% above mean), corporate profits as a share of GDP 70% above mean! All of which suggests stocks at present levels are priced to deliver negative real returns for the next 10 years if bought or held from here.

Table 1 - Last 13 S&P 500 Bear Markets

Start	End	Duration (Months)	Annualized Return	Cumulative Return
9/1929	6/1932	33	-51.5%	-86%
3/1937	4/1942	62	-16.3%	-60%
5/1946	6/1949	36	-10.9%	-30%
8/1956	10/1957	15	-18.1%	-22%
12/1961	6/1962	6	-45.7%	-28%
2/1966	10/1966	8	-31.7%	-22%
11/1968	5/1970	18	-26.0%	-36%
1/1973	10/1974	21	-31.7%	-48%
11/1980	8/1982	20	-16.9%	-27%
8/1987	12/1987	3	-77.1%	-34%
7/1990	10/1990	3	-60.6%	-20%
3/2000	10/2002	30	-23.3%	-49%
10/2007	3/2009	17	-44.7%	-57%
Average		21	-35.0%	-40%

Source: Markets Never Forget (But People Do) - K. Fisher and L. Hoffmans

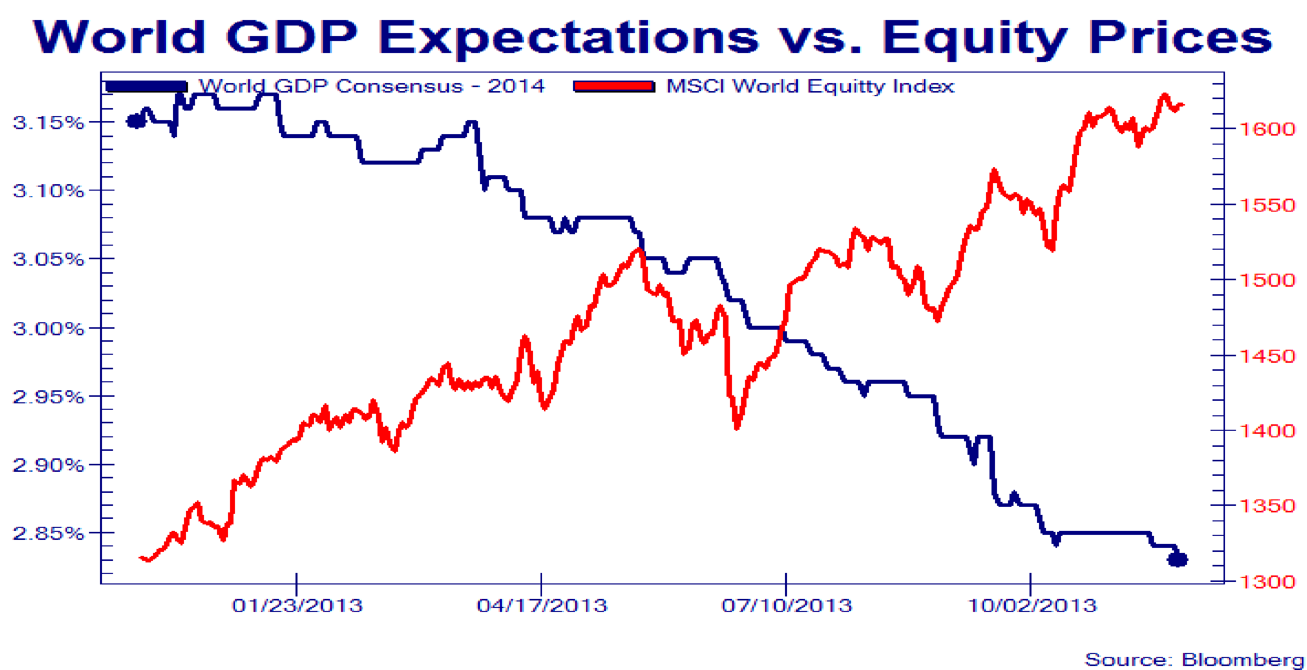
As we digest this numerical reality, it is also important to note that study after study confirms 90% of asset managers, stock pickers and investors fail to capture index returns and have significantly underperformed the 3% a year of the S&P Index - all while enduring incredible capital risk and volatility throughout. Imagine that those of us who have managed to capture 3% a year with low volatility have actually been 98-percentile performers in the investment climate we have worked through since 2000!

For all the bragging and mocking from those strapped to the equity bull today, those of us who have value rules, can take comfort in a little admitted fact: **the majority of those managers/investors *needed* a massive recovery the past couple of years just to try and recoup the even bigger *losses* they had in the 2001-02 and 2008 bear markets. And *in their panic to get back what they lost, most are now stuck on an over-valuation high wire with no net, no protection plan and little likelihood of safe passage from here*.**

Over the past 14 years, investment firms have experienced huge asset turnover as clients have repeatedly fired and fled mainstream managers and advisors. Many are now recently settled in with new managers, thinking they have found a superior strategy and service because their account values have recently been going up again. What they don't realize is that they are actually seated in a different rail car on the same long-always equity train headed straight over the cliff of the next bear market ahead. What nearly everyone misses in these cycles, is that *it is not how much our capital rises in the up cycle but rather how much we lose in the down cycles that is most definitive* of our investment performance over time. And thanks to QE mania over the past 3 years, stock valuations today are now the most expensive they have ever been in history alongside the recent market tops of 2000 and 2007—both of which were followed by 50% price declines each.

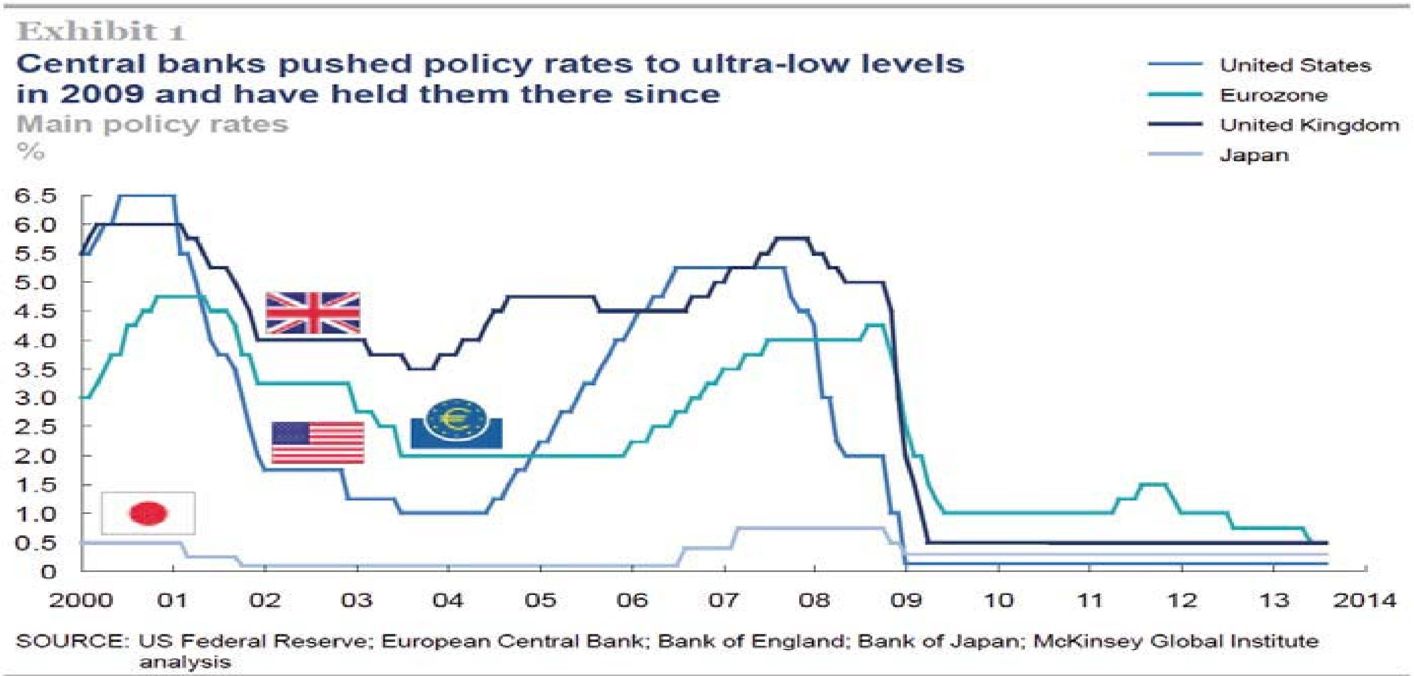
We must remind ourselves that far from losers and underachievers, we at VPIC and our clients today enjoy a rare position of strength as we avoid unpalatable equity risk, with liquid assets, big picture understanding and a plan to buy when lower prices present once more, just as we did last in the 2003-2009 cycle. A unique feature of the next downturn however, is that this time as never before, Central Banks have spent their monetary tools trying to support the weak recovery and have little left to help truncate the next sell off in asset prices. This offers potentially even greater upside for those who can be defensive now and buy at discounts later.

The simple problem with highly valued stocks is that they leave no room for disappointment in economic performance or any other shock. Yet in the real world, periods of disappointment are a naturally recurring phenomenon! This next chart shows how the gap has grown this year between soaring global equity prices (red) and plunging world growth forecasts (in blue).

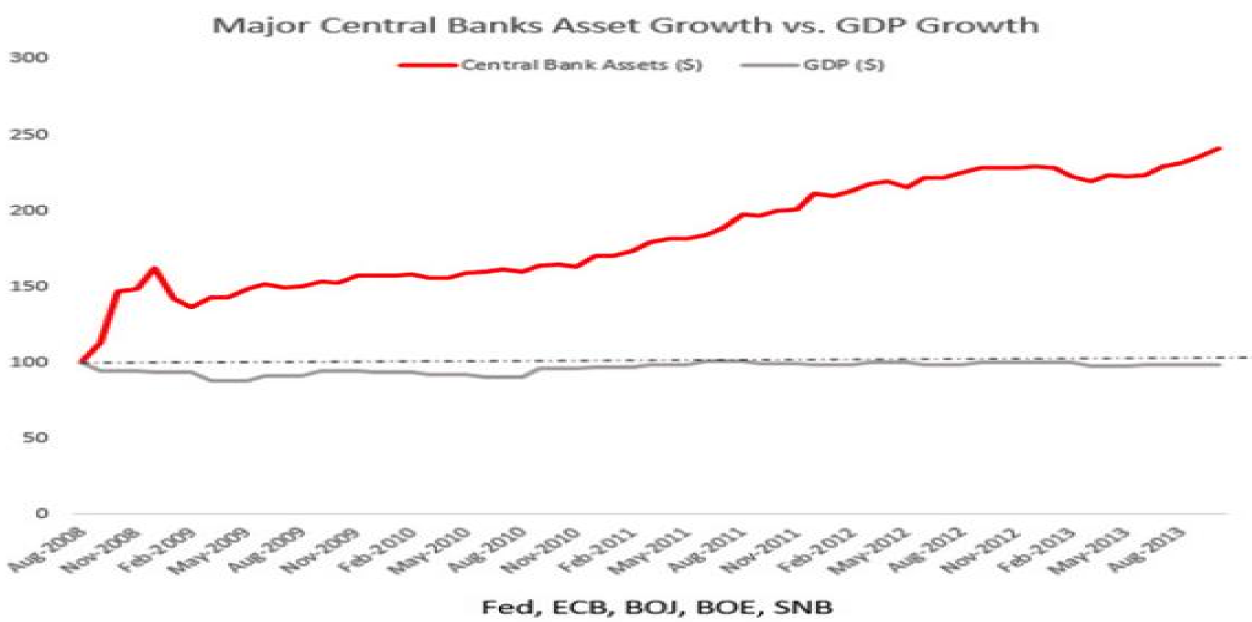


Central Banks can only lower interest rates and buy financial assets *hoping for growth*--they have no other tools in their arsenal. As shown in the next 2 charts:

Global interest rates have already been at virtually zero since 2009—can't do more here.

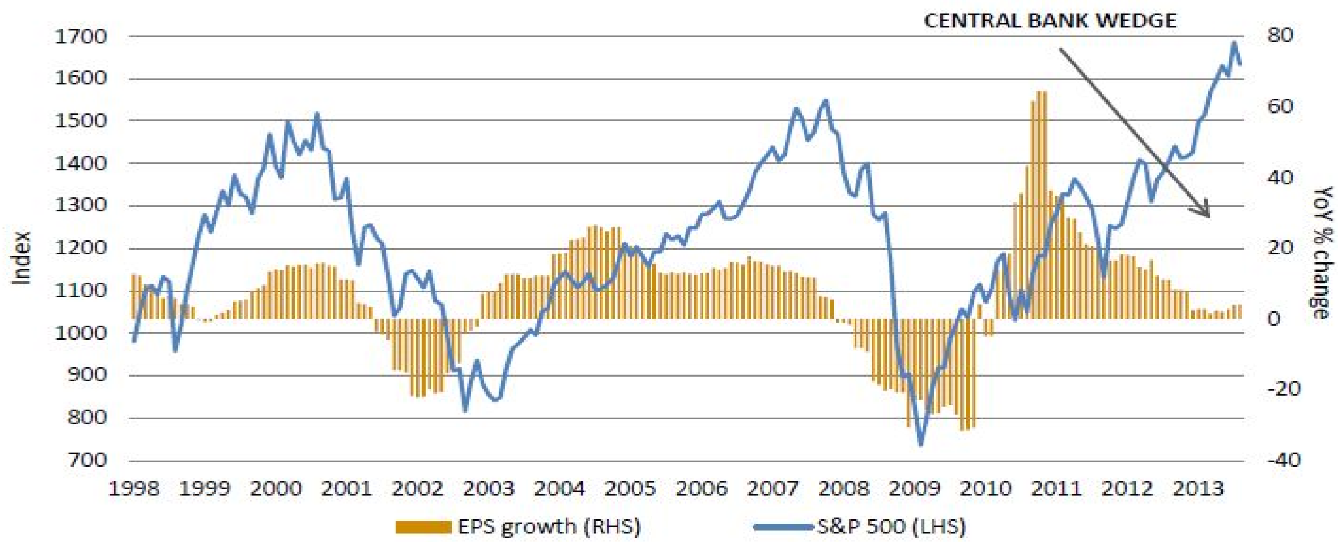


And the US Fed, ECB, BOJ, BOE, SNB have already bought 4.7 trillion of financial assets since 2009 (red line below) but global GDP growth has not revived (grey flat line below).



Fourth quarter earnings forecasts continued to decline this month, with companies preannouncing 10.6 negative for each positive outlook change (the most negative on this ratio ever recorded). Earnings growth has been falling steadily since 2011 (gold bars below), while US stock prices have continued to soar (blue line below).

FIGURE 1: MONETARY POLICY ARTIFICIALLY SUPPORTING ASSET PRICES



Source: Bloomberg as of 30 September 2013

US dollar Index gained on the month attracting global capital inflows. We expect this trend may continue: negative for commodities and S&P earnings. The next breakout test for the U$ Index shown below is $85.

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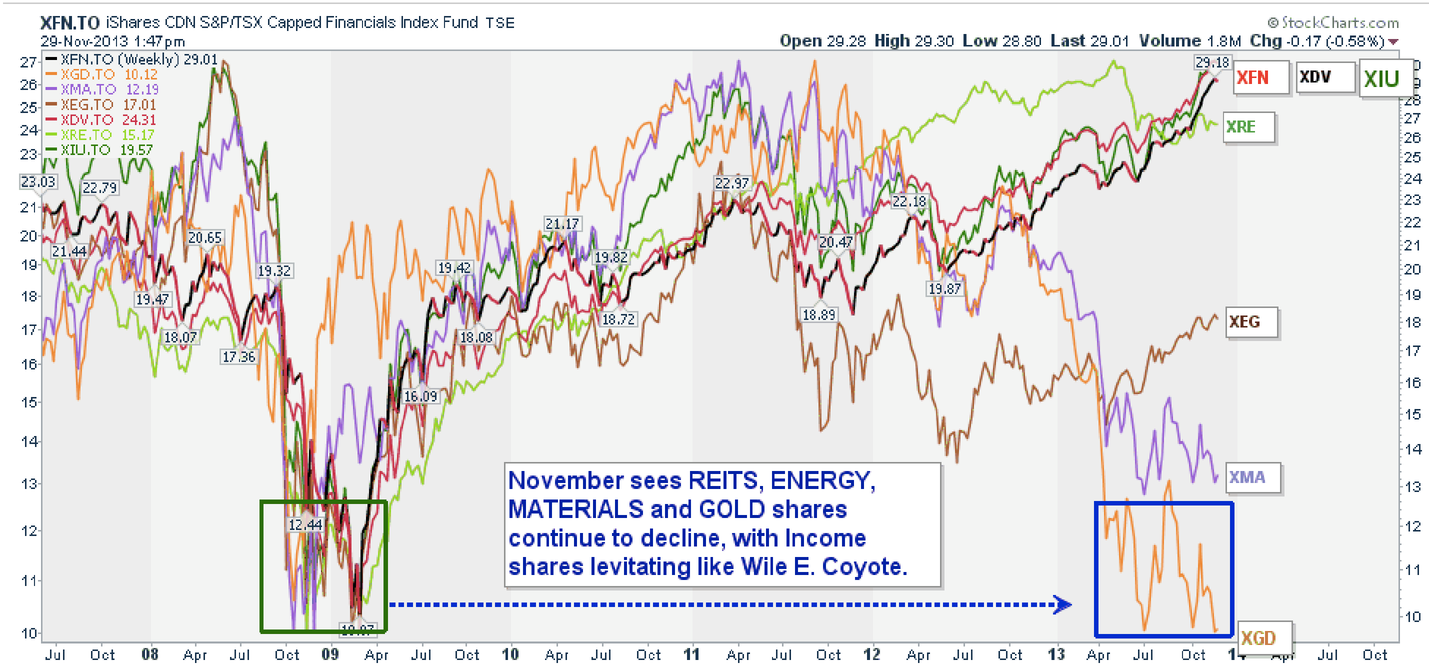
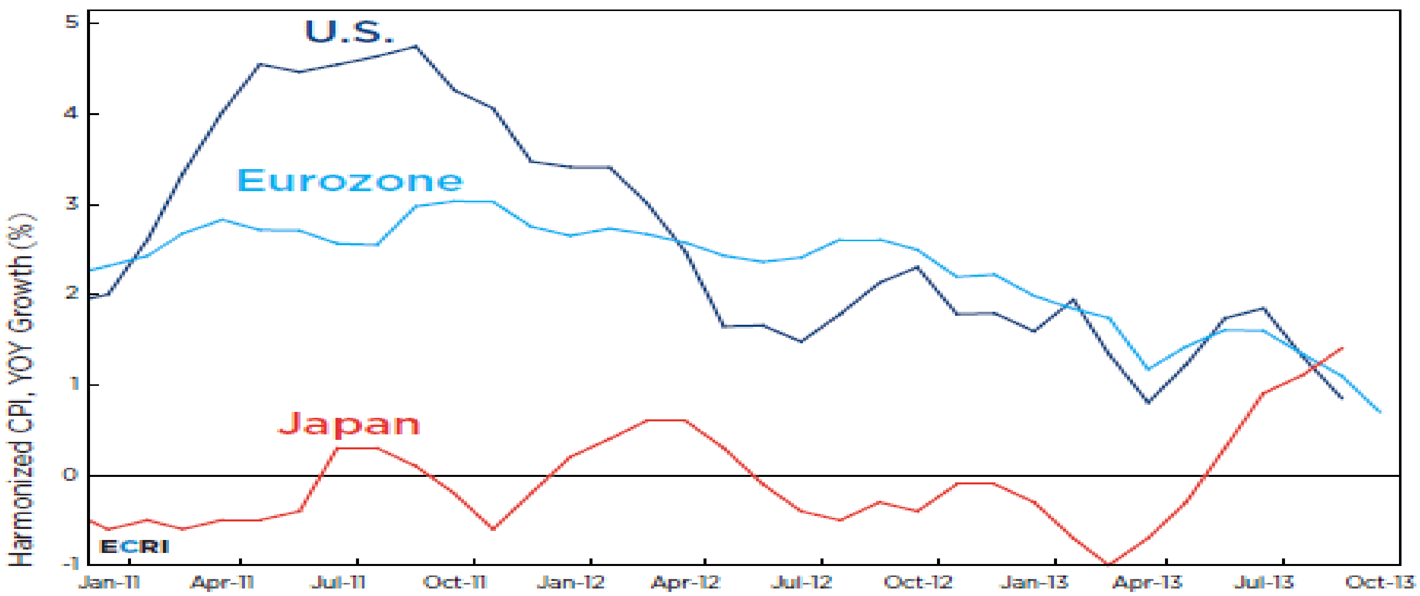
The Canadian dollar 2009-2013: back at May 2010 level down 10.8% since 2011 and still falling

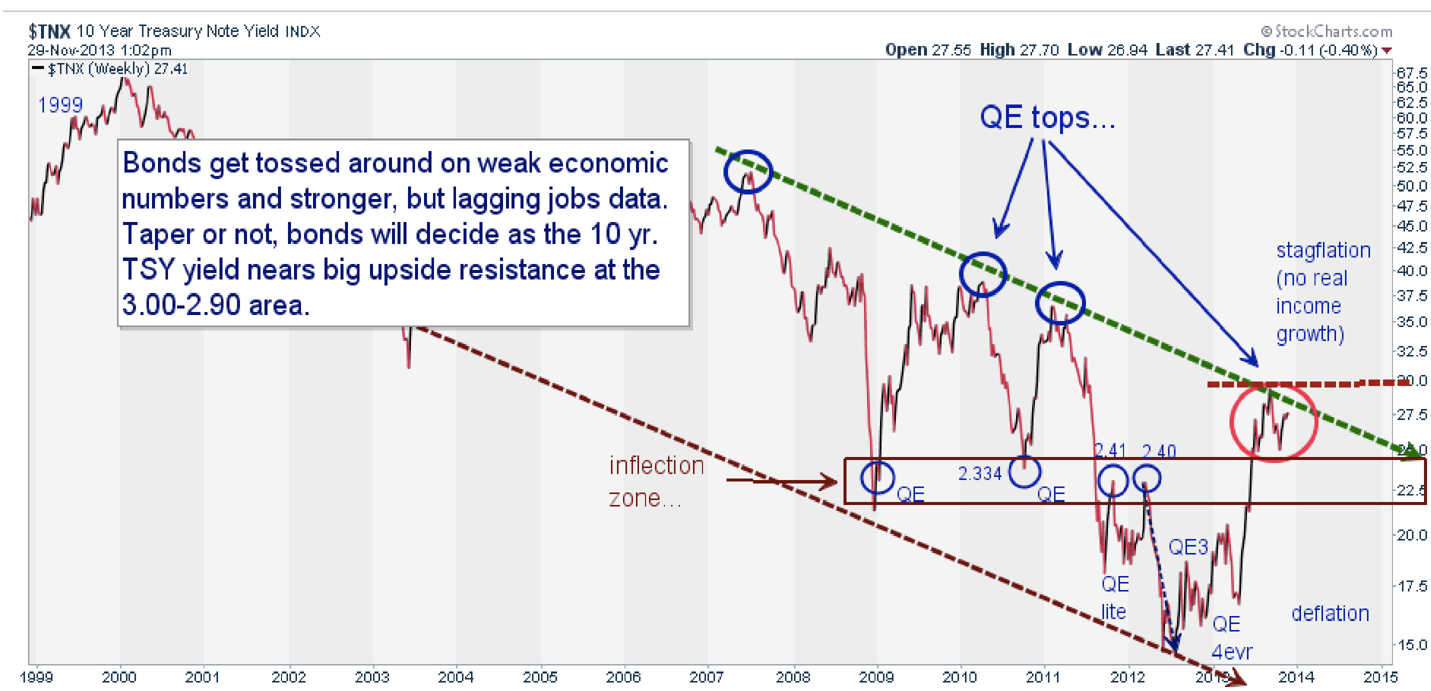
2008-2013: Note miners, materials and energy led to downside in 2008 and plummeted again with broad markets and dividend stocks in March 2009 amid panic selling. A similar test is likely ahead.



The deflationary forces of deleveraging have been overwhelming Central Bank efforts to create inflation as shown in this chart plotting the year over year growth of CPI since 2011 in the US and Eurozone, with a tick up to 1% only recently in Japan since intense stimulus efforts resumed there last spring. **(Chart source: ECRI)**



US 10 year Treasury yield 1999-2013 still in lower yield trend channel—deflation not inflation—so far



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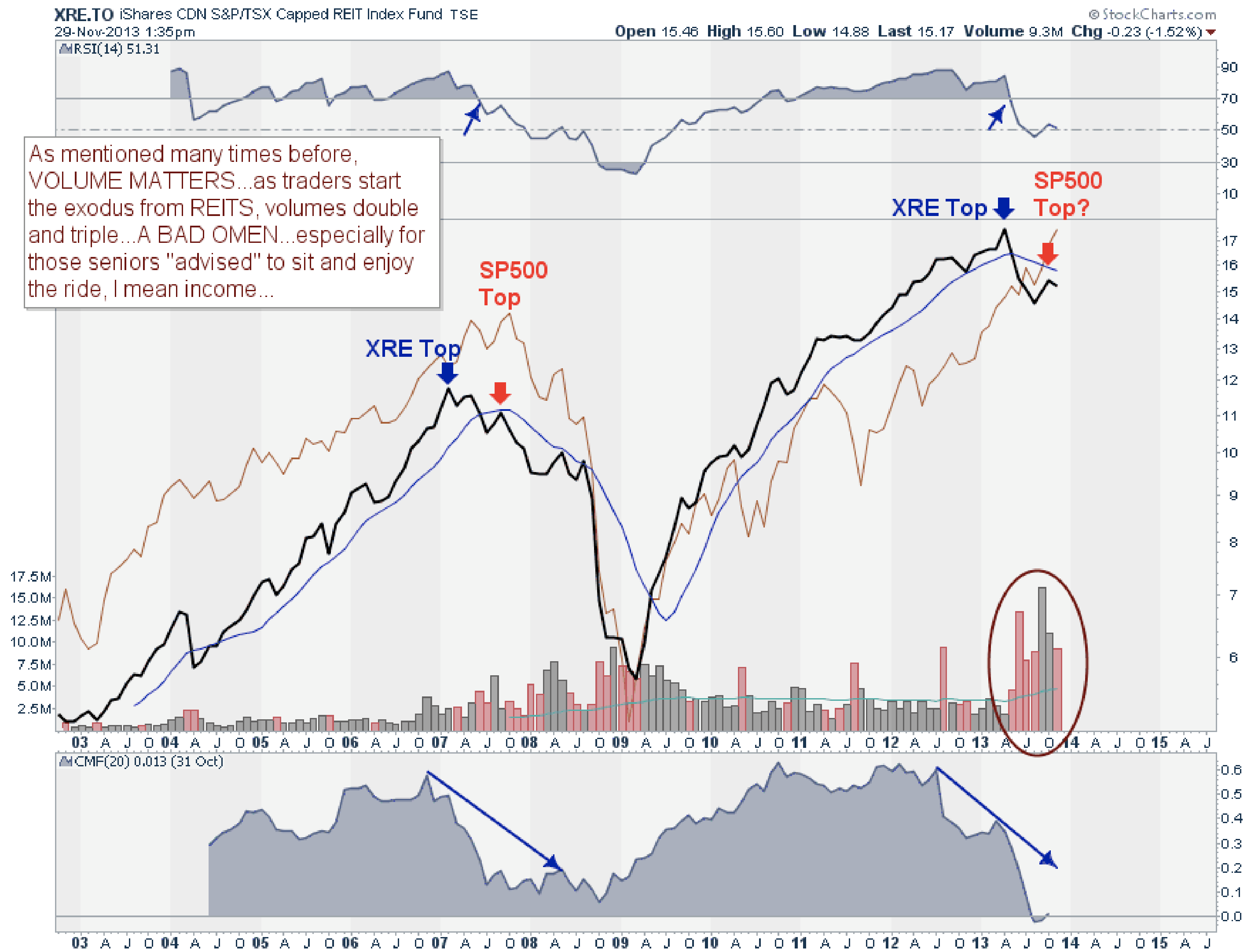
This chart of the S&P 500 and the interest sensitive Real Estate Investment Trust (REIT) index (XRE) is suggesting a similar price top as it did last market cycle, where the XRE rolled over 8 months in advance of the S&P at the 2007 market peak (note arrows below), and has been falling again now since April 2013 on large selling volume (red circle at bottom of chart).



Over the past 3 years, monetary authorities have deliberately thrown those desperately seeking income to the wolves that are hiding among dividend paying shares and other higher risk income assets. We definitely wish to add dividend-paying equities to our portfolios and <u>our anticipated mean reversion in this area has been making progress over the past few months, as prices have been dropping and yields going up.</u>

Once indiscriminate buyers and levered-traders have been wrung out of these areas, we will be pleased to buy back growth and income sectors that will then be at more reasonable valuations— offering lower price risk, and higher income yields—well positioned to move up with the next organic business cycle expansion when present bulls will be battered and beaten into pessimism once more.

MAKE NO MISTAKE, although you may not feel it at the moment, **YOU, DEAR CLIENTS, ARE now what the market refers to as the "STRONG HANDS",** as we bide our time and earn the right to buy assets once more off the "weak hands" holding them presently at extreme valuations and on record margin debt.

The rally over the past 3 years has been powerful, irrational and speculative in nature. As such it has lasted longer than we'd like, and could continue— like a water torture—a little longer still. We all have to allow for that. **Every day the rally continues it is setting up for an even larger decline ahead.** We are, of course, concerned for those who are not defensive today and will be financially harmed again in the next downturn, but **<u>we are also incredibly excited for what is setting up to be the investment opportunity of our lifetime</u>**.

We must remember that historically, secular bear periods last about 17 years and serve to slash equity valuations by 2/3rds before they complete, while secular bull periods follow to ramp valuations up once more over a similar 15-20 year period. The two 50% cyclical declines of this secular bear since 2000 made some progress in lowering valuations from all time highs in 2000 toward fair value at the fleeting low in March 2009. **However, since then, that progress has been quickly undone as QE mania drove a rapid resurgence toward extreme valuations again by 2013. No other secular bear period in history has ever ended before US stocks are unloved and labouring to find buyers at less than 8x their 10-year average real earnings**. At a PE of 25 today, we have every rational reason to expect that the low in valuations for this secular bear was not March 2009 (just 9 years after it had begun) and not at a PE of 12 (some 65% above historical bear-ending lows), but somewhere ahead in our not too distant future. Hang tight!

And now we welcome that month of Holiday Cheer once more...

Quotes of the month:

"I have learned over the years that when one's mind is made up, this diminishes fear; knowing what must be done does away with fear." —Rosa Parks (1913-2005) African-American rights activist

"I realized early on that success was tied to not giving up. Most people in this business gave up and went on to other things. If you simply didn't give up, you would outlast the people who came in on the biz with you." – Harrison Ford (1942-) Actor

"The seed of a bamboo tree is planted, fertilized and watered. Nothing happens for the first year. There´s no sign of growth. Not even a hint. The same thing happens – or doesn´t happen – the second year. And then the third year. The tree is carefully watered and fertilized each year, but nothing shows. No growth. No anything. Then the bamboo tree suddenly sprouts and grows thirty feet in three months." — Hilary Hinton "Zig" Ziglar (1926 –2012) American author

"The prudent see danger and take refuge, but the simple keep going and pay the penalty".
-- Proverbs 27:12

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