Investing for People

It may be that over the long term stocks outperform bonds...
until the long term is the wrong measuring time horizon for an individual.

It may be that real estate is always a good investment…
until the time that you need to sell and it's not.

It may be that the stock market rises while liquidity and solvency of the banks remain unresolved, while consumer spending is constrained by high and increasing unemployment and excessive leverage, while corporations suffer the costs of excess capacity and debt burdens, and while residential and commercial real estate continue to decline in value.

It may be that the stock market reflects multiples of uncertain and opaque earnings significantly higher than the multiples implied by the corporate bond market that is pricing in higher risk (albeit at much improved credit spreads than those six months earlier). And it also may be that share prices at these high levels are unsustainable considering the earnings and balance sheet pressures on corporations.

Today, individual investors are confronted by conflicting impulses – their fear of losing their net worth and their desire not to miss out on profit opportunities. Individual investors must consider fundamentals vs. perception, transparency vs. opacity, and reality (balance sheets and current market multiples) vs. speculation (on future earnings and economic activity that is for now largely dependent on uncertain government programs). Normally this analysis should be in the context of an individual investor's particular situation, although there are times when the capital market risk/reward balance trumps individual circumstances and the focus must be on downside protection.

This is one of those times.

Thus far in 2009, risk, asset values, employment, and corporate earnings models are searching for an equilibrium point. Government programs aimed at providing liquidity to the capital markets, underwriting a low interest rate environment, and stabilizing the banking sector continue in full force. There is, however, great uncertainty surrounding the government-sponsored TARP capital injection program and the more recent loan and asset-backed securities purchase programs introduced in March. It seems premature to have confidence in bank share prices or bond values. Notwithstanding reports that the velocity of decline in the economy has slowed (that is, the streaming economic news has become "less bad"), the fundamental deterioration of value and credit reflected in the loans and assets held by the banks weighs heavily on their balance sheets and on the economy. The broader erosion of credit-worthiness in the commercial real estate sector is an additional impending reality as debt coming due is not easily re-financed given falling rents, higher vacancies, reduced collateral value and earnings outlook.

The perennial risks inherent in equity investing include valuation risk, information risk, and systemic risk. Valuation risk may be thought of as share price as compared to earning expectations and equity prices as compared to other investments. Information risk may be thought of as the level of transparency in assessing the earnings quality and financial condition of corporate issuers. It may also be thought of as transparency in the operations of the capital markets. Systemic risk may be thought of as interrelated risk among companies and/or sectors of the capital markets that are dependent upon each other and may cause an exponential consequence due to the inter-relationship if there is failure or disappointment by any link in the chain.

The bull market which commenced in 2003 was fueled by leverage that accelerated earnings but was not always readily transparent. Off balance sheet financing techniques, derivative contracts and the shadow credit market of securitization operated to pump additional leverage into the system without reflecting such on corporate balance sheets. The credit risk that ensued was transmitted to many institutions whose credit, as a result, became impaired and who were also counter-parties in derivative trades that elevated systemic risk.

To manage risk, investors must look to the best information available, which may not always be sufficient to confidently make a definitive determination. Nevertheless, when risks are elevated portfolio construction and asset allocation principles must be engaged to manage these risks. As risk increases, the allocation to riskier assets must decline in order to maintain a comparable risk/reward profile in the portfolio. As the fundamentals governing this risk/reward balance change or become more transparent, the portfolio should be adjusted.

The recent rise in share price reflects an expansion of the P/E ratios by 38%. In February, at an S&P 500 value of 660 the implied P/E ratio was 15x 2009 operating earnings. At an S&P 500 value of 907, investors are paying 20.6x[1] operating earnings in a slow or negative growth environment.

At times such as these, investors should ask – has the environment for risk changed? Although analysts and commentators observe that markets anticipate an economic recovery, if share prices increase at a pace that is not earnings justified and are supported by external and likely unsustainable factors, valuation risk is heightened even though the immediacy of systemic risk (failure) may be diminished (for example, by government intervention). As risk morphs, asset allocation should nonetheless be determined by overall risk relative not only to the potential for reward (upside), and possible underperformance, but also relative to the potential for loss of principal.

The question that is sometimes asked is whether such periodic changes in asset allocation are tantamount to market timing. On the contrary, it is the antithesis of "timing" which may be dependent on cyclical trends, short-term trading patterns, and technical analysis that may not even be tied to the fundamental risk/reward level in an asset class or economic environment.

Share price is of critical importance in determining the appropriate equity allocation, preserving principal and attaining a reasonable rate of return. In order to make a determination of fair price, the level of confidence in quality of earnings and transparency of financial statements and parallel capital markets is a significant consideration. Investing at "too high a price" may result

[1] Based on S&P 2009 estimates (14.6x and 20.06x, respectively based on S&P 2010 estimates).

in a long-term rate of return that is substandard or negative. Similarly, a “stay the course” approach as the risk/reward balance shifts is economically equivalent to entry at an inappropriate point, and does not give due consideration to the potential for loss of principal. As we have seen, equities can rise to unsustainable levels and can fall precipitously though holding out the promise for recovery even if the underlying fundamentals are still tenuous.

Some consider today’s stock market a “stock pickers market.” Others consider it a “traders market.” Still others label it a “cyclical bull market.” As for individual selection of equities, the recent market actions have demonstrated that rates of return – both positive and negative – are impacted to a far greater extent by asset allocation and portfolio construction than individual stock selection, and should be the primary focus for individuals.

Perhaps the most troubling aspect of the current market environment is that because of government intervention driving down interest rates, investors are effectively pushed toward riskier investments. This distorts the risk/reward analysis that historically trades higher returns available in equity investing (at the price of the greater possibility of sustaining a loss of principal) for lower risk fixed income returns (that were generally thought of as secure as to principal). Investors should today consider the possibility that a *de minimis* fixed income return may be a better choice than equities at elevated share price levels in the current economic and capital market environment.

In order for our capital markets to work efficiently (that is, pricing in the appropriate risk/reward balance in investment asset classes), there must be transparency, equal access to information, and equal sophistication on both sides of the trade. The parties on each side of the trade must also bear the risk of their decisions. It is difficult to see in this environment of shadow markets, changing accounting and regulatory rules, derivative contracts and government support in the private sector that these market forces and relationships can be restored to “normal” in the near term. For these reasons and the increased valuation risk, an underweight allocation in equities by comparison to the higher allocation during periods where these risks were not as prevalent should be considered as the “new normal” allocations going forward. As overall risk subsides, allocation to equities should be increased although the individual investor must remain ever cautious of the ongoing problem of opacity (information risks) that bodes for more modest equity allocations in the future.

Because individuals, unlike institutions, require access to their capital based on life event triggers, such as reduced earned income, retirement, education costs, assistance to family members and illness, they may not always have the luxury of “staying the course” as long term investors. The “long term” may turn out to be the wrong term based on the evolving and often unpredictable circumstances of their lives. Individuals are best served by managing to the fundamentals of risk and reward as applied to their particular personal circumstances, the capital markets and the broader economic environment.