Keep it Real

By Bill Koehler, CFA

Fans of 1970's music may remember a popular song titled "Got to Be Real." It was performed by an artist named Cheryl Lynn and the 1978 song turned out to be her biggest hit. In this lively, energetic rhythm and blues song, she espouses the importance of being "truly real" in approaching friendships and other personal relationships. While the song was certainly not intended to offer investment advice, the fact is that 40 years later, her message has another application. Keeping it "truly real" is also sound advice in approaching and navigating the investment markets. Whether one is an individual investor, an institutional investor or even an investment adviser, recognizing market realities can go a long way toward helping an investor achieve investment success.

Recognize Market Realities

Adopting a realistic approach grounded in knowledge of market history, probability theory and a healthy respect for emotional intelligence is key. In other words, recognizing the importance of understanding possible future return patterns and keeping one's emotions in check. All of which is easier said than done for most investors.

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Current Environment

U.S. stocks just delivered their best first half return since 2013. Through July 7, the S&P 500 is up nearly 10% for 2017. Bonds have provided needed diversification but smaller returns. Bonds of the intermediate investment grade variety have returned a little over 2% so far in 2017, equal to the current dividend yield on the S&P 500. If the current conditions persist, 2017 will mark the ninth straight year the S&P 500 has posted a positive total return.

Consumer confidence is at an eight-year high. In fact, it is a great time to be a consumer. Competition in virtually all industries has never been more intense. Across much of the globe, an abundance of better, faster and smarter choices are now available to consumers across an array of product lines and markets. With the exception of health care, higher education and selected housing markets, prices are generally flat to declining.

Diversification Working

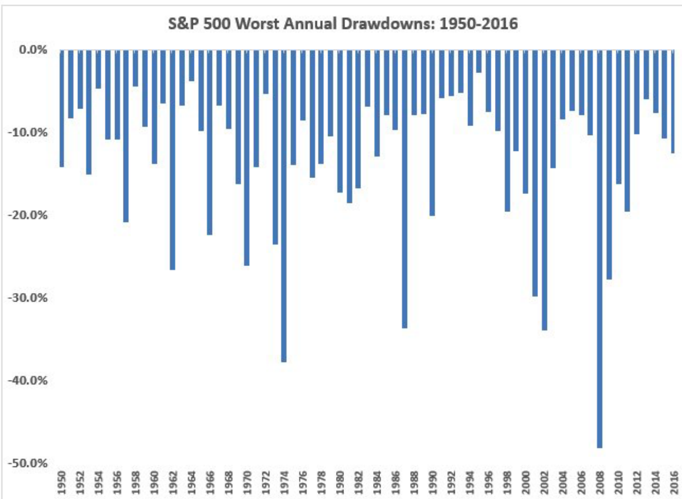
Unlike the last several years, where global diversification did not benefit investors, over the last year, international equity markets have awakened. While we still favor a portfolio that is U.S. centric, we have long favored the benefits of globally balanced portfolios. Global economic growth is improving. Eurozone GDP recorded its second highest level since 2011 in the first quarter of 0.6%, which still trailed U.S. GDP growth of 1.4%. Manufacturing activity in Europe reached a six-year high in June. The Stoxx Europe 600 has returned almost 14% in dollar terms so far in 2017.

In the realm of "actions speaking louder than words", it is worth noting that European companies are attracting capital as investors see improving economic conditions on that continent. For example, Nestlé, a bell-weather European holding, attracted a $3.5 billion investment in June from a U.S. based hedge fund, Third Point, who is pressing Nestlé for greater profitability. We believe it is likely that similar transactions will emerge in the aftermath of the recent French elections which served to bolster faith in the long term viability of the euro.

Markets or Take-out Windows?

While global equity markets have been strong recently with little volatility, I am reminded of a portfolio manager with whom I worked years ago. Quick-witted, he had a saying he liked to use when referring to markets in the midst of a sustained upward trajectory, "Remember, if markets only went up, they wouldn't be called markets. They would be called take-out windows." Said another way, markets go up *and* they go down.

While the U.S. stock market's long term bias over decades and decades is upward sloping, we must not forget to expect losses from time to time. Ben Carlson, the author of a worthwhile book called "A Wealth of Common Sense," has written on this recently and his accompanying chart is below. It details all of the worst intra-year drawdowns on the S&P 500 by calendar year since 1950 through 2016.



The largest drawdown (decline from a peak to a trough) so far in 2017 is -2.8%. This is unusual. History tells us, as evidenced by the chart above, that the average drawdown in a given calendar year over the last 67 years is -13.5%. The median drawdown is an inter-year loss of -10.5%. The good news is that while there were double-digit drawdowns in more than half of these 67 years, stocks were still positive in 79% of these calendar years. Even with the drawdowns, stocks still compounded at an 11% rate over this time period.

Expect Losses....And Long-Term Gains

The reality to be recognized is that the majority of time that one is invested in the stock market, one is going to be experiencing a drawdown. New highs are obviously not achieved every day and on 50% of all trading days, stocks finish the day down. The fact is new all-time highs, as we are experiencing now, only happen on roughly 6% of all trading days. Markets are at levels below all-time high levels fully 94% of the time. As Carlson says, when one invests in stocks it is wise to expect that they will go down with regularity, with knowledge that, over the long term, stocks provide long-term gains.

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Final Word

To be clear, this is not a call for an immediate correction. That is not the intention. However, it is a reminder that history, always to be respected, is suggesting a more normal return pattern complete with drawdowns larger than -2.8% (and eventual gains) is at least on the horizon. It is best to be expecting its arrival.

In summary, in our opinion, it's wise to heed Cheryl Lynn's advice and know that when it comes to investing, having a "Got to Be Real" perspective has benefits. Adopting a realistic approach, one that relies heavily on knowledge of market history, a strong sense of potential returns based on simple mathematics, and a healthy dose of emotional control greatly increases the probability of investment success.

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