

April 10, 2013

The bear, the bull—and the 10 lessons learned



Long-term investment challenges faced and overcome (Part I)

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Long-term investors face constant challenges. Their emotional fortitude and their net worth are constantly being tested by the painful losses of market crises, as well as the ensuing allure of pleasurable profits. Perhaps no back-to-back calendar years in the last seven decades tested investors quite like the equity bear market of 2008 and the subsequent steep bull market (most of 2009).

Here are some of the enduring principles of investing that have recently come into sharp focus. We firmly believe that acting on these lessons is essential for successful long-term investors.

1. Be Patient and Do Not Panic

The often-cited proverb, "Patience is a virtue," is applicable to many facets in life and can be particularly helpful for investors during challenging economic times. History has shown that market declines are inevitable. Since 1900, there have been 32 stock market declines of 20 percent or more. Understanding that declines, some quite prolonged and steep, are part of investing can provide some necessary perspective, thereby helping investors avoid the temptation to overreact. As Portfolio Manager Howard Marks of Oaktree Capital recently said, "Investment performance in a single year should matter principally only to people who are going to liquidate their portfolios at the end of that year."

While maintaining a long-term perspective through down times can be difficult, it can often lead to significant rewards for long-term investors. The five-year average annual return following the 32 declines of 20 percent or more was +11.4 percent. It is also important to keep in mind that the market has gone up more often than it has gone down.

From 1928 to 2009, the U.S. stock market delivered positive returns in 60 out of 82 one-year periods, or 73 percent of the time. After the equity market bottomed in March of 2009, large cap stocks gained 77 percent through March 31, 2010. This strong rebound was enjoyed by those who

remained patient and didn't panic. As one portfolio manager recently opined, "Often times the best investment is the hardest one to make at the time."

2. Downside Risk and Leverage Should Not be Ignored

The credit crunch from the end of 2007 to 2009 reminded consumers, companies, and investors of the painful consequences of risk and leverage. As markets recover and credit becomes more available, investors must keep in mind that debt and risk are not just a means to generate excess returns, but come with very real costs. Corporations, and more importantly investment strategies, that employ excessive leverage must be scrutinized and closely monitored.

Many market pundits have urged companies, as well as hedge fund managers, to realign managers' compensation with the interests of shareholders. If a manager is compensated for near-term results, that individual is more likely to take on excessive risk to achieve those goals. Even if this approach may lead to short-term success, in most cases it will result in long-term failure.

Investors should reevaluate their risk aversion, including the maximum downside loss with which they are truly comfortable. Although we anticipate that markets will trend upward in the long-run, investors need to consider their staying power during periods of significant wealth destruction before determining their return target.

Every investment has risks. For instance, many investors believed real estate property values could not decline, which we soon discovered to be far from the truth. As stated by legendary investor John Bogle, "When reward is at its pinnacle, risk is near at hand."

3. Correlations Increase in Times of Market Stress

Investment professionals have widely accepted the portfolio construction process of Modern Portfolio Theory (MPT). MPT suggests that by combining a series of uncorrelated asset classes with favorable risk/reward characteristics, an investor can reduce overall portfolio volatility. While the theory holds true over the long-run, during periods of extreme market stress the correlations of riskier asset classes tend to converge.

Even effective long-term portfolio diversifiers such as commodities and REITs fell when stocks tumbled in 2008. The correlation of the DJ UBS Commodity Index to the S&P 500 increased exponentially from 0.05 before Lehman Brothers' collapse to 0.84 afterwards. In addition, the DJ Wilshire REIT Index went from a correlation of 0.37 to 0.85 over the same time period. Many market observers contend that the integration of capital markets and free trade have decreased the diversification benefits between asset classes. Should market integration continue to increase, investors may have difficulty identifying asset classes with long-term diversification benefits.

Despite recent challenges, several asset classes held their diversification benefits from 2008 to early 2009. Most notably government and municipal bonds maintained fairly low correlations to equities during the market downturn. Additionally, hedge fund of funds had moderately low correlations to domestic equities, despite experiencing declines as leverage unwound in late 2008. Investors should remember that history has repeatedly proven the benefits of remaining broadly diversified over full market cycles. While maintaining diversification may not prevent portfolio losses in down markets, it should continue to mitigate portfolio volatility over the long-term.

Three more (Part II)

Perhaps no back-to-back calendar years in the last seven decades tested investors quite like the equity bear market of 2008 and the subsequent steep bull market (most of 2009). Here are some more of the enduring principles of investing that have recently come into sharp focus. We firmly believe that acting on these lessons is essential for successful long-term investors.

4. Liquidity Matters

Simply stated, market liquidity is the ability to sell an asset without causing a significant movement in its price. For markets to successfully function there needs to be a balance of enough liquidity to encourage market activity, but not too much that could lead to excessive debt and asset bubbles.

Many economists refer to liquidity as the “lifeblood of the markets,” because if liquidity stops flowing, the markets can come to a crashing halt.

Despite its importance, liquidity can often be taken for granted by investors, leading to painful results. Before 2008 many investors assumed that the ample liquidity that had been available in the past would continue to allow quick liquidation of their positions at fairly predictable prices. As the financial crisis accelerated, fear quickly took hold within the markets and liquidity began to dry up.

Many investors who had overestimated their financial strength and underestimated the damaging impact of illiquidity were obliged to sell assets at prices sharply lower than just a few months prior. Prudent investors need to constantly assess how much of their portfolios should be in highly conservative, liquid investments in order to avoid having to sell parts of their portfolio when liquidity stops flowing.

5. Market Timing is an Unsuccessful Strategy

It is impossible to accurately and consistently predict short-term market movements in order to be invested when prices move up and on the sidelines in cash when prices fall. Market timing requires an investor to link at least two right decisions: when to get in and when to get out. Then these two successful decisions must be repeated multiple times to be effective over the long-term.

Being out of the market at inopportune times can be very costly. An investment made 25 years ago in the S&P 500 Index would have earned an average annual return of +10.4 percent before taxes and transaction costs. However, if the same investment missed out on the top performing 25 days in the market during this period of approximately 6,300 trading days, the average annual return would have shrunk to +4.3 percent. Peter Lynch, former portfolio manager for Fidelity Magellan Fund commented, “Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in the corrections themselves.”

Looking at 2008 and 2009, very few investors fully anticipated the depths of the economic recession, as well as the timing of the subsequent rebound. Sadly, many investors that were swayed by their emotions and sold their equities after the steep declines returned to the market (or are still waiting to do so) only after its dramatic rebound. The result of this poor timing is that investors locked-in meaningful losses and then missed out on the subsequent gains. In the end it is better to have a long-term strategy based on appropriate downside risk tolerance and systematically rebalancing the portfolio in both good and bad markets.

“Successful investing is about always trying to gauge the ratio of risk to reward. If you choose to ignore any form of risk, your outcome could prove to be less satisfying than you expected.” -- Ross Moscatelli, Denver Investments

6. Tail-Risk Should Not Be Ignored

In recent years, Nassim Taleb, author of the acclaimed book “The Black Swan”, has popularized the term “tail-risk”, or “fat-tails”. This expression is often used to describe systemic events that cause abnormal, asymmetrical market declines greater than three standard deviations. In other words, these events are akin to 100-year floods.

While fat tails represent statistically improbable events (0.15 percent probability in any one year), in reality they occur more often than statistics would lead us to believe. Since 1972, the S&P 500 Index has experienced four distinct periods with market stress exceeding three standard deviations. Given the frequency of abnormal market distress during the past four decades, investors have become increasingly aware of the impact of tail risk and continue to search for ways to avoid such events.

The inability to effectively quantify potential fat tail events may have been a primary factor contributing to the recent credit crisis. Many investment banks, including Lehman Brothers and Morgan Stanley, used a common metric known as Value at Risk (VaR) to identify maximum downside risk in their portfolios. VaR attempts to measure maximum downside risk on the basis of normally distributed risk/reward characteristics and asset class correlations.

However, the model’s failure to account for increasingly common abnormal events contributed to some of the largest losses ever witnessed on Wall Street, including the collapse of Bear Stearns and Lehman Brothers. While there is no proven solution to avert all systemic risks, the use of derivatives and cash floors have become somewhat more common. Nonetheless, these methods tend to have significant costs and may drag on portfolio performance. For now, the best remedy for systemic shocks is likely the benefit of maintaining a well diversified portfolio over a long time horizon.

Consider the case of Bernie Madoff (Part III)

7. Investing with Trustworthy People is More Important than Chasing Returns

The recent market environment provided numerous examples of what can occur when thorough due diligence is not consistently applied to investment decisions. Many investors, and even financial professionals, became ensnared by the wishful thinking that past performance will be predictive of future performance (a tendency to extrapolate the recent past into the future). Perhaps the most publicized example of not using a thorough due diligence process is the case of Bernie Madoff.

A recent news article outlined an internal debate at a large private bank over whether to invest with Madoff. Many within the bank argued against investing with Madoff, citing issues such as the lack of a transparent investment process. However, others were compelled by what appeared to be an extraordinarily consistent, historical performance record. The performance numbers were adequate enough for the bank to invest \$700 million of their clients’ money with Madoff’s Ponzi scheme.

The financial press is filled with tragic stories of people who mistakenly based their investment decisions primarily on past performance. These stories about being defrauded illustrate the

irreplaceable need for investors to focus on why and how a manager's performance was achieved and on the qualitative attributes of the manager's team and investment firm.

Admittedly this type of analysis requires significant time and effort as compared to simply ranking managers by historical performance. At Innovest, our due diligence group conducts over 250 investment manager meetings each year. We believe that our ongoing close contact with managers helps us to maintain very high standards in our selection process and to reduce our vulnerability to mistakes. We routinely pass on an investment if the manager's process lacks the transparency necessary for our review, or if our conviction level is not extremely high. While there are no guarantees that this process will always lead to success, we contend that hard work and adherence to a thorough process adds value for our clients over time.

8. Be Mindful of Your Investment Horizon

During periods of either extreme market pessimism or exuberance, investors have a tendency to lose sight of their investment time horizon. The time period over which an investor needs to draw on his or her portfolio is a key factor in determining the ability to bear risk. Prior to the market meltdown of 2008, many investors opted to take on more risk in hopes of reaching future objectives through overly optimistic return expectations. Other essential variables, such as increasing capital contributions, were minimized. Many investors now find their portfolios at depressed levels with less time to recover their losses.

Alternatively, investment losses in 2008 prompted many investors to dramatically reduce their portfolio risk profile and move into more conservative investments. However, long-term investors who kept their portfolios aligned with their time horizon by maintaining their equity positions did not miss out on the market's steep rebound, which began in March 2009.

Some in the academic community have long maintained that investing should be a rational process without influence from non-rational emotions. However, the study of behavioral finance shows that various emotions, including fear, pain from losses, greed and pleasure from gains, can adversely impact investment decisions and sometimes cause irreversible financial damage. While we know that it can be very challenging not to react emotionally to recent events, we continue to emphasize that investors' risk profiles should primarily be a function of their time horizon and not swing with reactions to recent market trends.

“Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it.” -- Warren Buffett

9. Volatile Markets Can Create Opportunities

Market volatility has prompted many investors to run for the sidelines. Despite miniscule earnings on short-term deposits, cash levels have approached all time highs. However, this volatility has created opportunities for investors with gumption and a willingness to take a forward-looking and long-term approach. From the lows of March 2009 to June 30, 2010, large cap stocks rebounded 57 percent, and small cap stocks rallied over 80 percent.

A similar rally occurred within the lower quality fixed income markets. In 2009 yield spreads for domestic high-yield bonds contracted significantly from roughly 2,000 basis points over 10-year

Treasuries to less than 700 basis points. Several other asset classes that recorded their worst year on record in 2008 proceeded to have one of their best years ever in 2009.

While it is easy in hindsight to identify these examples, history has shown time and again that there are tremendous opportunities to be uncovered in volatile markets. Investors who purchase attractively valued assets for the long-term are much more likely to be rewarded than those trying to jump in and out of the financial markets. A portfolio manager recently shared with us that, “Oftentimes the best investment is the hardest one to make at the time.” It is critical to have a disciplined strategy that will be an objective guidepost when facing volatile markets.

10. Never Employ an Investment Strategy that Cannot be Understood

Over the last decade the number of highly complicated strategies increased at an exponential rate. Many of these strategies employ quantitative models that are opaque and difficult to understand for the average investor. Moreover, portfolio transparency is often poor because of a manager’s unwillingness to divulge proprietary data. Many investors became unaware of implicit portfolio risks in these complex strategies.

For instance, various quantitative models select securities on the basis of historical market patterns and price momentum. While these types of strategies do well when markets exhibit relatively stable and consistent trends, they often fail to capture volatile periods or inflection points in the market. Many model-driven investment products performed poorly during the market crisis and its subsequent recovery in 2009.

In the years leading up to 2008, many core bond managers touted their strong investment records generated in part through their use of high-performing securitized residential mortgage-backed securities. Strong investment returns, however, did not match up with what was marketed as a low-risk strategy. Only during the financial crisis of 2008 did owners of these products discover their excessive exposure to sub-prime mortgage loans, which collapsed in value as housing prices declined and teaser rates reset. Long-term investors are more likely to be successful if they look for hidden risks when examining managers’ track records and use strategies that can be easily understood.

Conclusion

While the lessons learned from 2008 and 2009 are easy to identify in hindsight, we believe that recalling and acting on these principles should be beneficial to long-term investors. It is likely that the financial markets will continue to be volatile, presenting new challenges and investment opportunities. Over time, a prudent, thorough, and ongoing investment review process will remain indispensable for meeting financial objectives.

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