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# Don't Just Do Something, Stand There!

They say that patience is a virtue. But few people attribute that virtue to me.

Early in my 43-year career in the investment business, I succumbed to an occupational hazard: I became an information voyeur. Daily I read . . . okay usually scanned . . . *The Wall Street Journal*, *The Financial Times*, *The Economist*, and *The Washington Post*. When I was home, I watched CNN as well as Fox News. (Gotta be sure I get a fair and balanced perspective on political events.)

With all this information, I was frequently tempted to do something with it—buy or sell a stock or add to my bond position by reducing my equity exposure. However as time passed, I learned, often the hard way, that my initial instincts about a seemingly important piece of information were frequently wrong.

## Dead money or dead wrong

Once I bought shares in a well-known restaurant chain, but sold half my position at a loss when competitors began taking market share and earnings stalled. Wall Street analysts covering the company concluded that my investment was "dead money"—the management team was sub-par and there were no near-term prospects for turning it around. So I sold. A few months later an activist hedge fund investor came along, threw out the management team and installed a new one. Within two years the stock doubled as the company regained its footing.

I was dead wrong. I had become a victim of group think, i.e., when everybody thinks alike everybody is likely to be wrong. Moreover, I had failed to appreciate the rise of the activist investor, an investment phenomenon that has grown in importance over the past decade. In today's world, if a public company doesn't manage itself well for the benefit of its shareholders, the likes of Carl Icahn, Dan Loeb or Bill Ackman may come along and demand changes.

Gradually, I learned that sometimes "doing nothing" can be a wise decision. When the urge is greatest to "don't just stand there, do something!" the best decision can often be to just stand there.

When economic news is bad and stocks are declining, the urge to take action can be unbearable, particularly in a group setting like the investment committee of a pension fund. During the Great Recession of 2008-2009, I served as an unpaid adviser to a pension fund. In the early phases of the bear market, committee members seemed satisfied to "think long-term" and accept declining asset values as a temporary price they had to pay for being invested in the stock market. In fact, the pension plan was invested in a broadly diversified portfolio of good quality stocks and bonds managed by a strong stable of investment managers. In addition it owned no hedge funds or other illiquid investments. If any plan could ride out the storm, this one could.

## Panic and impatience

Then in September 2008 all hell broke loose with the bankruptcy of Lehman Brothers. The economic and stock market decline accelerated and a full blown financial panic ensued. Treasury Secretary Henry Paulson was on his knees in the Capitol pleading with Nancy Pelosi to support his bailout plan for the nation's banking system. In October, market maven Jim Cramer was on TV saying, "Whatever money you may need for the next five years, please take it out of the stock market right now, this week." By November, the Dow Jones Industrial Average was down 40% year-to-date.

Members of the pension committee (as well as their adviser) were getting nervous and impatient. Western civilization seemed to be in a meltdown. How could the committee stand by and do nothing? Didn't prudence dictate that they do something to protect pension assets from further attrition? My gut told me that the fall of 2008 was not a good time to give up on the stock market, but my brain had difficulty coming up with a convincing case for staying the course. After all, stocks declined over 80% during the Great Depression of the 1930s.

Finally, someone came up with an ingenious plan. Future monthly contributions into the plan would be held in cash until "market and economic conditions stabilized," but the fund would not pull money out of the equity market. In this way, most everyone could be satisfied that the committee took some action to protect the plan. But the action taken had little impact on the plan's asset allocation—its benefit was more psychological than real. This approach wasn't exactly "doing nothing," but it was pretty close. When conditions improved in mid-2009, the 2% or 3% cash position was reinvested in the stock market.

## Four concepts and caveats

Of course, standing by and doing nothing is not an investment strategy for all seasons. So here are a few concepts and caveats to keep in mind.

**There's a *yin and yang* to free market economies and their stock and bond markets.** When they go down, they usually go back up sooner or later. Recessions and bear markets foster corrective actions which lead to recoveries and bull markets. Economic expansions, particularly in their later stages, foster excesses which lead to recessions and market declines. The same holds true for individual stocks and sectors. In 2016, Health Care was the only sector within the S&P 500 to post a decline: so far this year it has produced a double-digit return, ranking just below Technology as the best performing sector of the market. In 2016, the Energy sector was the market leader with returns twice the market averages: so far this year, Energy is dead last, one of only two S&P 500 sectors to post declines this year.

**The case for doing nothing generally improves as stock prices decline and economic conditions deteriorate.** Psychological studies show that investors tend to be more risk averse than reward seeking: they fear a 20% decline in stock prices much more than they value a 20% rise. Thus the most common mistake investors make is selling after a steep decline in the market. That's the way people got wiped out in 2008-2009—they sold out near the bottom and never reinvested in the ensuing bull market.

*Flush with more cash than ever, activist investors are pursuing bigger corporate prey . . . Indeed, one-third of the 42 S&P 500 and Fortune 500 companies that replaced a CEO this year grappled with the demands of activist shareholders during the prior chief's tenure.*

~Wall Street Journal
July 6, 2017

*This week, Argentina startled the markets by issuing $2.75bn worth of century bonds, with an effective yield of 8 percent. You might have thought this would be a hard thing to sell. After all, Argentina has defaulted on its debts eight times in its 200 year history, with no less than five defaults in the past century alone, . . . the bigger reason why demand is so high is the action of central banks: quantitative easing has pumped so much liquidity into the markets that investors are frantically—desperately—chasing any investment that might produce a return.*

~The Financial Times
June 23, 2017

*The yields on government bonds in the euro zone jumped and the euro rose to its highest level against the dollar this year after Mario Draghi hinted that the European Central Bank was ready to begin unwinding its stimulus measures. In a speech the ECB's president focused on the region's improving economy, and notably the pivot from "deflationary forces" to "reflationary ones."*

~ The Economist
July 1, 2017

*US risks hitting allies as it moves to raise drawbridge on steel imports. After two years of lobbing threats at the global economy as both candidate and then president, Donald Trump is preparing to deliver his first big protectionist action and potentially trigger a trade war.*

~ The Financial Times
June 23, 2017

**Quality should be a key consideration in deciding whether to retain a "troubled" position in an individual stock or bond.** Companies can go bankrupt and stocks can go to zero. High quality companies—those with stable earnings and cash flows and strong balance sheets—have the ability to weather the storm or, perhaps, attract a buyer. Low quality companies often do not. Selling XYZ stock after an 80% price decline might be a good idea if the company is in a weak financial position. It may not survive long enough to enjoy a turnaround, particularly if credit conditions in the economy deteriorate.

**If you don't know what to do, staying fully invested in diversified, high quality equity or a balanced portfolio is not a bad option.** Over the 90 plus years of its existence, the S&P 500® index has posted positive annual returns 74% of the time, and negative annual returns 26%. The average compound annual rate of return (dividends plus price change) is about 10%. One of the best ways to accumulate wealth is be a long-term investor and enjoy the benefits of compounding. Studies of equity mutual fund performance show that low turnover is positively correlated with good relative returns. In other words, good managers don't trade in and out of stocks frequently and stay fully invested. The turnover of many top performing funds is around 20%, which implies a five-year holding period for the average stock in a portfolio.

## Outlook and Action

So what, if anything, should investors be doing now? First, some context. In July, the bull market in stocks entered its 100th month. That's quite a bit longer than the 60-month average for bull markets since 1914. At this writing (S&P 500® index was at 2423 on June 30th) prices have risen 262% from their lows on March 9, 2009. That's much higher than the average bull market gain of 177%.

There's an old saying that bull markets don't die of old age, they are killed by the Federal Reserve. Indeed, the key reason that this bull market has lasted so long is that the economic expansion that underpinned it was so lackluster. With GDP growth of 1.5% to 2.0%, inflation and other excesses don't develop quickly, so the Fed can remain accommodative. Most major economic and stock market declines are preceded by a period of rising interest rates initiated by the Fed and worsening credit market conditions. Interest rates are rising, but very gradually. Credit market conditions are currently good. Yields on lower quality debt are still historically low relative to Treasuries. Tight credit spreads indicate that credit is readily available on favorable terms to a wide range of borrowers.

The leading indicators of US economic activity suggest no recession over the next 9 to 12 months. Corporate earnings are on the rise after flatlining through 2015 and 2016. Powered by improving global economic conditions, S&P 500 earnings should rise about 9% this year to $129.

Against this backdrop of generally favorable conditions are some concerns. Stock valuations are high by historic measures—the S&P 500 price/earnings ratio is slightly over 20 times last year's earnings and almost 19 times this year's earnings. The era of extraordinarily easy money appears to be ending—central banks around the world are beginning to raise interest rates as "reflation" is replacing "deflation" as a key monetary concern.

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Another growing concern is the distorting effects of index funds on stock prices. The extraordinary growth of index funds, i.e., passive investing, over the past decade may be setting investors up for some unintended consequences. According to a recent report by Merrill Lynch, today 37% of US equity fund assets are managed in index funds compared with only 19% in 2009. Most of this money is flowing into exchange traded funds (ETFs).

Stock selection by most ETFs is based on the stock's percentage weight in the index, not on company fundamentals like revenue, earnings, and valuation. During the first half of 2017, when Technology was a popular sector, five stocks (Apple, Google, Amazon, Facebook and Microsoft) accounted for almost 40% of the gain in the S&P 500, despite accounting for less than 15% weight in that index. The fear is the growing popularity of unmanaged ETFs could be reducing the overall liquidity of the equity market and increasing price volatility. Perhaps ETFs represent a new form of quantitative "momentum" investing. Remember the popularity of quantitative equity models in the run up to the market crash of 2008? They worked well until they didn't.

In my view, the US equity bull market is in "the late innings," but not yet over. With equity prices near record highs and valuations (price/earnings ratios) stretched, it's a good time to start gradually preparing portfolios for trouble ahead. The financial quality of stock and bond holdings should be increased. The maturity of bond portfolios should be shortened or at least "barbelled", i.e. emphasize short and long maturities over intermediate maturities. For equity portfolios, consider reducing index fund exposure in favor of equity strategies with high active share and low down-market capture ratios.

My biggest near-term concern is that the US economy gets too strong too fast. It's the synchronized global economic expansion, not Washington politics, that's driving stock prices to new highs. So forget Trump and think Goldilocks. So far, the expansion is "not too hot" so as to ignite an inflation problem, nor is it "too cold" to cast a chill on earnings growth. Let's hope it stays "just right."

*American manufacturers are growing at the fastest pace in almost three years, reflecting improved economic conditions both at home and abroad. The Institute for Supply Management said its manufacturing index rose to 57.8% in June from 54.9%. That's the highest reading since mid-2014 and well above the 55.6% forecast of economists surveyed by MarketWatch.*

~MarketWatch.com
July 3, 2017

*Some argue that passive at 37% of US fund assets is too small to affect the market. But that sounds like wishful thinking and it echoes the argument prevalent a decade ago that subprime at 23.5% of mortgage originations in 2006 was simply not big enough to affect the housing market let alone the financial system.*

~Barron's
July 7, 2017