January 20, 2016

These are the Times that Try Men's Souls - Thomas Paine, “The Crisis”, 1776

Many investors are understandably feeling anxiety over various geopolitical developments in recent weeks as well as the rough start in the stock markets here and abroad thus far this year. In addition, investors who have owned diversified portfolios comprised of not only U.S. large cap stocks, but also mid and small caps, European and Japanese and especially emerging market stocks have experienced disappointing results over the past year or so. The outlook is unclear, and it is hard to feel confident that some of the most significant challenges facing our government and those of our allies and vexing the outlook for our financial markets will show meaningful progress anytime soon. That all being true, we appreciate the fact that many of you are questioning the merit and wisdom of "holding" the diversified holdings which include quite a few market segments that provide the greatest concern. It is a fair question that I will try to address in today's letter.

In Defense of Diversification

As I have often acknowledged, we don’t have a crystal ball so we do not know what is going to happen to any particular stocks, economic sectors, international markets, the U.S. $ versus the Japanese Yen, etc. in the days, weeks and months that lie ahead. While one approach is “when in doubt, get out”, we believe the better approach is to remain invested and diversified. I am sure that strikes some of you as a copout or perhaps just otherwise unacceptable. Rest assured, I do not come about this position casually. On the contrary, it is based upon the lessons I have learned through the teachings of some true investment titans, extensive research I have read and my attuned involvement in the financial markets over the past 30 years.

Let's start with the basics. Investor "A" owns a portfolio comprised of "U.S. large capitalization stocks" and Investor "B" owns those securities plus mid & small cap U.S., plus Europe, Canada, Japan & Australia (e.g. the developed world ex - U.S.) plus the rest of the world's stocks (e.g. the emerging markets). First there are a few things we do know. There will be periods (sometimes a number of consecutive years) when Investor "A's" portfolio will perform better than the diversified portfolio held by Investor "B". Indeed we have been in one of those environments for quite a few years now. Historically, the opposite has also frequently been true. Indeed as we will see, large cap U.S. has been a significant laggard over some extended (e.g. multi-year) periods. While we don't know what the future holds, my experience has been that "U.S. only" investors often embrace international and/or mid & small caps at inopportune times and vice versa. While we would not be terribly surprised to see the "U.S. is best" trend continue for some time; we believe the "diversified portfolio" has more merit over the next several years.

"Many shall be restored that are now fallen; and many shall fall that are now in honor." - Horace

Benjamin Graham, the mentor to Warren Buffett (among other iconic investors), used this quote in preface to his 1934 seminal work, Security Analysis. Often referred to as the "father of value investing" it is hard to overstate the contributions he has made upon generations of disciplined investors. I have always found that quote to be particularly fitting because it captures the essence of the stock market as today's darlings often turn into tomorrow's goats and those that are unloved and reviled often survive and thrive. Here are several more of my favorite quotes made by some iconic investors --
"Be fearful when others are greedy; be greedy when others are fearful" - Warren Buffett

"You make most of your money in a bear market. You just don't know it at the time." - Shelby Cullom Davis

“In bear markets, stocks return to their rightful owners.” – J.P. Morgan

First you may be asking yourself, “Who said anything about a bear market?” To be clear, I am not suggesting that the recent declines in the U.S. averages constitute a bear market. Indeed with respect to the U.S. market while many stocks are down more than 20% from their 52-week highs, the averages themselves are down about as much as we see in a “typical” correction. Rather, the bear market I am referring to pertains to the emerging markets. Specifically at the current price of $29.12 the vehicle we use to access the emerging stock markets is down more than 1/3 from its 52 week closing high of $45.08 made on April 28, 2015. Furthermore, its value is only 50% of its $58.64 closing value of October 31, 2007 (e.g. more than 8 years ago). Please see the table below.

The data above is small, so hopefully these comments will help. First, the chart shows the annual return for the S&P 500, EAFE (Europe, Australia & the Far East), the MSCI World and the MSCI Emerging Market indices. The best calendar year return is at the top of each column and the worst is at the bottom. The S&P is always the figure in red and the emerging markets is always shown in blue. Notice that the S&P is often on the top or the bottom and the same is true for the emerging markets. Furthermore as you can see, the annual difference is frequently more than 15% (and occasionally more than 45%).

As you can see, there has been a seesaw with respect to trends favoring the U.S. and then the emerging markets. During the first 4 of the past 21 years (e.g. 1995 thru 1998), each $1 invested in the S&P grew to $2.90. You will recall this was the roaring bull market of the mid to late 1990s. During this same time, each $1.00 invested in the emerging markets, fell to $.66. However, in 8 out of the 9 subsequent years, emerging market returns trounced the S&P (e.g. year end 1998 through year end 2007). During this time, each $1.00 invested in the S&P grew to $1.23 while each $1.00 invested in the emerging markets grew to $5.19. Once again leadership changed. Specifically since year end 2007, each $1.00 invested in the S&P has grown to $1.66 while each $1.00 in the emerging markets is only worth $.79.

As you can also see, the S&P led all the indices in 4 out of the most recent 5 years. Since the end of 2010, each $1.00 invested in the S&P 500 has grown to $1.81 while over the same time, each $1.00 invested in the emerging markets is worth $.79 (e.g. a negative return of 21%). The obvious question is what does the future hold?

As mentioned above, the trend favoring the U.S. stock market may well persist. Indeed, we would not be surprised to the S&P go up 20% from here or for the emerging markets to lose another 20% in the near term. Both are well inside the likely range of outcomes. However, when we ask which of the two might provide a return of 50% to 100% more quickly over the years ahead, we believe it could well be the emerging markets. Since we are discussing international markets, it seems appropriate to share some quotes from Sir John Templeton whom many call “the father of international investing”.

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Here are some things John Templeton had to say about finding outsized future returns --

“People are always asking me where is the outlook good, but that’s the wrong question. The right question is: Where is the outlook most miserable.”

“There is only one reason a share goes to a bargain price: Because other people are selling. To get a bargain price, you’ve got to look for where the public is most frightened and pessimistic.”

“To buy when others are despondently selling and to sell when others are avidly buying requires the greatest fortitude and pays the ultimate rewards.”

“If you search worldwide, you will find more bargains – and possibly better bargains – than in any single nation.”

“Whenever you purchase a large amount of future earning power for a low price, you have made a good investment. The only way to accomplish this is to buy when others are selling. Investors often struggle with this concept; it is not easy to act contrary to popular opinion.”

“Whatever the reason, investors are on the sidelines, sitting on their wallets. Yes they will tell you: ‘Buy low, sell high.’ But all too many of them bought high and sold low. Then you ask: ‘When will you buy the stock?’ The usual answer: ‘Why, after the analysts agree on a favorable outlook.’ This is foolish but it is human nature. It is extremely difficult to go against the crowd – to buy when everyone else is selling or who has sold, to buy when things look the darkest, to buy when so many experts are telling you that stocks in general, or in this particular industry, or even in this particular company, are risky right now.”

More generally about investing here are some other quotes from Sir John --

“Bull markets are born in pessimism, grow on skepticism, mature on optimism and die on euphoria.”

“Looking for a good investment is nothing more than looking for a good bargain.”

“Invest for maximum total REAL return. This means the return on invested dollars after taxes and inflation. That is the only rational objective for most long-term investors. Any investment strategy that fails to recognize the insidious effect of taxes and inflation fails to recognize the true nature of the investment environment and thus is severely handicapped.”

“Diversify. In stocks and bonds, as in much else, there is safety in numbers.”

“No matter how careful you are, you can neither predict nor control the future.”

“Invest – don’t trade or speculate.”

“Buy value, not market trends or the economic outlook.”

“In almost every activity in life people try to go where the outlook is best. You look for a job in an industry with a good future or build a factory in an area where the prospects are best. However, my contention is that if you are selecting publicly traded investments, you have to do the opposite.”

“If you expect a company to grow and prosper, you are buying future earnings. You expect that earnings will go up, and because most stocks are valued on future earnings, you can expect the stock price may rise also.”
“Keep in mind the wise words of Lucien Hooper, a Wall Street legend: ‘What always impresses me,’ he wrote, ‘is how much better the relaxed, long-term owners of stock do with their portfolios than the traders do with their switching of inventory. The relaxed investor is usually better informed and more understanding of essential values; he is more patient and less emotional; he pays smaller capital gains taxes; he does not incur unnecessary brokerage commissions; and he avoids behaving like Cassius by ‘thinking too much.’”

John Templeton generously shared his beliefs on other more general topics --

“Only one thing is more powerful than learning from experience, and that is not learning from experience.”

“Unfortunately, too often people focus on the negatives and lose sight of the multitude of blessings that surround us and the limitless potential that exists for the future.”

“Success is a process of continually seeking answers to new questions.”

Last, but not least, he wrote, “The unknown is not knowable, and is vastly greater than the known.”

Reasons Why We Like International.

Rest assured we have a favorable outlook for the long-term outlook for the U.S. economy and markets. Notwithstanding our faith in the long-term outlook for the U.S. economy and markets, we like holding strategic allocations in international (as well as mid & small caps). First we believe as we have seen in the past, it highly likely that leadership will change. This generally means more broadly diversified portfolios will likely exhibit less volatility up and down over market cycles (see table). In addition, we think it is more than plausible that the share of future market value may continue to grow for emerging markets. This is predicated upon the belief that these countries’ share of population and global GDP (already at roughly 80% and 50%, respectively) will continue to grow over time. In addition, if that proves true, we believe their collective share of global stock market value will also increase from less than 10% presently. Time will tell but that does not seem unrealistic to us. Indeed the fact that ownership of these markets feels so uncomfortable makes us believe the worst may surprisingly be behind us.

Presently, the S&P 500 has a PE ratio of approximately 16x (based upon the median estimate analysts have for this year’s earnings). Therefore, if the PE ratio stays the same and earnings grow at 5%, the price level would rise to approximately 2850 in 9 years and it would reach 3800 in approximately 15 years. Under this scenario, the total return realized from ownership of the S&P 500 would be about 7.5% annually (e.g. earnings growth + the dividend yield). Of course if the PE ratio remains the same and the earnings growth rate proves higher, the time to reach 2850 would be shorter and the annual rate of return would be higher and vice versa. An increase in the PE ratio would also enhance the return and shorten the time period to reach 2850 and vice versa. With respect to the emerging markets, the share price has fallen by roughly 50% despite the fact that earnings growth over this 8-year period has been quite favorable. This means that the PE ratio has contracted sharply (and it is presently less than 15x). If the underlying economies continue to grow at a greater rate than the U.S. (they may or may not), then earnings growth might be higher than the 5% I used in this example for the U.S. If that were the case, then the time required to see an increase in price of 50% and 100% would be faster (even in the absence of an increase in the PE ratio - which also may or may not happen). Given the fact that the PE ratio is low and the dividend yield is more than 1% higher, the potential for better gains seems real to us.
I liken declines in prices and valuation to a compressed spring. While we don’t know how much additional (if any) compression lies ahead, the upside when the PE expands is very robust. As you know, the S&P 500’s price level has been cut in half twice since early 2000. Moreover, you may recall vividly that, it did not feel the least bit sensible to most investors to hold let alone add to equities in the fall of 2002 or the early part of 2009. The economic backdrop was poor and most people and forecasters expected it to get worse. However at the bottom, when pessimism was the prevailing view, the period of discounting long-term future economic growth ended. Investors who stayed the course recovered their losses while those who sold locked them in. Since 2007, aggregate GDP and corporate earnings gains in the emerging market countries have been quite good, yet as mentioned earlier, the price level is down about 50% (and valuation is down appreciably more than 50%). We believe the longer and deeper the compression of valuation, the more pronounced and enduring the recovery is likely to be. Indeed in prior periods when emerging markets generated robust returns, valuation expanded from a very modest level. As unlikely as it may seem today, that is what we believe could happen over the next 3 plus years.

In sum, I believe that investments made when times are good and confidence is high are typically not as profitable as those made after years of underperformance amidst an uncertain/gloomy outlook. It is not enough to discern or forecast the relative direction of two economies or the earnings of market segments. The second level question is centered upon not only expectations but also an assessment of how much is "priced in" or reflected in valuation. If you think about how much value can change, it is pretty clear that no trends last forever, nor do any stocks, sectors or market segments always out- or under-perform. Furthermore, much in keeping with the teachings of Mr. Templeton and others, market bottoms have historically been found months and sometimes years before there was much in the way of economic recovery, let alone investor sentiment. Success in investing often stems from our ability to be optimistic when the outlook is most cloudy and skeptical when all the lights appear to be green.

We recognize that the concerns over plunging energy prices, geopolitical tensions in the Middle East and with North Korea are very real and these challenges may well remain with us for years or decades to come. However, I believe that we have faced greater challenges and that we will once again persevere. And when I say “we”, I include many of the nations including China that are generating so much angst today. We want to continue to own these securities when most investors want out. Our concerns are real; but they may also be adequately discounted in the markets today. Also with respect to oil prices, we know that Saudi Arabia is flooding the markets with oil to punish and discourage other producers. That said, tensions in the Middle East could cause disruptions in supply and force prices up.

It is worth remembering that when journalist and patriot Thomas Paine wrote “the Crisis” during our Revolutionary War, our forefathers were facing the most powerful army and navy in the world and I dare say expectations for America’s future were quite low during those years. Since then, the world has endured tremendous economic setbacks including the global Great Depression and two World Wars and yet we have been able to move ahead. I think we may well look back at this period of consternation as a period of opportunity particularly for those who have the courage to remain invested in troubled sectors including China and the rest of the emerging markets. Time will tell, but in the words of Bob Dylan, “What looks large from a distance, close up ain’t never that big.”

Warmest regards,

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