Views from the Peak

Timely information for friends and clients

Be fearful when others are greedy and only greedy when others are fearful. –Buffett

My last newsletter focused on the risk and the future return potential of the market. The market went on to make new all-time highs in February. Things changed quickly. The annualized return on the total stock market since January 2000 went from about 5.6% at the start of the year to about 3.9% as of March 19th. A portfolio of 50% in the total stock market and 50% in the total bond market has returned 5.3%.

From the snort of a bull to the roar of a bear

As of Wednesday, March 11th, we entered an official bear market when we closed down about 21% on the total stock market value. The market had shed all of the gains it had made since early 2018. On March 16, 2020, the total stock market index, the Wiltshire 5000 was down 29% from its peak of 34,617 on February 19th. Almost 30% wiped out in a less than a month. That is crazy.

During the next few days, we would proceed to go lower and then shoot higher. During the week of March 9th, we made a record. We had 2 of the top 20 down days and one of the top 20 up days. What is interesting when you look at the other days in the top 20, almost all happened during financial bear markets or the great depression.

This market reminds me of the ride where you go straight up and then it drops you down. It teases you a few times before it gives you the large plunge. We don't know if this has been the tease or will be the plunge.

Piles of sand

In 2018, I wrote about the sand pile experiment. In 1987, Peter Bak, Chao Tang and Kurt Wiesenfeld developed a program to simulate a grain of sand being added to a pile. What they discovered was that the pile entered a critical state depending on its height and width. Once it did, you did not know which piece of sand would ultimately cause the pile to collapse.

Covid-19 may end up being the sand added to the pile that led to the collapse. There was already a pile in a critical state. I would say that the virus along with the oil shock is a bag that was dropped on the pile.

Sand in the pile

As we discussed several years ago, corporate debt was at record highs and proceeded to make new highs. It is estimated to be about $15 trillion by the US government. Stock buybacks have been at record highs. They accelerated after the tax cut and repatriation of profits. S&P Indices reports that $4.5 trillion has been spent on buybacks since 2012.

The government deficit has been increasing by 15-20% a year. Companies that should have gone bankrupt in the 2015-16 have been allowed to hang on even though they had no path to profitability. Auto sales have been trending down. So have large truck sales. Credit card balances and student loans keep increasing to new highs.

The price that people were willing to pay for a $1 of average earnings over a 10 year period (Shiller PE) had been increasing. As of the end of January, we were paying $31 for every dollar of average 10 year earnings. If we inverse this, then we were purchasing a 3.2% yield on our investment with the risk of a 50-60% decline. This was a similar level to what it was in September 2018 right before the market started its downward march in late 2018**. It was at about 27 in January 1929.**

The 3 month to ten year treasury yield curve had inverted. This was a sign once again that all was not well. Wall Street paraded all of their experts to the networks saying that "it's different this time." The fed manipulated the curve so it was not a valid indicator. It was not different this time. The credit market had serious issues that were left to build up.

The response so far

The government has unleashed more financial help for markets than they did in 2008. Credit markets have had liquidity issues. Much of this help has been to get the credit markets moving again.

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Our Mission

To enhance our clients' financial lives by bridging the gap between their most cherished financial goals and the resources that they bring to the table. We do this by helping them create a realistic investment plan and keeping them on-track through advice and education.

Industries like airlines are clamoring for a bailout. According to Ycharts, they have spent almost $45 billion since 2012 on buybacks. Now they want a $50B bailout?!?! Why didn't they create a 6 month emergency fund like a family is supposed to do?!?!

Unfortunately, a bailout may be necessary. For example, Boeing has asked for $60B. Their product is necessary for the country. Their supply chain is at risk. In my opinion, this should come with a restructuring much like what happened to GM during the last recession. We should not reward companies that do not build themselves up for an emergency.

The virus

We do not know how this virus will run through our society. The steps taken so far with cancellation of events, cruises, parks, etc… will cause short term pain for corporations, but hopefully slow the progression. Slowing the progression is very important. Let's see why.

The math of spreading.

Let's say a friend gives us $2 on day one and doubles it for 30 days. How much money would we have at 10, 20, 29 and 30 days? On day 10, we would have $1,024. On day 20, we would have $1,048,756. On day 29, we would have $536,870,912. On day 30, we would have $1,073,741,824.

Imagine that it was only $1.50. We would have about $192M after 30 days. The spread of viruses is much more complex, but you get the idea. Controlling the spread is important to give our brilliant scientists time to come up with treatments and vaccines.

Remember how losses work

A few years ago, we discussed the math of loss. If we lose 50%, we need a 100% return to get back to even. Let's say this is an average 35% loss. We will need about 54% to get back to even. You can see how losses matter more than capturing all the gains. If a manager captures 50% of the downside and 75% of the upside, then he can usually outperform over many full market cycles.

Attention shoppers, we have a blue light special

It may sound bad, but my hope is that we will see 50-60% down. Remember, I take after my mom. She always taught me to buy on-clearance. I still buy t shirts when people are buying sweaters. We are not at clearance levels, but probably closer to fair priced even at 30% down. That is before any fallout from the virus. That may reduce earnings by 20% or more.

Remember January's newsletter

We invest conservatively. Conservative means that we take account of math and probabilities to make investment decisions. We allocate based on those. We ignore the hype and the short term calls for the year. We want to partake in gains. We don't want to blow ourselves up. We don't want to permanently impair our capital.

Bear markets are our favorite time to invest. We understand that bargains are found when stores hold clearance sales. Our managers love these times. They want to find a new business that is on-sale. They can let the math do its work over the next 7 plus years. This is when they shine.

Assets serve a purpose

Stocks are to provide growth and income. Bonds are to provide stability and income. We combine them for an investment that works in both good times and bad times. We know that we need to be cautious when times are good and we need to take advantage of bad times.

The doctor is in…

Let's make sure we are thinking logically and not emotionally. History in the market continues to prove that we should keep a mixture of stocks and bonds as long term investors. It also continues to prove that investors are their own worst enemies. Many of them piled in over the last year thinking that 2018's drawdown was the bear market. When the market increases, but corporate profits as a whole are stagnant, something should give at some point. In this case, it was the market.

Make sure your friends and family are thinking ok. In 2008 and 2009 I talked many people off of the ledge. They had chosen the biggest and fastest roller coaster. If any of them are panicking, please feel free to share my number. Like Lucy from the Peanuts cartoon, the doctor is in.

During these times, I remember two quotes from the Army. ***Prepare for the worst, and hope for the best.*** The other was ***"if you get through an operation, and you feel that you over-prepared, then you did the right amount of preparation."***

Thanks for taking a look.