RBC Wealth Management

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July 2019 Investment Commentary

Recently, we've observed an odd set of financial and economic distortions that the stock market appears to have shrugged off. Various measures of the U.S. economy are at the strongest level they've been ~~at~~ since before the financial crisis, yet the Federal Reserve just stimulated the economy by cutting interest rates. Corporations have borrowed excessive amounts of debt to buy back and boost their stock, a trend which must come to an end at some point. Companies with no profit or cash flow, and no known path to profit or cash flow, sell for more than companies with an established track record of profit and cash flow. And the U.S. government continues to go deeper down the debt hole. Yet despite these oddities and distortions, investors have acted as if none of this matters, with stock prices at record highs. Well, if something seems too good to be true, it probably is. We've seen this movie before. Just think back to 2007, 2000, 1980, etc. At some point the excesses of the present will cause some pain.

While there's no doubt that the current excessively frothy times will meet a counter balance of excessively pessimistic times at some point, no one knows precisely when that will happen, nor how it will play out in the stock market. In the past, we have witnessed many times when things looked too good to be true. We felt that the market became overheated in 2017 following the presidential election and tax cut, and we did indeed experience two corrections in 2018, including a large 20% drop in stocks classified as a bear market. Yet those who tried to time the market and sold stocks after they fell have missed out on a very strong recovery. Trying to time the market will result in a lower return than simply staying invested and participating in all the upside peppered with temporary downturns. Thus, we need to stay invested. We need to stay invested in order to generate an adequate return for our investors. But perhaps most important of all in the current climate of optimism, we need to stay invested in a way that protects our investors from the negative consequences of the present excesses. We must invest in a way that avoids the riskiest areas of the market – this is not the time to become aggressive and chase after returns.(1)

So, how do we invest in a manner that positions our clients to take advantage of long-term growth while at the same time protecting them from potential negative consequences of excessive optimism and speculation?

First and foremost, we focus on keeping our clients out of financial bubbles, since getting caught up in a bubble can result in no long-term gain for investors. We primarily achieve this by refusing to follow the crowd into popular investments. The fact that an investment has gone up a lot over a few years says absolutely nothing about what that investment will do over the next ten or twenty years. An article published this past March in the Wall Street Journal reported that of the four companies with the largest stock market value in 1999 – Microsoft, Cisco, Intel, and Oracle – only Microsoft had a higher stock market value than it did twenty years ago. Almost all investors know they shouldn't follow the crowd. But in practice, not doing so requires discipline, patience, a long-term view, and a fiercely independent mindset. It requires the ability to watch other market participants temporarily make easy money in investments they don't understand, and it requires conviction that over the long-term, those investors will suffer as a result of their speculative behavior. This brings to mind a quote from the shareholder letter published last year by Warren Buffett, the greatest investor of our lifetime: "The less the prudence with which others conduct their affairs, the greater the prudence with which we must conduct our own…What investors then need instead is an ability to both disregard mob fears or enthusiasms and to focus on a few simple fundamentals. A willingness to look unimaginative for a sustained period – or even to look foolish – is also essential."(2)(3)

As we mentioned above, of the four largest stock market value companies in 1999, only one has a larger stock market value today. Such a circumstance helps explain why stock market indices have achieved no long-term return at different periods in history. One such period occurred from 1964 to 1981, a time period over which the Dow Jones Index essentially remained flat. Warren Buffett attributes this stagnant investment period in part to overvaluation of auto and airline companies, which were the hot new technology companies of their era. While those companies transformed the world and earned tremendous revenue, they earned minimal profits, and many have filed for bankruptcy. More recently, the S&P 500 index remained flat over the time period 2000 to 2013, partly explained by the fact that the stock market values of Oracle, Cisco, and Intel remained lower in 2019 than they were in 1999.(4)

So, keeping our clients out of bubbles constitutes the important first pillar of our strategy for generating long-term investment gains while protecting our clients from the consequences of excessive optimism and speculation. A second pillar of that strategy involves only selecting investments where – after careful and thorough analysis – we can conclude that we understand the long-term profit dynamics of both the company and its industry. Only under these circumstances can we calculate a reasonable price to pay for the investment. The more susceptible a company is to change and disruption, the less certain the view we can develop of the future. We prefer companies with boring, stable, predictable, and repeatable results. While this investment strategy may lack the excitement and romance that many people associate with Wall Street, we recall what Warren Buffett has said: "Beware the investment activity that produces applause; the great moves are usually greeted by yawns."(5)

Only after finding companies with boring, stable, predictable, and repeatable results can we achieve the third pillar of our investment strategy, which consists of paying a reasonable price for each of our investments. If a company's profits and cash flows vary widely or could change substantially in the future, we can't calculate a reasonable price to pay. As we described above, the reason Cisco, Intel, and Oracle have stock market values below what they were twenty years ago is the stocks became highly overvalued. Seeking to pay a reasonable price for an investment helps protect our investors against a scenario of no long-term gain.

The fourth and final pillar of our investment strategy consists of maintaining 3-5 years' worth of living expenses in cash and bonds for clients currently living off their assets. This allocation allows our clients to maintain a portion of their assets in growth-oriented assets such as stocks, in order to grow their wealth ahead of inflation and taxes. The remaining portion of their assets invested in cash and bonds provides a stable source of funds that clients can use to cover living expenses in the event of a prolonged market downturn. Investing in this manner allows us to balance growth versus income for retired clients, and prevents us from having to attempt to time the stock market, which leads to failure.(1)

Best Regards,

The Crescent Group
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Sources:

(1) DALBAR
(2) The Wall Street Journal
(3) Berkshire Hathaway 2017 Chairman's Letter
(4) Fortune
(5) Berkshire Hathaway 2008 Chairman's Letter