# The Financial Navigator – November Newsletter

With the U.S. stock markets climbing for essentially five straight years many investors are concerned about an imminent market pullback of 20% or more. Of course, Wall Street brokerage houses have come rushing forward with products designed to exploit the investor fear and concern while boosting their revenue. Lately I have seen more marketing by the Wall Street firms of sophisticated market timing mutual funds, and hedge funds targeted not at their usual clientele, pension funds and college endowments, but at main street investors. The articles below discuss both strategies and provide some useful counterclaims to the sales hype concerning these products; something to consider before one commits to an investment that most main street investors don't understand.

You may know someone who has the same questions and concerns about the market and their portfolio. If you think it will help, feel free to forward this email and let me know if you have questions about a specific situation.

Sincerely,

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## ***CAPE Fear: Valuation Ratios and Market Timing***

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As broad market indices such as the S&P 500 have set new record highs in recent weeks, many investors have become apprehensive. They fear another major decline is likely to occur and are eager to find strategies that promise to avoid the pain of an extended downturn while preserving the opportunity to profit in up markets.

One approach that has attracted considerable attention in recent years is adjusting investments based on the CAPE ratio—the Cyclically Adjusted Price / Earnings ratio. Developed by Nobel Prize winner Robert Shiller of Yale University and John Campbell of Harvard University, the CAPE ratio seeks to provide a road map of stock market valuation by comparing current prices to average inflation-adjusted earnings over the previous 10 years.[1] The idea is to smooth out the peaks and valleys of the business cycle and arrive at a more stable measure of corporate earning power. Shiller suggests that investors can improve their portfolio performance relative to a static equity allocation by overweighting stocks during periods of low valuation and underweighting stocks during periods of high valuation.

A CAPE-based strategy has the virtue of using clearly defined quantitative measures rather than vague assessments of investor exuberance or despair. From January 1926 through December 2013, the CAPE ratio has ranged from a low of 5.6 in June 1932 to 44.2 in December 1999, with an average of 17.5.

Using the CAPE ratio might appear to offer a sensible way to improve portfolio results by periodically adjusting equity exposure, and many financial writers have focused on this methodology in recent years. As an example, a timing newsletter publisher earlier this year observed, “For the S&P 500, this ratio currently exceeds 25.6, which is higher than what prevailed at 29 of the 35 tops since 1900.”[2] Many investors find such an approach very appealing. Does it work?

The challenge of profiting from CAPE measures or any other quantitative indicator is to come up with a trading rule to identify the correct time to underweight or overweight stocks. It is not enough to know that stocks are above or below their long-run average valuation. How far above average should the indicator be before investors should reduce equity exposure? And at what point will stocks be sufficiently attractive for repurchase–below average? Average?  Slightly above average? It may be easy to find rules that have worked in the past, but much more difficult to achieve success following the same rule in the future.

This implementation challenge appears to be the Achilles’ heel of timing-based strategies. A study in 2013 by professors at the London Business School applied CAPE ratios to time market entry and exit points. “Sadly,” they concluded, “we learn far less from valuation ratios about how to make profits in the future than about how we might have profited in the past.”[3]

As an example of the potential difficulty, consider the CAPE data as of year-end 1996. The CAPE ratio stood at 27.7, 82% above its long-run average of 15.23 at that point. The last time the CAPE ratio had flirted with this number was October 1929; the CAPE was at 29 as stock prices were about to head over the cliff. It seems plausible that followers of the CAPE strategy would have been easily persuaded that investing at year-end 1996 would be a painful experience.

The actual result was more cheerful. The next three years were especially rewarding, with total return of over 107% for the S&P 500 Index. For the period January 1997 to June 2014, the annualized return for the S&P 500 Index was 7.7%, compared to 2.4% for one-month US Treasury bills. Stock returns were modestly below their long-run average for this period, but the equity premium was still strongly positive.

By comparison, a timing strategy over the same period that was fully invested in stocks only during periods when the CAPE ratio was below its long-run average produced an annualized return of 3.1%. All timing strategies face a fundamental problem: Since markets have generally gone up more often than they have gone down in the last 90 years, avoiding losses in a down market runs the risk of avoiding even heftier gains associated with an up market.

A successful timing strategy is the fountain of youth of the investment world. For decades, financial researchers have explored dozens of quantitative indicators as well as various measures of investor sentiment in an effort to discover the ones with predictive value. The performance record of professional money managers over the past 50 years offers compelling evidence that this effort has failed.

Despite this evidence, the potential rewards of successful market timing are so great that each new generation sees a fresh group of market participants eager to try. Searching for the key to outwitting other investors may be fun for those with a sense of adventure and time on their hands. For those seeking the highest probability of a successful investment experience, maintaining a consistent allocation strategy is likely to be the sounder choice.

## ***Over the Hedge***

Jim Parker, Vice President-Dimensional Fund Advisors.

According to consulting firm McKinsey and Co, hedge funds and other “alternative” investments will command up to 40% of the asset management industry’s global revenues by 2020 as investors seek them for “safety and consistent returns.”[4] Certainly, some recent trends might appear to point in that direction. According to Hedge Fund Research, investors allocated $30.5 billion of new capital to the industry in the second quarter of this year, the most since early 2011.[5]

Cited by researchers as driving the flows are the imminent end of the US Federal Reserve’s stimulus, escalating geopolitical tensions, a rise in mergers and acquisitions, and the belief that conventional asset valuations are “extended.” But hidden among these overall numbers are some other trends. For instance, the Wall Street Journal recently reported that public pension funds in the US are backing away from hedge funds because of concerns over high fees and poor returns.[6]

In its quarterly statement on monetary policy in August, the Reserve Bank of Australia noted that hedge funds had significantly underperformed a simple balanced portfolio of global bonds and equities for three consecutive years.[7] “This underperformance has been especially pronounced for macro funds, which trade in response to movements in economic variables; such funds have posted virtually no return over this period,” the central bank noted.

The results may provide reason for some investors to think twice about the merit of hedge funds, which typically take bets on stocks, bonds, and other securities, often using borrowed money. Hedge funds will often charge high management fees of around 2% of assets under management, plus 20% of any profits earned.[8] Those fees represent a high bar for investors who resort to these funds in an attempt to earn returns above what they would receive from a simple index fund. To seek those above-index returns, in many cases investors must first pay the cost of shorting. This is the practice of selling securities that the seller does not currently own and subsequently repurchasing them. Essentially, it is a bet that the stock price will fall. To fund your bet, you often have to take out a loan. This is a not an immaterial cost. While increasing a portfolio's expected return, the leverage used by many hedge funds also magnifies the volatility of a fund's return. It can be hard enough for ordinary investors to put up with the underlying market's ups and downs, never mind magnifying them by a multiple of two, four, or more.

Added to the costs of shorting and the effect on volatility of leverage, hedge funds are known for lacking transparency. While this can be seen as an advantage for hedge funds in making it difficult for competitors to copy their strategies, it can also make it hard to quantify where the returns are coming from and what risks are being taken.

Hedge fund databases suffer from many biases, which make performance studies difficult. Survivorship bias is one. This refers to the tendency of failed or closed funds to be withdrawn from databases. But more importantly, hedge funds voluntarily report, which means they tend to report only when returns are good.

So, in short, the risks around hedge funds are often unclear, leverage can increase volatility, fees tend to be excessive, and returns—at least in recent years—have been less than spectacular. It becomes easier to see why many public pension funds are "over the hedge."

**References**


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