The Only Investment Strategy That Makes Sense To Me

Saturday's With Jim

By Jim Pursley
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Dear Friends,

Financial market direction – up, down and sideways – is the result of forces caused by the buying and selling activity of millions of investors. It is a rare person who can make sense of the markets day to day, week to week or even year to year moves. Taking a long, multiyear cyclical view of the markets, however, does reveal patterns that are mostly discernable and tradeable. Howard Marks, in his forthcoming book, Mastering The Market Cycle, asserts that "You should scale back or crank up the level of risk you take in the markets but only when signs of euphoria or despair become extreme. The more often you do change your stance, the less likely you are to be relying on valid indicators." Marks goes on to say that the markets, he means stock markets, move in huge, multiyear cycles whose turning points are far apart. An investing strategy based on finding major turning points can be very profitable when viewed by a long lens, provided that the signals are detected and acted upon within a reasonable time of their occurrence.

Business Cycle Investing

Howard Marks, Chairman of Oak Tree Financial, a Los Angeles investment firm specializing in distressed bonds, wrote in early 2007 that he thought that the real estate market was very frothy and that his firm was getting defensive. He wrote again in October 2008, a short while after the bankruptcy of Lehman Brothers Investment Bank, that market risk had greatly lowered. Marks anticipated the Great Financial Crisis (GFC) by a few months, ditto its end in the financial markets. His firm progressed through the GFC very well because of Marks' attention to the seldom occurring, but potentially highly profitable, trading signals which heralded the beginning and end of the GFC. We have adapted Marks' strategy in our investments for you, calling it business cycle investing.

Finding Inflection Points in The Business Cycle

A clue can be found in the words of Warren Buffet, perhaps the world's greatest living investor, admonishing us to "be fearful when others are greedy and greedy when others are fearful." One of our indicators, then, is market sentiment.

We have also noticed that the Federal Reserve's interest rate increases have been instrumental in the timing of ten of the last thirteen recessions. And so, we compare the Fed Funds rate with other market interest rate measures to see if the Fed has gotten “too tight”, draining liquidity from markets and placing a barrier to economic activity.

While the Federal Reserve may be complicit in sowing the seeds for bear markets, their actions alone would not cause investors to flee in droves in fear and panic. Bear markets are usually preceded by speculation and economic imbalances which are often called the “new order.” But bear markets can also be caused by events such as the Arab oil embargo in 1973 following the Yom Kippur War. We hope that our eclectic reading habits will help us detect the next inflection point.

In addition to market sentiment, Federal Reserve monetary policy and speculative activity/economic imbalances we also follow some data which offer additional clues about the strength of the markets and the economy. Examples are the Chicago Federal Reserve National Activity index, the “TED spread” – a measure of the cost of short-term interbank rates and moving averages of high yield bonds (they tend to crater before stocks) - and unemployment claims.

There is no reason to panic just yet. The yellow lights are flashing warning signs, but this condition can persist for some time before markets become dangerous.

Thank you for investing with us.

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