Tempering Risk, the Secret of Great Long-Term Returns: Uncommon Knowledge for the Common Good II

Saturday's With Jim

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Key Points:

- About 90% of the time it's safe to enter into long term investment in stocks
- About 10% of the time, marked by excessive ebullience and market imbalances, it's best to avoid stocks
- During the 90% of stock exposure, modulating the stock allocation according to market valuation reduces risk and amplifies long term returns
- Allocation to high quality bonds and cash should be increased when stocks are very unattractive
- Diversification among types of assets reduces risk in all market environments

Dear Friends,

Last week we showed how just a marginal change in investment return produced outsized account growth over long periods, such as 35 years. We cautioned that reaching for maximum returns magnified timing risk, the risk that markets would be overvalued when we begin our program, resulting in perhaps a large initial loss for us as markets return to normal valuations. Today, let's discuss how we can moderate the risk of underperforming our potential returns. We believe it will be helpful for you to understand the underpinnings of our investment strategy, though you may not do the hands on work yourself.

We're ready to invest, but are the markets conducive?

Truly, beginning a long-term investment program almost any time will make us good money if we stick with our investments as they zigzag their way upward. We will encounter really horrible starting points only about 10% of the time. These inopportune times are characterized by high public enthusiasm, high valuations and divergences between the favorites du jour and other areas of the market. Investing when markets are enthusiastically bid up for years is a recipe for losses of such a magnitude as to cripple our investment program for a decade or more. If we are retiring at any of these "10%"periods, our retirement income may be permanently impaired. How can we know for sure that we face imminent downturn, a "Minsky Moment" when markets turn from greed to fear almost overnight?

Metrics of excess

Let's take today's stock markets to illustrate when not to invest. Five years ago, investors were so beaten up and discouraged by the 2008-9 financial crisis and fearful that they would never again have a decent income, not to mention decent investments, ever again. Yet, as we sit today, the U.S. stock markets have roared ahead by more than doubling and household net worth (what we own minus what we owe) stands at new all-time records. By our measures of ebullience and excess though, our contemporary stock markets are not yet unsafe to enter. Company earnings, the foundation for stock prices, have kept pace with the rise of stock prices, leaving the markets fairly valued but not anywhere near the danger zone for new money. Investor enthusiasm is healthy, but not excessive. This rally is still under believed and unloved. If history is a guide, the end will come when "it's different this time" will resound across the land, carried by people from all walks of life as they attempt to get rich from the latest investing craze. We may only be a few years away from such ebullient investing times, but they are not at our door.

Is there periodicity to financial excess?

Looking back to 1926, initiating a 100% stock portfolio in 1928-29 would have not made money until the 1940's. Initiating a 100% stock portfolio in 1966 would have tread water (after inflation) until 1982. Initiating a 100% stock portfolio in late 1999 or early 2000 would have doomed the growth of our money until about 2013. There seems to be about 40 years (two generations) between periods of excess and their aftermaths. Will the pattern continue? Will it be 2040 before we see the next major top? Don't bet on it. Historical patterns can give us some potentially profitable hunches, but are in no way guaranteed to repeat.

The mechanics of risk reduction

It's hard to make predictions, especially about the future according to sage Yogi Berra. Predicting the timing of rising and falling cycles for U.S. stocks, foreign stocks, emerging markets stocks and bonds of all types is a fool's game. Thus we diversify between them, not mechanically but with varying weightings as market and economic cycles wax and wane and as the various asset types in which we invest move in and out of favor. We never exit an asset type completely, but we will occasionally change their weightings to magnify gain and to reduce risk.

In conclusion, according to historical data, long-term investing is highest when portfolios can remain over weighted in stocks. Indeed, roughly 90% of the time markets are safe to enter on a long-term basis. For the other 10% we must be cautious and underweight stocks until they bottom.

Next week, we will show the drivers of shorter-term (20 years or less) time horizons on final account balances.

Thank you for investing with us.