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CAPITAL INSIGHTS

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For All Of Us Born Beneath An Angry Star, Lest We Forget How Fragile We Are

You may be familiar with the title of this month's Capital Insights that is a line from the song, "Fragile," by Sting. We thought the quote apropos given that as of early July, we have now crossed into our sixth year of the current economic recovery. Ours is the fourth longest economic expansion cycle on record since 1945, and for now, it's not over yet. Even more impressive, conjoined with this recovery has been the bull market in equities. If we define a bull market in stocks as a price gain of 20% or more, there have been 25 bull markets since 1929. Of those, there have only been three bull markets in the last 85 years longer than the current. The average bull market has lasted 31 months. As of August, the current bull market has lived on for 64 months, double the historical average. Lastly, the average bull market since 1929 has seen stock prices roughly double. Admittedly from the perhaps anomalistic price depths of 2009, the current bull market has witnessed very close to a tripling of value. As legendary Merrill stock market technician Bob Farrell was fond of saying, "bull markets are more fun than bears." Here, here, Bob. But we also know that trees do not grow to the sky, so lest we forget how fragile we are.

It just so happens that we also have a personal saying we are quite fond of at Capital Planning Advisors. You'll find it directly below.

"We cannot predict the future, we can only prepare ourselves for the future in a well thought out and disciplined manner."

This is the headline caption on the page of our website that describes our Wealth Management services. The quote is intentional in that it constantly reminds us of what we believe to be the two key attributes of successful investment management over time – humility and the importance of risk management in the investment process.

We believe it is an important time in the current market cycle to not only take stock (pun clearly intended), but also highlight and share our thoughts on risk management. Is this discussion a "call" on the current market? We promise, it is anything but. In this discussion our goal is to describe our specific approach to managing investment risk. We employ a multidisciplinary process focused first and foremost on client centric goals, objectives and total family circumstances. The second, and equally important, overlay is the ongoing discipline of managing price risk in individual investments, asset classes as a whole, and total portfolio valuations. Investment management is as much about being opportunistic in the acceptance of prudent risk relative to reward as it is about consistency in preserving capital. In other words, the sell discipline is equally, if not more important than the buy decision. As trite as this may sound, successful investment management is not exclusively about making money, but also about consistently not losing it, all while realizing an important subset of investment risk is that of potentially lost opportunity. The cornerstone of investment management is the successful management of risk.

The Components Of The Risk Management Process

When Will We Learn To Behave?

Let us start by saying that risk management in the investment process is as much an art as it is a science, necessarily because it is integrally intertwined with the dynamics of human decision making. As you may know, Behavioral Finance is emerging on the current academic landscape, yet we have only clearly scratched the surface.

Making money in investing can be quite an emotionally enjoyable experience. But the loss of capital can be one of the most emotionally destructive, to say nothing of potential life impacts. First and foremost, we need to be honest with ourselves in how we individually accept and react to investment risk. Although it's very easy to say, emotional agnosticism, an investor's greatest ally, can be very difficult to practice. Successful professional investors continually train themselves to check their emotions and personal biases at the office door.

Quite unfortunately, Wall Street and a good portion of the professional investment community have become obsessed with beating market averages as a measure of success. For many families and individuals, nothing could be further from the truth in terms the achievement of their unique goals and personal objectives. Our advice is to focus on your individual situation and your family needs in light of your goals and objectives. It is the achievement of individual financial goals that is most important in the activity of investing. Forget

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bragging rights at cocktail parties, and remember, individuals tend to only boast of their triumphs, never their defeats. Those are usually suffered in silence, just ask any CPA. So in focusing on individual needs, goals and objectives in managing capital ensures specific personal financial risk points are both well-defined and protected across market cycles. The only person an investor needs to impress is themselves. No one else matters.

While on the subject of human behavior, also quite important in the investment risk management process is to understand herd or crowd decision making. From the early days of man, we have acted in herds whether hunting, protecting each other, etc. Crowd behavior and decision making is hardwired in our development as a species. Investors collectively involved in the financial markets clearly constitute a herd or a crowd. Here are a few "crowd behavior" rules we live by:

1. Beware of crowds at extremes in the markets, both at tops and bottoms.

2. Contrarian thinking helps in decision making.

3. Markets run in cycles and tend to revert to the mean over time.

4. When all the experts and market gurus agree, then something else is likely to happen. What everyone already knows is not worth knowing as the markets discount the future.

5. Greed and fear are two of the most powerful human emotions, don't let either of them affect your decision making.

6. Most humans are "wired" incorrectly when it comes to investments. When something doubles, they want it twice as badly. When it drops in half, they want nothing to do with it. This "wiring" is amplified in crowds.

7. It is *never* "different this time."

As part of our risk management process as it applies to human behavioral and decision making traits that influence financial markets, we continually monitor and assess data points such as bull/bear sentiment surveys, levels and rate of change in margin debt (reflective of "animal spirits"), levels of public participation in buying and selling, etc. Extremes both scare us and embolden us, depending on whether we exist in a bull or bear market environment.

Jesse Livermore was a very famous and fabled stock market trader in the 1920's and '30's. One of the most insightful comments he made was, "the decision making on Wall Street never changes, just the wallets do." We remain absolutely convinced that to understand and make effective decisions in the financial markets, we must first understand ourselves as human decision makers, both individually and in crowd environments. Only then can we understand and manage the risk inherent in human and crowd decision making over market cycles. We've often joked with clients that "we don't sleep at night so you can." We're only half joking.

Within The Hidden Law Of A Probable Outcome, Let The Numbers Lead The Dance

In addition to emphasizing and monitoring the behavioral character inherent in the rhythm of financial market cycles and highlighting unique client circumstances in implementing and setting risk management boundaries, exercising fundamental and technical price discipline specific to individual investments, broad portfolio asset class exposure and overall account valuations is essential in the investment risk management process.

Historical valuation road markers matter! It's as simple as that. But of course the curveball is that every bull and bear stock market cycle have their own unique twists and turns. Their own unique fingerprints. Their own unique siren's calls and Cassandra-like prophecies. Historical valuation lows are a call to action in terms of heightening evaluation, assessment and implementation of investment opportunities. So too are historical valuation territory highs a call to action in setting hard downside price stop points for individual investment vehicles.

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Price management discipline is the key to successful outomes in every market cycle regardless of unique cycle specific character differences. As prices ascend in each cycle, we raise our risk management stop points. In aging market cycles, the protection of profits takes precedence over the ultimate maximization of the last dollar of price gains.

In its most basic form, the ownership of a stock is a claim on the future cash flows able to be delivered by the underlying business. Stock price at any point in time is what investors are willing to pay to receive those expected cash flows. At high price points relative to expected future cash flows, future stock price returns diminish, and vice versa. It is within this ongoing dance of the numbers in each market cycle that risk management boundary lines are drawn.

In addition to monitoring and respecting historical guideposts in individual investment vehicle and macro financial market metrics, keeping our finger on the pulse of global macroeconomic fundamentals, global capital flows that impact investment outcomes, and liquidity dynamics underpinning geographically specific capital markets and asset classes is very important. A final essential tool in the overall risk management tool box is technical (chart) analysis. Price charts represent the "vote" of the collective marketplace at any point in time. As we have matured in the investment management industry over a series of decades, we have come to respect and integrate the message and intentional marriage of fundamental (numbers) and technical (charts) analysis in the overall portfolio implementation and risk management process.

We remain convinced that successful investing over time is equally characterized by both avoiding meaningful drawdowns to the greatest extent possible as well as participating in bull market advances.

Sometimes We Glimpse A Shadow Falling, The Shadow Disappears

Where do we find ourselves in the current market cycle? As described at the outset of this letter, the current bull market in equities is extended in both time and price relative to historical context. Current valuations are nearer historic highs than not. But the special character points of the current cycle include a doubling of government debt since 2009, a Fed that has printed approximately $4 trillion in new funds in addition to removing rate of return from safe investment vehicles (zero interest rate policy), and an unprecedented convergence of global capital flows from both Asia and Europe into US asset markets (both financial markets and real estate).

Valuation levels alone do not automatically topple bull markets. Neither do extended technical chart patterns in isolation. Neither does a slow growing economy. We exist in a global economy where global capital flows more freely than at any time in history. Importantly, we need to remember that nothing happens in isolation on the global landscape.

Historically high valuations heighten our current risk management overlays on portfolios. Drawing "lines in the sand" under which we will not allow individual investments to fall is now very important. No one knows where or when a market or asset class will peak, that's guesswork. Discipline involves participating in the ongoing market advance, but simultaneously having a plan to protect. That's the key – having a predetermined game plan for all market outcomes. This may include price stop levels on individual assets or sectors, price or valuation targets where assets are sold as a matter of discipline, hedging in particularly tax sensitive portfolios, etc. Very few, if anyone gets out of a market at the top or in precisely at the bottom. If achieved, that's luck. Risk management disciplines are about conviction and implementing a plan of action before very large drawdowns occur. It has been said that the five most dangerous words in investing are, "it is different this time." We suggest to you that perhaps the second five most dangerous words are, "what do I do now?" We never want to ask ourselves that question. The best plan for offense in investing is a solid game plan for defense.

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