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CAPITAL INSIGHTS

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AT THE MARGIN

What is perhaps the greatest risk to individual investors these days? Is it the potential for a decline in corporate earnings based on a slowing global economy? Is it that current valuation levels in both equities and fixed income instruments are much nearer historic highs than not? Is the biggest risk a US Fed that will soon raise interest rates for the first time in close to a decade?

Although all of these are specific investment risks we face in the current cycle, our contention is that the single largest risk to investors is a risk that has been present since the beginning of what we have come to know as modern financial markets. The single largest risk to investors is themselves. By that, we mean the influence of human emotion and psychology in decision making.

After many years of managing through market cycles, we have observed that humans are uniquely wired incorrectly for long term investment success. When asset prices double, we want those assets twice as bad. When asset prices drop in half, we want nothing to do with them. Isn't this exactly what we saw in US residential real estate markets a decade ago? Isn't this what we experienced with the rise in dotcom stocks in 1999 and their demise over the three following years? Human decision making shapes the rhythmic bull and bear market character of asset prices. We know the two most prominent emotions that drive markets higher and lower are those of fear and greed. One of Warren Buffet's most repeated quotes continues to ring true today – "Be fearful when others are greedy and greedy when others are fearful." This represents the opposite of "following the herd."

If we turn the clock back far enough in early human life, we know that humans ran in packs. Strength and protection was found in a pack or herd. It was when humans ventured away from the protection of the herd (consensus thinking) that they were physically vulnerable. The fight or flight mechanism has been an integral part of human development over time. Several thousands of years later, these learned decision making responses are simply hard to "turn off." We find comfort in decision making within the herd. When confronted with challenge, it's either fight or flight. These ingrained human character traits are why we often see investors buy much nearer a top and sell close to market bottoms. Decision making driven by emotion, as opposed to logic, is the single greatest impediment to long term investment success. There is an old saying in the markets - "Human decision making never changes, only the wallets do."

Just what does this have to do with decision making in the current environment? Remember, as investors, controlling our emotions is probably the single greatest obstacle to sound decision making. As such, we need to anticipate potential emotional triggers so we can better confront and allay our own human responses to market outcomes. There is probably no greater human emotional trigger than actual price volatility itself. If we can anticipate and understand why price volatility may occur, we hope to dampen our own emotions and objectively steer through the vagaries of market cycles.

What we are seeing in the current market environment as a catalyst for potential heightened forward market price volatility is the current level of NYSE margin debt outstanding. You may be familiar with the financial market characterization of "animal spirits." The concept of "animal spirits" is integrally intertwined with human emotion, in this case meaningfully heightened confidence. There probably is no greater show of human confidence in the investment markets than borrowing to fund an investment. Certainly, leveraged investors expect a return above their cost of capital, with expectations usually much higher than just this simple metric. The direction and level of margin debt outstanding at any time is a reflection of these so called "animal spirits," it is a reflection of human confidence. Continued on page 2

AT THE MARGIN Continued from page 1

Let's have a look at where we now stand. NYSE margin debt outstanding rests at a record level of just over $500 billion as of the latest June reading. It has hit a new all-time high right alongside the equity market itself, exactly in line with what we would expect in terms of the emotional side of human decision making.

A few observations regarding the consistent patterns of human decision making seen in the historical rhythm of margin debt are important. First, it is clear that margin debt peaks very close to the final run to cycle highs in stocks with each bull market cycle. Remember, when asset prices double, we as humans want them more than ever (greed), but when prices are cut in half, we avoid them like the plague (fear). Margin debt is up just shy of $50 billion this year after being flat in all of last year. After these near vertical historical accelerations at cycle tops, margin debt has peaked and begun to decline while stocks temporarily go on to new highs – this divergence being the tell-tale indicator equities have peaked for the cycle. This has not yet occurred.

As we step back and reflect on "rational" decision making, it would be much more appropriate (and profitable) if margin debt outstanding peaked near the bottom of each market cycle (low prices) and shrank near the top. As long as human decision makers susceptible to emotion are involved, that is not to be.

The final important observation germane to our current circumstances is that when market prices turn down, margin debt levels drop like a rock. Think about leverage. It works so well when the price of assets purchased using leverage rise. Yet leveraged equity can be eaten alive in a declining price environment. Moreover, margin limits can force investment liquidations if an investor is unable to meet a "margin call" (a demand for the contribution of more equity capital as collateral behind margin debt). Forced liquidations are simply price insensitive selling. Of course, this will only occur after prices have already dropped meaningfully enough to either force margin calls, or cause margined investors to liquidate simply in order to remain solvent or limit loss.

Why is all of this talk about margin debt important? Ever higher levels of margin debt represent tomorrow's heightened price volatility in some type of a stressed market environment, whether that be a meaningful correction or outright bear market. Both are an eventuality, the only question is when, and we're not there yet. In the meantime, monitoring trends in levels of margin debt is one of a necessary number of risk management tools. Meaningfully declining monthly levels of margin debt will be a red flag at some point. The key is knowing it will come and being able to act unemotionally and rationally when it occurs. Continued on page 3

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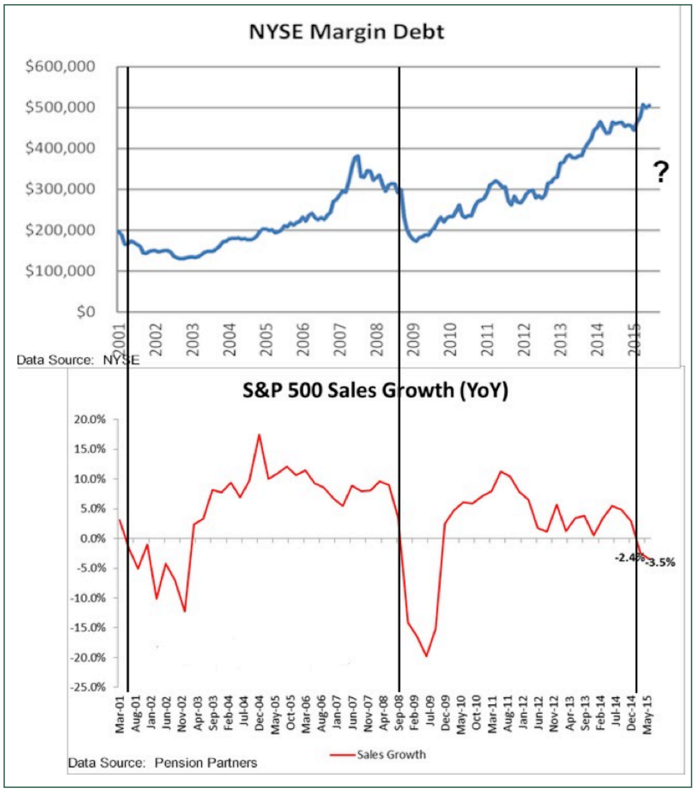
AT THE MARGIN Continued from page 2

We think it is important to note that in the two prior market cycles, margin debt declined noticeably after the year over year change in S&P 500 sales (revenues) fell into negative territory, as we are now seeing in 2015. As you can see from the chart below, the year over year change in S&P 500 sales from 2014 to 2015 has crossed into this negative territory.



For now, this heightens our focus on watching monthly margin debt levels closely. Time for radical asset allocation shifts? No. In the two prior cycles, a decline in revenues broadly across the markets was accompanied by a decline in earnings. In the current cycle, stock buybacks continue to support accelerating earnings per share growth broadly, despite sales being soft. Moreover, a good piece of the reason S&P revenues have declined year over year is due to the price of energy. In the prior two cycles, margin debt and the equities markets peaked for the cycle prior to a decline in corporate revenues. What is occurring now just reinforces our thinking as to the unique nature of the current market and economic cycle, and our need for thinking above and beyond the standard metrics of prior cycles.

When it comes to margin debt, now for something completely different. As we look at margin debt levels in the US, the end of the world is not upon us, far from it. Total margin debt in the US is less than 2% of the value of the total NYSE. This is not the case in other markets globally. We're sure you are aware of the 35%+ price volatility in the Chinese equity market over the last few months. Although the real impetus behind the initial rise in Chinese equities was government stimulus, it was accompanied by what you see in the chart below. Chinese margin debt relative to the size of its equity market has been unprecedented globally at above 8%, and so has the Chinese stock market's price volatility. We'd suggest it's a good bet the price volatility in China is not over quite yet.

In summation, historically high levels of margin debt will result in heightened financial market price volatility at some point, as ultimately occurs in every cycle. Expect it. We need to be emotionally prepared for this occurrence and incorporate margin debt analysis into our ongoing risk management toolset. For capital that is prepared and managed for risk, ultimate margin liquidation will be tomorrow's investment opportunities. We simply hope that understanding and anticipating repetitive patterns of human behavior will allow us to avoid our largest investment enemy – ourselves.

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