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CAPITAL INSIGHTS

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# Is It Safe?

Most of you are probably either too young to remember, or simply were not yet born when the 1976 film, Marathon Man, hit the silver screen. In the film, Laurence Olivier plays a Nazi war criminal attempting to smuggle his cache of diamonds into the US. Roy Scheider plays a government agent who has been tracking Olivier, but Scheider is murdered. Olivier ends up torturing Scheider's brother, played by Dustin Hoffman, in an attempt to ascertain whether it is safe to smuggle his diamonds into the country. Olivier repeatedly questions Hoffman, asking him, "is it safe?" (to smuggle the diamonds), while he tortures him. That question, "is it safe?" became the most well-known line of the movie and really the tagline for which the movie has been remembered decades later.

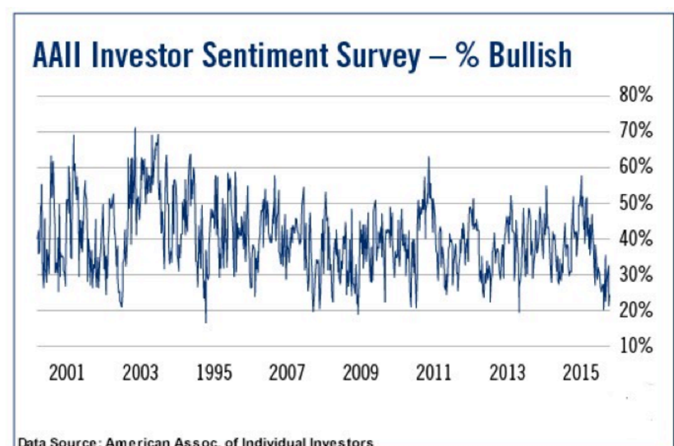
The US stock market began the first two weeks of 2016 with the worst initial two-week calendar performance in the entirety of market history. To be honest, price volatility started long before the dawn of the current year, but statistics like this are headline grabbers, aren't they? After a somewhat bumpy start to the year, from mid-February through very early March, we've had a bit of a respite from downward price action in stocks. Of course this is a very short period of time. So, as we look at the broad financial markets and US stocks specifically, in our best Laurence Olivier imitation, we ask, "is it safe?"

Our decades of financial market observation and involvement have taught us a number of very valuable lessons. One of those lessons is that two of the most important drivers of really any asset price are short term investor sentiment (emotion) toward that asset and longer term fundamental valuation character of that asset. Sentiment drives short term behavior, but over the longer term, fundamental valuations are key to asset price movements.

Think about real estate in the mid 2000's. Many camped out for days to be able to put offers on a home purchase. Everyone had to be in, even those with very shaky financial wherewithal. Sentiment/emotion was wildly positive regarding the asset class that is real estate. Yet from a fundamental perspective, real estate purchases and price appreciation were being driven by very questionable underlying mortgage financing. Of course into the housing price bust period of 2006-2009, no one showed up any longer to put offers on homes. Sentiment toward real estate had turned wildly negative as stories of defaults and foreclosures peppered the media. Asset prices driven far too high by buyer emotion coupled with risky financing succumbed to the pull of fundamental valuation gravity. The financial markets are no different. As the old saying on Wall Street goes – human behavior never changes, only the wallets do.

So how does this apply to where we find ourselves in the financial markets of the moment? We believe it is very important to look at shorter term investor sentiment as well as longer term fundamental valuation character. Remember, what drives the short term is emotion and sentiment. In that wonderful two-week historic downdraft at the beginning of 2016, what did we see in terms of investor emotion?

The American Association of Individual Investors is a non-profit organization with about 150,000 individual investor members. AAII's purpose is to educate individuals regarding stock portfolios, financial planning, and retirement accounts. But importantly, the AAII has been keeping a longstanding weekly survey of individual investor sentiment. The long term history of this sentiment survey is seen in the following chart. This graph represents the percentage of survey participants currently "bullish" on the stock market outlook.

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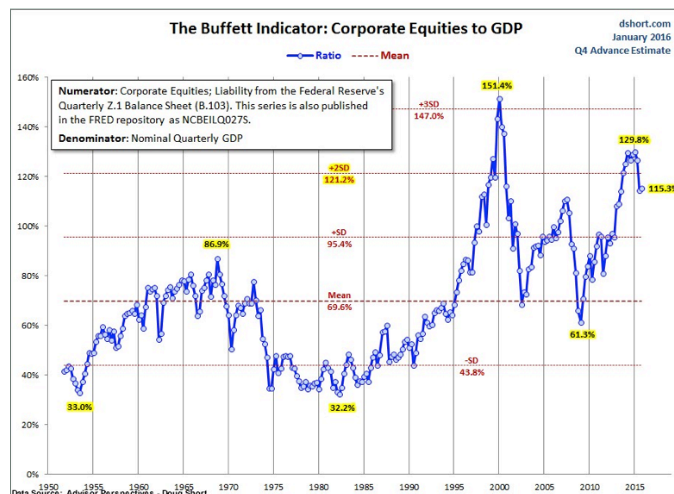
What is clearly obvious is that investor sentiment going into 2016 was at one of its lowest historical points. Emotion was dark. Certainly investors had become very worried about the stock price volatility we have been experiencing since the summer of last year. Point being, this survey tells us that we entered the year with very few enthusiastic buyers. Very few. It's no wonder we got off to a rough start. Human emotion was the key short term driver of the early 2016 stock market experience.

What is also true is that from a human behavioral standpoint, investors express deep caution after they have sold or lightened up stock exposure, not before. In like manner, they tend to be bullish, or positive, after they have purchased stocks, not before. It's our human need to justify decisions we have made. As such, surveys of sentiment are very often contrary indicators. As Warren Buffet has said many a time, "be fearful when others are greedy and greedy when others are fearful." What we have described is exactly what he is referencing in this famous quote. Remember, sentiment drives the short term.

So has investor sentiment gotten deeply dark enough to suggest that February may have seen an important stock market low? Not so fast. Although monitoring investor sentiment is important in trying to understand the short term, valuations drive the longer term. Where do we stand with longer term valuations?

Let's once again invoke what Warren Buffet has called his most important stock market indicator. Back in the early 1990's, Buffet told us that his most important market valuation indicator is the "Market Capitalization to GDP ratio." In English, what does this mean? The market capitalization of any stock is the price of the stock multiplied by the number of shares outstanding. If a company has 1000 shares outstanding and it sells at $5 per share, the market is assigning a $5,000 total value to that company. If we look across the entire stock market, we get a sense for the value of all stocks. We then compare this to US GDP – the value of financial assets relative to the real economy.

Below is an update of Buffet's favorite valuation indicator as of January 2016. The very simple message of this chart is that stocks are not cheap based on historical perspective. Far from it.




Is Buffet now liquidating his portfolio given that his favorite indicator is flashing caution? Not in the least. A big part of the reason is that the dynamics of the current cycle are so special. The Central Banks globally have pushed short term interest rates to and through a 0% return. There are few places in the financial markets for capital to earn a decent return. Hence, the tension of the short term versus the longer term in the stock market of the moment.

Just what does this "tension" mean to us as investors? As we have spoken about many times, risk management is key to successful longer term investment outcomes. We need to have a plan for risk management and need to remain disciplined in our actions. Secondly, we need to remember that it is not a stock market, per se, but rather a market of stocks. The media tends to discuss and treat the stock market as if it is a monolith, but nothing could be further from the truth. What is important is being very intentional about where in the markets one chooses to invest, but even more intentional about areas to avoid.

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Since the summer of last year, large capitalization US blue chip stocks have held up very well, but smaller and mid cap stocks have experienced a bear market (down more than 20%). Likewise, foreign and emerging market stocks have felt the claw of the bear. So as we ponder the question as to whether it is safe to jump back into the stock market, the correct answer clearly becomes that it depends on the individual investment merits and valuation character of assets under consideration. It also very much depends on individual tolerance for risk, investment time horizons, goals, etc. These may all sound like "catch phrases," but they are extremely important in terms of where we find ourselves in the current cycle.

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