The nature of change - why this is so important

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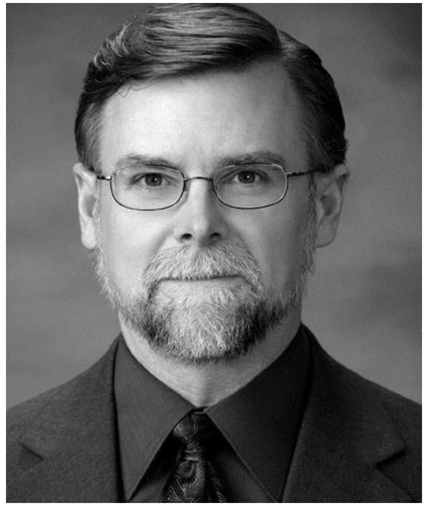

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"It's hard to imagine an industry more ripe for disruption than the business of money. Over the past five years, PayPal has issued 26x more patents than Goldman Sachs"

Scott Galloway

Change is the natural order of things

- But much like “risk” . . . change is similarly “multi-dimensional”

- Think
  - Speed versus
  - Direction

A client-facing piece on “The nature of change”

INVESTMENT PERSPECTIVES - APRIL 1, 2021

The way back is closed, only the path forward remains open

There are different types of change

It’s a trite phrase to say *“change is the natural order of things,”* sounds too much like an excuse.

Worse yet, it serves to mask the different types of change - and how the best approach for dealing with one type of change is the worst for another.

Different types of change are distinguished by two attributes:

- Speed or pace
- Smoothness or direction

Speed or pace

Speed or pace is either fast or slow. Most of the time, change proceeds slowly. Telecommunications provides a ready example.

For fifty years, telecommunications developed at a slow but steady pace. But then, with the development of integrated circuits (silicon chips), the Internet, lithium batteries, and the World Wide Web, the pace of change moved from slow to fast.

Automobiles and personal travel provide a second example.

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Most of the time, change is about “pace” or “speed”

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SLOW

FAST

2nd example - Automobiles

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← SLOW → ← FAST →

A different kind of change

Smoothness or direction

A different type of change is related to smoothness and/or direction. Often the distinction is seen most clearly when our system either bends or breaks. The early 1900s provide an excellent example.

Directional change - back in 1914 . . .

1914-1921

- Creation of the Federal Reserve
- Russian revolution
- Global pandemic (The Spanish Flu)
- Great Depression of 1920
- World War I

- Depended on other nations for capital
- Largely an agricultural economy
- Developing superior manufacturing techniques allowing it to grow its exports

- Shifted to a provider of capital to other nations
- Era of the roaring 1920s
- Optimism, rapid growth, and purchase of cars

The pressures resulting from the global pandemic, world war, and economic depression during the years 1914-1921 helped change the direction of the US economy and the priorities of American society. While the creation of The Federal Reserve System in 1914 helped facilitate that directional change. A more recent example unfolded during the mid-1900s.

Directional change - back in mid-century

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1929-1946

- Great Depression of 1929
- World War II
- Eight-year drought - The Dust Bowl
- ENIAC began the computer revolution
- A scalable market for U.S. Treasury bonds was developed

- Large and rapidly growing economy
- Relatively separate from the rest of the world, endeavoring to remain apart and uninvolved

- Leader of the Free World
- Major provider of capital to other nations
- Nation builder

The pressures resulting from the 1929 Depression. The environmental disaster of the eight-year drought, and WWII fundamentally changed the direction of the US economy and meaningfully altered the preferences of American society. The change that unfolded during these years was more akin to the breaking of a bone and its subsequent resetting.

Life teaches us how to successfully manage change

Best method for dealing with change

Life provides valuable lessons. We’ve learned that when managing through change defined by speed or pace, it’s best to just keep doing what’s worked so well in the past. Maybe we tweak our approach at the edges to account for recent developments. But we stick with what has proven itself out through the test of time. OK, maybe when the speed of change ramps up from slow to fast we have to be a bit more nimble, and perhaps tweak the edges a bit more aggressively, but that’s about it.

But what if the change is “directional”?

In contrast, when managing through change defined by a directional shift, breaking instead of bending, or just a simple discontinuity, the worst possible approach is the one described above. Continuing to do what worked so well in the past almost assures that we’ll faceplant.

Why most people fail to successfully manage “directional” change

The best approach when facing a change of direction is to forget everything we think that we know and start with a clean sheet of paper. Such an approach requires that we ask: “What’s the game, rules, players, field, and their relative strengths and weaknesses?” By asking this question, we’re admitting that we can’t predict the future, but we can narrow it down to a small number of possible outcomes and assign probabilities to each.

How does this relate to investments?

Investment is no different. We experience remarkably long periods of smooth, flexible, unidirectional change, mostly slow, but sometimes fast. Success, during such periods, is best accomplished by continuing to do what worked so well in the past. At the edges, we seek to lower costs, improve tax efficiency, and make tiny adjustments for recent new developments.

But . . . occasionally (and thankfully not very often), investments experience a directional change or breakage instead of bending. Success during these periods requires that we set aside what worked so well in the past and seek an approach that best harmonizes with the inherent new realities. Individuals often have a hard time making these shifts if they've become emotionally attached to what worked so well in the past. Similarly, organizations often have a hard time making such shifts if they have monetary incentives tied to solutions from the past. Such individuals and institutions inevitably faceplant - and by so doing, create opportunity for the rest of us.

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Interest rates and bonds

Interest rates fell from 16% to ½% over the 40 years just ended. 2020 may have ushered in a change of profound dimensions, whereby interest rates now rise for the next 40 years. Why does this matter? When interest rates rise, bond prices fall. Do you want to invest in something whose price will be lower tomorrow than it is today? You might respond *"Well, I'll just buy the bond and then hold it until it matures. By doing so, I'll get my investment back plus some profit. I'll make money."*

Buy and hold a bond until it matures . . . Does NOT work !!!

There are several problems with this train of thought. The yield (total return) on a 10-year US Treasury bond is 1.70% today. If your combined marginal tax bracket for state and federal income taxes is 40%, inflation is running at 2.36% (the market's current expectation for the next ten years), and expenses and fees consume 1.20%, then your investment in a Treasury Bond is guaranteed to lose you money at a rate of -2.54% per year, every year, for ten years. You would be much better off just spending your money today.

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Will interest rates rise?

Will interest rates rise, going up instead of down, over the next several decades? Here are the reasons why:

Unsustainable Present - Interest rates are currently at unsustainably low levels. Current rates are at a level that is only consistent with a permanently shrinking economy, one in perpetual recession.

Shortages - There's been significant underinvestment across a broad range of industrial commodities and fossil fuels. As the global economy comes out of recession and returns to robust growth, a shortage will appear within these markets. Given how long it takes to develop new supplies, it is expected that commodity prices could rise for many years into the future.

Renewables - Most of the developed world has decided to shift from fossil fuels to renewable energy sources. Such a shift is unusually resource intensive, serving to meaningfully shift supply/demand relationships. This is expected to show up in heightened levels of inflation spread over one or two decades.

Protectionism - Many nations and regions of the world are enacting anti-free trade policies, seeking to beggar thy neighbor. This may stop or even reverse the century-long trend of ever-increasing global trade for goods, services, labor, and capital.

Money Supply - Most central banks have grown their money supplies at record-setting levels. Once the global economy returns to normalcy, this money printing may serve to support higher levels of inflation.

Activism - Many of the largest economies have embarked on what looks like a fundamental and long-lasting change with respect to both fiscal (spending money) and monetary (printing money) policy. Governments appear to have both the need and the ability to do so. The need arises from out of health, environmental, and most powerfully, societal motivations. The ability is an outgrowth of the change in political structure across many nations.

But, today's "directional" change is not just about interest rates

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Conclusions and next steps

If interest rates rise for the next 40 years, bonds will have embarked upon a path remarkably different from the one just completed. Managing such directional change by continuing to do what worked so well in the past might be the worst possible approach. Solutions exist, but they require starting with the proverbial tableau blanc, looking into the future for answers as to what will harmonize best with a different set of opportunities, risks, and rules of the game.

Is “directional” change at hend?

- If you have any doubt on this . . . Then read the latest piece by John Hussman

- You can find it at
- https://www.hussmanfunds.com/comment/mc210715/

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Sometimes People Just Don't Fact-Check

Some have falsely claimed that market cycles are getting shorter

Tactical Asset Allocation (TAA) relies on trending or momentum for its success. Some have falsely claimed that market cycles are getting shorter, and therefore TAA no longer has the inherent advantage that it once did. Let's fact-check this claim in order to determine its truth or falsehood.

Read More

Which Portfolio is Lower Risk?

We care most about risk when the sky is falling

When the market is going up, we don't care about risk. But when it's collapsing, we do. Since 1920, there have been nine stock bear markets. Let's compare how four hypothetical portfolios performed during these nine traumatic events.

Read More

But Has TAA Worked Better Than Bonds?

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PERSPECTIVES ON TACTICAL ASSET ALLOCATION (AKA SECTOR ROTATION)

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What happens when interest rates rise?

How does TAA perform during rising/falling interest rate environments?

To answer this question, we must:

- Identify a time period to examine,
- Specify how we define rising and falling interest rate environments,
- Identify a simple transparent TAA portfolio that anyone could replicate, and
- Provide comparative passive index benchmarks.

PERSPECTIVES ON TACTICAL ASSET ALLOCATION (AKA SECTOR ROTATION)

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Time - Can be your best friend

Matching a need - with an investment portfolio

I've determined how much I plan to spend (and gift) during years 10 through 15 (in the future). To support this plan, my portfolio will be invested for 12 ½ years (on average), the midpoint of this interval.

Many would suggest that an appropriate and common-sense asset mix would be 50% stocks and 50% bonds given this investment time horizon. No, not necessarily today, given current market valuations, but certainly as a normal average asset mix when one's investing for 12 ½ years.

PERSPECTIVES ON TACTICAL ASSET ALLOCATION (AKA SECTOR ROTATION)

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Why doesn't BlackRock offer TAA?

If TAA is so good, then why doesn't everyone offer it?

First off, BlackRock, Nationwide, Invesco, and Fidelity all offer TAA products. Nevertheless, the investment industry widely appreciates that TAA is not commercially viable, i.e., it won't sell well. How do we understand this seeming contradiction? As we explore this question, keep in mind the distinction between a product selling well in a commercial setting . . . and that same product being the best possible investment solution for an individual investor. The two have little if any overlap. Let's begin.

PERSPECTIVES ON TACTICAL ASSET ALLOCATION (AKA SECTOR ROTATION)

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A Pretty Good Outcome

Let's try a thought experiment - What if . . .

What if we build a passive portfolio from the 32 asset categories shown in the graphic below using the following weighs: 30.3% US stocks, 29.3% international stocks, 5.0% US Treasury bonds, 31.5% US investment grade corporate bonds, 1.4% international bonds, 1.3% gold, and 1.2% other commodities. Over the last 102 years (ending 1/31/2021) this portfolio would have delivered 11.53% per annum. That's pretty good.

PERSPECTIVES ON TACTICAL ASSET ALLOCATION (AKA SECTOR ROTATION)

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But has TAA worked better than bonds?

Is TAA versus bonds the right comparison?

Probably not. But to answer this question, we must first identify the all-important investment timeframe. I'm assuming here that the investor is targeting needs arriving between 5 and 20 years in the future. Therefore, their investment holding period or time horizon is 5 to 20 years.

For such an investor, a pure 100% bond portfolio won't work. It won't be able to generate the needed returns. Similarly, a pure 100% stock portfolio won't work. It'll be too volatile, exposing the investor to an undue likelihood of having to liquidate at an unfortunate point in time (when their account value is down).

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A Century of Evidence on Trend-Following Investi

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AQR

A Century of Evidence on Trend-Following Investing

Brian Hurst
Principal

Yao Hua Ooi
Principal

Lasse H. Pedersen, Ph.D.*
Principal

Fall 2014

Executive Summary

We study the performance of tren investing across global markets s extending the existing evidence by mo years. We find that trend following ha

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But first, let's work to better understand this issue. The following graph shows two different market paths. Each starts and ends at the same spot, and therefore both generate the same total return after many years.

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Important Disclosures

All data and statistics were provided by Global Financial Data, Inc., Hussman Strategic Advisors, Macro Strategy out of London England, and by BCA Research out of Montreal Canada.

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One of the limitations of hypothetical performance results is that they are generally prepared with the benefit of hindsight. In addition, hypothetical trading does not involve financial risk, and no hypothetical trading record can completely account for the impact of financial risk in actual trading. For example, the ability to withstand losses or adhere to a particular trading program in spite of trading losses are material points which can also adversely affect actual trading results. There are numerous other factors related to the markets in general or to the implementation of any specific trading program which cannot be fully accounted for in the presentation of hypothetical performance results and all of which can adversely affect actual trading results.

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