MIKE LIPPER'S BLOG

MONDAY MORNING MUSINGS FROM A. MICHAEL LIPPER, THE AUTHOR OF *MONEY WISE: HOW TO CREATE, GROW AND PRESERVE YOUR WEALTH*

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ABOUT MIKE LIPPER

MONDAY MORNING MUSINGS

A. Michael Lipper is a CFA charterholder and the president of Lipper Advisory Services, Inc., a firm providing money management services for retirement plans, charitable organizations and wealthy families. A former president of the New York Society of Security Analysts, Mike Lipper was President of Lipper Analytical Services, the home of the global array of Lipper Indexes, Averages and performance analysis of mutual funds. After selling his company to Reuters in 1998, Mike has focused his energies on managing

SUNDAY, JULY 7, 2019

Twin Problems: Not Enough Excitement and Too Many Fears - Weekly Blog # 584

Mike Lipper's Monday Morning Musings

Twin Problems: Not Enough Excitement and Too Many Fears

Editors: Frank Harrison 1997-2018, Hylton Phillips-Page 2018 –

Stock Markets Don't Confirm New Highs

On the Wednesday before the July 4th US Independence Day Holiday, the US stock market indices reached new highs on low volume. On the next trading day, in a shortened session, there was no enthusiastic follow through. Is the very slight decline is a symptom of a self-correcting advance that likely curtails a significant enthusiastic response in volume? Greed is now not overcoming the sense of ennui or complacency. Those not fully participating have lots of fears, like:

- The timing and nature of a stock market reaction to the oncoming recession?
- Unattractive political leadership choices
- Global strategic issues

These considerations and others were on my mind over the last four weeks when my wife and I visited London, Dublin, Melbourne, Uluru, and Sydney, where I talked with investment professionals and other investors.

Lessons from Uluru

Most investment types are very quick to adjust their thinking to the headlines of the day. As a brother of a US Marine Corps Reconnaissance veteran from the Korean War and my own search for appropriate long-shots, I wonder whether the right questions are being asked? In some ways the visit to Uluru helped crystalize my concerns, which made me re-think what I saw in London, Melbourne, and

Sydney.

Uluru is in a desert in the Northwest Territories, in the middle of Australia. It celebrates the Aboriginal worship of the massive rock formations sacred to them. In Uluru we found a good regional airport, a bunch of modern hotels, a fleet of tour buses and crowds of tourists, both from Australia and from around the world, with a focus on tours from Japan. Hotel reservations were difficult to obtain and the entire commercial scene was an enormous bet that tourists will continue to descend on Uluru for a long-time into the future. In a somewhat similar fashion, visits to London and Sydney, as well as my experience walking around New York City, one can't help but be impressed by the huge amount of permanent capital being invested in the continued growth of mid to high price tourism around the world.

Excess Expansions Bring Tears

I have often said that if one cuts into a securities analyst a historian will bleed. I have started to question whether this global outpouring of capital into hotels is somewhat like the gold rushes in the US, Canada, Australia, and South Africa? There were similar surges in the building of the transcontinental railroads in the 19th century and the over 300 automobile manufacturing companies competing in US and other countries in the 20th century. Closer to the present, one could look to the "Dot-Com" and sub-prime periods for phases of euphoria.

Demand Failures

There are many ways to look at these expansions and collapses. Most attention has been directed at what proved to be unsound financial arrangements, which in some cases were fraudulent, but in all cases were the result of bad judgement. Many of the dreams of the "Dot Coms" have subsequently been delivered, but by different groups with largely overseas resources. The biggest problem for the owners of over mortgaged homes was that momentary supply exceeded demand. To me, a more important issue was the failure of demand or substitute demand. Where could the talents involved have been utilized? Where could the workers and their families have found paying jobs?

Financial Services Clues

I pay particular attention to the Financial Services businesses, where almost all the participants in this global industry are trying to present themselves as Technology companies that happen to be dealing with financial matters. I wonder if this is similar to GE and many large industrial manufacturers in the 1950s, who began divisions to be in either Atomic Energy or Computers. Currently, Financials are competing with Tech companies for both experienced and inexperienced credentialed employees. They are paying Silicon Valley wages and are trying to manage these freer spirits in a more regimented company. In the academic world, are we producing too many people to

the investments of his clients and his family. His first book, MONEY WISE: How to Create, Grow and Preserve Your Wealth (St. Martin's Press) was published in September, 2008. Mike's unique perspectives on world markets and their implications have been posted weekly at Mike Lipper's Blog since August, 2008. Join Mike Lipper's community and subscribe to this blog via email or RSS by clicking below. Mike encourages reader comment; please use either the comment feature on his blog or reach him directly at aml@lipperadvising.com .

find long-term employment in Fin Tech? On Friday, the only major group to go up in price was Financials, a rare occurrence. The thinking behind this rise was that good employment numbers suggest the postponement of the expected drop in interest rates by the Fed and many Financials would gain due to level or higher interest rates.

Low Rates Produce Long-Term Troubles
Paradoxically, lower interest rates are not favorable long-term for the economy. Low rates encourage the issuance of lower quality credit loans or the renewing of loans of deteriorating borrowers. Furthermore, the lower the rates the less power the central banks have to step in and prevent major financial failures. Perhaps the most negative implication of low interest rates is that it does not address the globally growing size of the retirement capital deficit in a world when people are living longer and more expensively.

Question of the week:
Do you see excessive expansions?

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SUNDAY, JUNE 30, 2019

Reduce Investment Mistakes with Deeper Observations - Weekly Blog # 583

Mike Lipper's Monday Morning Musings

Reduce Investment Mistakes with Deeper Observations

Editors: Frank Harrison 1997-2018, Hylton Phillips-Page 2018 –

Loss Reporting and Analysis

One of the most useful exercises from the track is making a report on losing bets. Often in reading these reports it becomes clear that I overlooked or didn't value an observation highly enough. This type of oversight is common with all investors and analysts. This blog utilizes some observations from our visit to Australia plus some additional insights from pouring over the Barron's Market Lab data and current news events.

Crowding, Protection or a Bigger Target

Crowding for protection vs. becoming an enriched target for predators? One evening at sundown we watched waves of 13-inch fairy penguins unite and stream ashore, forming columns to enter breeding and birthing locations hidden on land. We have seen similar patterns in Africa, where hordes of zebras and other animals gather. In each case there is a lesson that there is safety in numbers. The predators tend to be solo or are in such small numbers that they can't eat them all, when the group is found, some will not survive.

As I have often said, the art of investing is somewhat like a narcotic, its effects make it difficult to avoid thinking about investing. When I see a large crowd gather together and move as a group, I can't help thinking of investors crowding into the limited space of a single investment or sector. The problem is that by gathering together they have created an appealing target for predators, who only need to attack a very limited number of victims to fulfill their needs. Several brokerage firms have been producing lists of crowded trades, which can be very specific and include market segments like US Treasuries of specific maturities or other investments in a crowded trade condition. Year to date through June 27th, 2019, only 4 of the 21 US Diversified Equity Fund investment objective averages gained 20% or more and in the sector funds universe only the two tech categories gained more than 20% (A crowded target for the press and politicians.) To some degree the FAANG* and BAT** stocks represent crowded trades and some of them are showing signs of peaking, which may be temporary.

(*) Facebook, Amazon, Apple, Netflix, Google. (**) Baidu, Alibaba, and Tencent)

Unrest in Southern China

Australia's largest trading partner is China and thus anything to do with China is of great interest to Australians. With the cooperation of the Chinese authorities, the National Gallery of Victoria has beautifully prepared an extensive exhibit on "The Terracotta Warriors". These unique sculptures of a large military force meant to protect the self-proclaimed First Emperor of China in his afterlife. As an accomplished horse breeder, he conquered all other tribes and ruled for only 14 years until his death. The Emperor was named Chin and his name became that of the nation he founded by simply adding an "a". He introduced numerous measurement systems that were used throughout his empire and while he was a genius in many respects, he was also very brutal.

Upon his demise he was replaced by the Han dynasty, which lasted for 400 years. They seized control by leading the first of several revolutions, starting in the south. The first emperor in the new dynasty was much kinder and introduced farming as distinct from nomadic life. Today, the Han people are still among those that dominate China. One cannot help thinking that the present leadership of China must be aware of this history and consequently are concerned about the unrest in the southern part of their country.

What the Stars Tell us About Ourselves

On two separate occasions we went into the desert with a group of tourists to gaze at the stars, constellations and planets. Initially we waited "for the stars to come out", which was an inaccurate statement of fact, but correct from the viewers standpoint. Later, the intervening clouds disappeared, and the stars became visible. We were informed that other stars would move into our view later that evening, which was again an inaccurate comment. This is exactly what the ancients thought until Copernicus began his scientific study leading to the realization of a round earth, although it's actually an elliptical shape bulging at the equator. This again was an observational point of view, not the correct recognition that the earth is rotating on its axis. From an analytical perspective, investors and politicians should understand that we live in a relative world where useful measurements include both relative changes and absolute movements.

Conflicting Information on Climate Change

Formerly, investors spoke of "global warming" but now refer to it as climate change. This raises the issue of the regular rotation of climatic change. For example, the Danes farmed in Greenland for 300 years, even though geological studies show that water occupied much of the land mass we know today. As with most scientific studies, we are coming up with conflicting information that should be considered in the data mix.

We were told for example that the southern coast of Australia is receding due to the rising waters from Antarctica. The increase in ice around Antarctica has led to the dumping of cold water into the stream that circulates around the ice mass. This in turn has forced the warm water trapped below the ice to move out and attack the southern coast of Australia. However, on Australia's north coast the land mass is growing, effectively moving the continent slowly north! I am not properly trained to deal with the conflicting evidence, but I can recognize that conflict exists.

There is no question that countries have not enforced enough barriers to coastal building. That is not new in my home state of New Jersey and is something that has been a legal matter since before the American Revolution. Waterfront property is almost always sought after. How much climate change is a function of human activity remains uncertain, at least in my mind?

Separating Pollution from Climate Change

What is certain is that human activity bears major responsibility for pollution, which can be addressed. Years ago, Pittsburgh was almost always clouded with smog from the burning of coal in steel production. With the cooperation of locals, they were eventually able to bring about brighter skies. Progress, albeit slow, is being made to reduce smog from autos in the Los Angeles Basin. The Chinese people and government have in some cases taken draconian steps to address their pollution problems, while other countries remain further behind.

It would be useful to separate the discussion of pollution reduction and the elimination of climate change, because the facts and history are quite different.

Current Inputs

One of the difficulties in determining useful inputs in periods of controversy is what to believe. The Washington Post did a good job of identifying the gross exaggerations coming out of the two democratic beauty contest evening panels, although they are not an altogether unbiased source. There were similar unrealistic statements on the other side too, which left me wondering if we have discovered a useful indicator: Veracity is inverse to volume? (It has generally worked in stock and manager selection.)

Observations on Tariff Chatter

1. 80% of the Consumer Services stock segments have risen year to date, but just 20% of the materials segment have. This suggests that stock buyers believe the consumer sector can absorb the tariffs, but the demand for materials is looking questionable.
2. The Dow Jones Transportation index is rising at a faster rate than the Industrial average. The stocks in the transportation index largely carry freight, which appear to be rising more than the decline in energy stocks. Transportation shares also attract more professional investors and less individual buyers.
3. The announcement of the restarting the tariff discussions was silent on the real, long-term concerns of the participants. Tariffs were supposed to be a method to get the critical discussion started on defense issues like the South China Sea, critical technology required for global leadership, and enforcement procedures.

Conclusion
Future spending is the reason that people save/invest. My bet is that in the long run carefully chosen equities and equity funds will be productive.

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A. Michael Lipper, CFA

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SUNDAY, JUNE 23, 2019

Our Investment Mistake is in Labeling - Weekly Blog # 582

Mike Lipper's Monday Morning Musings

Our Investment Mistake is in Labeling

Editors: Frank Harrison 1997-2018, Hylton Phillips-Page 2018 –

Mixed Results Change in Focus

While the S&P 500 went to a new record high on Friday, it and the other major stock indices closed down. This is both good and bad news. Investors were not sucked into the market, which confirmed their growing concern for future growth. Currently, many pundits are expecting the same, both in the slower growth of GDP and earnings per share. That is the bad news. The good news is the current lack of enthusiasm for stocks. The reason that this is good news is that often the final phase of a "bull-market" is wild enthusiasm for a subset of the market, which in turn drives the bulk of the market higher. This has not happened-----thus far. Also, more and more analysts are recognizing the deterioration of quality in credit instruments, including CLOs. With these concerns present, now is a good time to examine one's asset allocation. However, this should be done in terms of the intended use of capital, not as is more commonly done by asset class. Purposes are more useful than instruments.

Segmenting a portfolio

We learned long ago that a good way to avoid large losses is to divide our investment efforts into different parts that have different characteristics. The mistake that most make is labeling the diversified parts by asset class e.g. stocks, bonds, real estate and commodities.

These labels are too broad and do not suggest their intended portfolio use. Each of the labeled asset classes can be used aggressively or conservatively in terms of intended risk and reward.

The investment spectrum

I suggest that a single spectrum is more useful in building a successful portfolio. This spectrum incorporates the long-term movement of capital, from preservation to appreciation. Every investment is likely to have elements of both capital appreciation and capital preservation; however, at any given time one characteristic is more prominent than the other.

The Prudent Man Rule

If one thinks about the prudent (man) rule that Judge Putnam issued against Harvard in 1830, he was ruling based on what other intelligent men (thus the Prudent Man rule) used in their own affairs. (The judge did not recognize that men, while they may have been the ones transacting, needed to include the desires and wisdom of women in the decision-making process if they wanted a harmonious family life.) What the judge recognized was that different mixes of assets and liabilities produced different results and it was imprudent to rely on a single type of investment.

Betting on an uncertain future

In looking at my personal portfolios of assets, liabilities, and identified responsibilities, I try to group investments in terms of capital appreciation and capital preservation. I do this recognizing my inability to predict the future accurately, as life is full of surprises. This is where my analytical training at the racetrack shapes my thinking. Most money bet on a race is on the horse that appears to have the best chance based on prior success. The problem with this is that the pay-off odds are low and the winnings are insufficient to cover prior losses, unless a great deal more money is bet on the favorite.

While we all celebrate the story of a single-minded inventor betting all on a single invention, we realize that the chance of finding this magic are extremely low. This may well be the cause of my being a contrarian, rather than it being a personality failure. Thus, in my mix of capital responsibilities, my investments are spread out along the expectation line.

Considerations for capital preservation

Judge Putnam did not take into consideration the fluctuating levels of inflation and currency movements we face in the modern world. Capital preservation is not maintaining a specific number of dollars, pounds, euros, or yen, it is maintaining the financial ability to meet a standard of living that is appropriate. Thus, capital preservation stocks and funds are based on expected spending levels. In my own thinking it covers the cost of healthcare and education. Several investments in my capital preservation portfolio are in well managed, secular growing companies, often paying a predictable dividend. Over an investment cycle I expect this portion of the portfolio to do slightly better than average, mainly because it will go down less in periodic down markets.

Considerations for growth

Capital Appreciation stocks and funds are expected to add to our wealth over time and should generate growth above the expenditures inherent in the capital preservation portion of the portfolio. These investment vehicles can only accomplish this mission by entertaining more risk of capital loss. Over a limited number of investment cycles, capital appreciation stocks and funds should lose no more than 50% of their beginning value and should multiply their starting levels two or more times.

When one examines an investment vehicle, I hope you can see the combination of capital appreciation and capital preservation qualities inherent in each investment. Further, I hope your portfolios will have your own appropriate mix of capital.

How to Apply Capital Allocation

Making precise judgments about the future is probably impossible, but making judgments about the relative growth of capital and volatility is easier. I am sharing my thinking, not as a recommendation to follow, but as an example of how to assign relative probability to your holdings.

In terms of capital appreciation I have identified BYD, a Chinese auto manufacturer which produces the largest number of electric cars in China and has a contract to provide buses in Los Angeles. Furthermore, its chairman is busy working on other transportation products and services. These characteristics and developments, added to the cyclical nature of auto sales, suggest that reported earnings will be erratic for a while. Nevertheless, the possible potential is intriguing. A more diversified approach to capital appreciation would be mutual funds that focus on innovation and discoveries.

In terms of capital preservation, I use Berkshire Hathaway. It has built a portfolio of private companies and publicly traded securities designed for the heirs of Warren Buffet and Charlie Munger, as well as for a considerable number of their shareholders. One could also include the Rothschild Investment Trust, traded in London as a somewhat similar capital preservation vehicle.

Question of the Week:

What have you identified as Capital Appreciation and Capital Preservation vehicles for you and your accounts?

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SUNDAY, JUNE 16, 2019

The Most Dangerous Part of the Portfolio - Weekly Blog # 581

Mike Lipper's Monday Morning Musings

The Most Dangerous Part of the Portfolio

Editors: Frank Harrison 1997-2018, Hylton Phillips-Page 2018 –

Our portfolios are invested with our emotions, perhaps unconsciously. While we don't label each investment, we probably assign each to a capital appreciation or capital preservation label. We are willing to take a relatively large risk of temporary or even permanent loss of capital for expected larger returns with our capital appreciation assets. Much less risk is assigned to our capital preservation assets and we don't expect to take significant risks with those. (Future blogs will discuss the thinking behind this allocation.)

My concern is that some investors, lured by perceived history, are potentially taking unexpectedly larger risks with their capital preservation assets. If there were some material losses with any of these assets it might shake us up emotionally and cause us to question our whole investment philosophy and portfolio. With this shock to our investment system, it could cause us to retreat from investing at exactly the wrong time and cause us to fail to generate long-term capital growth for the entire investment portfolio. The rest of this blog is devoted to specific risks related to our capital preservation assets.

What We Don't Know

If we are to be honest we could right volumes examining what we don't know. For the sake of brevity I will highlight just three topics of what we don't know:

- The timing and extent of the next major market decline?
- Where today's fragmented data leads?
- When will interest rate risks be materially higher and under what conditions?

The reasons these are questions is that I don't know the answers. The reason that they are important to identify are because they are critical to the prudent use of high-quality bonds and bond funds as capital preservation assets. In looking at these assets it is important to recognize some of the essential differences between debt and equity, which impacts how we use capital preservation assets. Major bond considerations are as follows:

- Bonds and credits have fixed maturities, with some variability due to call features.
- Some fixed income instruments fit specific needs and might be held to maturity.
- Bonds are primarily traded between dealers acting as both principals and agents, without a consolidated tape.
- There are some differences in both law and regulation between stocks and bonds.
- Governments, through both their treasury and central bank intermediaries, use bonds to transmit messages to the economy.

Investment decisions are based on both experience and current thinking. In reaching any decision, investors would be wise to listen to the words of the late, great, and former client Sir John Templeton and recently quoted Howard Marx, another former client. They said the four most dangerous words ever spoken are “this time it’s different”. Or, is this the wrong standard of probability? (Lessons can be learned from the racetrack too.)

What Does the Current Data Show?

The answer is mixed and one can choose to emphasize almost any piece of data for either the bullish or bearish side, as follows:

1. The year to date share volume on the New York Stock Exchange is down 39%. (Investors not exercised)
2. Three major stock indices have eclipsed their 65-day moving average.
3. The ETF weekly performance winners are sector bets.
4. 47 of the 72 prices of stocks, ETF, commodities and currencies are generally rising.
5. Deposit interest rates jumped this week to 0.75% from 0.72% for MMDA.
6. The Barron’s bond confidence indicator is only a little less favorable to the highest quality.
7. The total returns on the average High Yield bond fund has rotated around those of General US Treasury funds. (No convincing pattern year-to-date, but behind for five years)

Where’s the Risk?

The risk is in the belief of some bond holders who hold low risk securities on the assumption they won’t go down materially in price. What could go wrong? Bonds, most of the time, move in tandem with general interest rate moves. (Current interest rates are historically low and many think they will go even lower still. However, current rates are insufficient to cover a possible partial or complete default at a time when there is increasing need to roll over maturing debt. At the same time rates are below the needs of retirement accounts, which are facing greater demands from retirees living longer.)

In the UK, bond fund holders have suffered from the collapse of net asset values caused by a well-known “bond king”. In the US, in every decade we have had at least one formerly very successful leading bond manager fall materially. The repeated pattern is that the manager discovers a group of bonds or credits that are under appreciated in the market before they rise. The manager’s success brings in more money for him/her to manage at the very same time that the cheap bonds are bid up by other managers and competitors who were not previously aware of these “bargains”. In time the formerly “cheap” merchandise becomes “expensive”, often at roughly the same time there are problems with the issuer of the bonds. What was expected to be credit quality gains become credit quality losses, with some of the bonds suffering from the withdrawal of buyers. The pattern has been repeated since the age of Shakespeare's "The Merchant of Venice", as well as in numerous other markets. Thus, I have high confidence that it will happen again at a time and place to be determined. Part of today's problem is that there are very few bond analysts and portfolio managers who were operating more than 35 years ago when the bond bull market began.

Two Worries

The first is that for the relatively small number bond holders, directly or through investment vehicles like mutual funds, they will withdraw from investing at the very point when there are more than the normal number of bargains available.

Markets around the world are synchronized across asset classes with a reasonably fixed level of liquidity and move to where they can get the highest risk assumed rate of return. Thus, it is possible that a large problem in one asset class in will drain other markets, at least temporarily.

I have done my fiduciary duty by warning you, but I hope I am wrong, although the odds will be on my side eventually.

Question of the Week:

What would you do if one or more of the bonds you hold drops 10% in a day?

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SUNDAY, JUNE 9, 2019

On the Right Learning from the Left - Weekly Blog # 580

Mike Lipper's Monday Morning Musings

On the Right Learning from the Left

Editors: Frank Harrison 1997-2018, Hylton Phillips-Page 2018 –

After nearly a week of visiting managers in London, it is evident there is fear of the Left on both sides of the "pond". The purpose of this blog is not to debate the political values of the chasm between the two sides, but to reflect on the 75th anniversary of the landing in Normandy. My wife Ruth visited Bletchley Park, the home of the prodigious code breaking effort to understand and anticipate enemy positions and movements. This was part of our own memorial to those who died and were injured, including the walking wounded and those without physical injuries. On Saturday we visited the Imperial War Museum and got some additional understanding of the battles fought. It is appropriate for an investor to study military battles as each day there is a battle for investment survival and hopefully success. Thus, to me it is natural for those on the right to analyze those on the left.

Need for Investment Success
Excluding the gambling need of most investors, they should have a suitable contingency reserve, which can be summed up in three parts:

- Health
- Education
- Retirement (may include legacies and charitable giving)

I have long suggested that investors divide their investable resources to fund these needs. While there are people lucky enough to be a beneficiary of inherited wealth, most investors gain their wealth through productive work.

Changing Political and Social Leadership is Inevitable

We all know that demography is destiny. What we should know is that as generations evolve, the governed start to speak and think differently than those governing. Years ago I sensed this growing divide in the United States, but didn't know if the change would be led from the right or the left. The choice is not about policies, even though that is what many will believe. I believe the change will come from the growing age gap between the leadership and its followers.

As a member of the senior band, I recognized that the leadership of the old left (Democrats) is somewhat older than their opposition. Thus, the group trying to seize power is more likely come from young left leaning groups. The Republicans had their chance with The Silent Majority, which was behind both the Ronald Reagan and Donald Trump surprise victories. But thus far neither of these have created a "movement".

What do those who chant the slogans of the left want?

An axiom in politics is to support a grand idea like equality and/or some other unselfish demand. As has been mentioned repeatedly at cocktail parties in Washington, nothing succeeds as much as interest, such as self-interest. It is my belief that self-interest is motivating and driving the young on the left, somewhat equivalent to those leading the Children's Crusade in the era of the European attack on Jerusalem.

Many of the current young generation are pessimistic in their outlook and have not enjoyed much in the way of competitive success. Nevertheless, they instinctively want the very same outcomes the older groups have achieved through education, such as healthcare and retirement. They would also like to have a life away from work, rather living to work like their parents and grandparents. Many of the younger generation are coming to the realization that their lack of practical education, rather than outmoded schooling from teachers who do not live in "the real world", has made them unemployable except in low-end jobs.

The solution being fed to them by those higher in the new structure is, if you can't earn the money to meet your defined needs the government will supply. That is why they are pushing for healthcare for all, free college education, forgiveness of educational debt, and a large and sound social security pension system. That this structure will collapse in two generations is not a deep concern.

What can be Done?

While technology will reduce the scope of repetitive jobs, it is creating a vast number of positions for those of integrity who have the analytical capabilities to provide critical analog skills in a digital world. Their education needs to start at home, where living skills and attitudes about honesty, chores, and looking out for others are emphasized. Eventually these principles will seep into primary and secondary educational institutions, then onto higher institutions of learning. Employers need to view their first line workers as investments that need to be nurtured and should view them as eventual customers that will keep the system expanding.

In the Meantime, We Must Invest

In my meetings with CEOs of various successful investment organizations on both sides of the Atlantic, I find many that are long-term pessimistic about their future due to low or negative flows, fee compression, and heightened regulation (more to come after the next recession). They are desperate to increase the longevity of their client relationships, as many asset management clients rotate out in four years and wealth management clients in eight. Due to competitive pressures they can't materially lower their portfolio management people costs, although it's somewhat easier to do in wealth management. All feel the competitive pressure of ETFs.

The Real ETF Advantages and Disadvantages

The main competitive pressure from ETFs is from very large index funds investing in the S&P 500 Index. From an investors' point of view the advantages are just the opposite of what too many believe. In order they are:

- Wide momentum biased diversification
- No cash
- Low fees

The wide large-cap momentum priced diversification in the S&P 500 includes various stocks that can be used for growth and value in many gradations. Also, the portfolio is refreshed by eliminations and additions due to mergers, price movements, and IPOs.

The second advantage is that index funds do not hold cash as a liquidity reserve. They handle their excess liquidity needs using futures. Actively managed funds typically carry redemption and opportunity reserves, which means they are only 95+% invested. (That is the reason index funds fall more than actively traded funds in a declining environment, with the reverse being true in the early stages of a recovery.)

The low fee and bid/ask spread entering and leaving ETFs gives them less than a 1% advantage these days. The principle disadvantage is that as more money flows into a market-cap weighted index, one is putting money into the most popular stocks, which are often expensive. The S&P 500 Index can be beaten. Through the close on Thursday, 18 investment objective fund averages are beating the index year-to-date.

The Big Disadvantage

I was very sorry to learn of the death of John Neff this week. He was the long-term portfolio manager of the Windsor and Gemini funds. I would guess that John rarely owned stocks that were not in the S&P 500 Index, although he owned fewer of them and in different proportions. His style was between value and growth, capturing elements of both. He had many winners investing in companies that had secular growth in revenues, but which lagged the earnings power they once showed. His deep analytical skills and perceptive questions gave him confidence in betting against the crowd. He did this very successfully with Citi Group. At one point he was probably the largest shareowner in the stock and made multiples of his cost. At the time of John's retirement dinner from Vanguard in New York, the only non-Vanguard people there were the chair of Citi and me. Jack Bogel made most of his investment profits with John Neff. On my trip to London, two of the more successful managers I met with use a similar style to invest successfully.

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SUNDAY, JUNE 2, 2019

Confidence Deteriorating Normally, Recession Unavoidable - Weekly Blog # 579

Mike Lipper's Monday Morning Musings

Confidence Deteriorating Normally, Recession Unavoidable

Editors: Frank Harrison 1997-2018, Hylton Phillips-Page 2018 –

One investment trap is having extreme faith in historical statistical norms. This week's numbers basket has the following negative indicators:

1. McDonald's was the only stock to be up in the Dow Jones Industrial Average
2. There were 38% more Puts purchased than Calls
3. The Delta Market Sentiment Indicator is bearish, recommending 100% cash
4. The American Association of Individual Investors is only 25% bullish and 40% bearish
5. The Barron's Confidence Index favors best quality bonds over intermediate quality, a bearish signal for stocks
6. Only 22 of the 72 weekly price indicators rose in the week
7. Stock prices are breaking down from triple top formations, a reversal signal
8. Of the 25 best performing mutual funds, only 5 are invested in developed markets, 10 in emerging markets, 5 in India, 4 in Latin America, and 1 in China. Of the 10 poorest performing funds, 4 are invested in Natural Resources and 3 are invested in alternatives
9. Money Market Funds, particularly institutional funds, and other short-term funds were big beneficiaries of flows

Reactions:
Not because I am a contrarian, but I learned at the racetrack that heavily backed horses win only about one-third of the time and pay very little in exchange for their exposure to "racing luck". Something market analysts refer to as "surprises". With pundits generally being very responsive to the echo chamber, it is likely that there will be an increasing volume of bearish proclamations, with some of these politically motivated. They will all see a recession ahead.

They will undoubtedly be correct, there is a recession ahead. I have close to 100% confidence with that statement. Why? Because since recorded time there have been recessions, even before governments and central banks thought that they controlled rather than influenced markets. I have much more faith in the rules that govern all human and other animal behavior. Greed and Fear are two motivators embedded on the same coin. Greed is essentially the desire to acquire enough assets and/or power that one can escape the fear of insufficiency.

Recessions Are Needed
Almost every expansion, if it continues, will lead to an excess of supply and speculative behavior. When these excesses become too great, they are brutally eliminated. The emotional rule is that if my neighbor is out of work it is a recession, but when I am out of work it is a depression. (To the best of my knowledge the term depression was first used in the US in the 1930s. It is a term from psychology that describes how people feel rather than an economic condition.)

Are Excesses Big Enough for a Major Recession?
One of the lessons of history is that the many changes in fundamental condition are not generally identified before there is a decline. Today, one must look hard to find the growing imbalances that could set off a chain reaction that would bring down the economy. I don't currently see the growth of imbalances sufficient to set off the reaction. However, the so-called immediate cause for the beginning of World War I was the assassination of the Austrian Archduke by a crazed person. Even then, it took another six months before hostilities started.

As a prudent investment manager and investor, I am always scanning for future problems that could grow large enough to start a major recession, or even a depression. There is one element that could lead to a smaller reaction. Much like the prime mortgage crisis, it has been identified by a minority of watchers, including some at the Federal Reserve. The element of concern is the growth of credit extensions by non-bank financial institutions, which have provided loans with light loan covenants. If that area blew up unexpectedly it might conceivably take 5% or less off our GDP, or one year's growth.

Others in my cast of possible but unlikely horrors are medical, weather, or technological tragedies that we have not seen before. In this scenario actuaries have no data to guide them. I could see such an event taking a low double digit hit to global prosperity. Possible yes, but the odds are very small.

What to Do?

Because others are worried, I am less so. I view any sort of major market drop as an opportunity to find new leadership at fair prices. In the past I have missed some of these opportunities because I was waiting for truly bargain prices. I was not sufficiently aware of Charlie Munger's fair price doctrine. There is always the risk of being too smart and out-smarting oneself. Thus, I am generally maintaining my equity positions. I will be willing to sell some of my positions in order to buy what I believe to be the new leaders when there is a double-digit breakdown.

Question of the week:

What is your intended strategy when it becomes clear to you that we are in a market breaking recession?

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SUNDAY, MAY 26, 2019

MEMORY TRAPS JUDGEMENT - Weekly Blog # 578

Mike Lipper's Monday Morning Musings

MEMORY TRAPS JUDGEMENT

Editors: Frank Harrison 1997-2018, Hylton Phillips-Page 2018 –

In the US it is the season to remember and celebrate the past. For more than 150 years we have had Memorial Days to honor those who served and died in the defense of their country. It is also the time for college commencements. (Like many other families we proudly celebrated multiple college and high school graduations this month) Victors write the published history and exploits are summarized and simply told. It is the simplified and often enhanced versions that are remembered in succeeding years.

This habit is harmless unless it becomes the basis of judgement in dealing with the likelihood of future events. I have often said that if one cuts an analyst, a historian will bleed. Caltech(*) professors have determined that the part of the brain that deals with making judgments is the portion that stores memory. I feel that comparisons of the past with the present or perceived future, unadjusted, can lead to significant errors of judgement. Errors of judgement can be costly in all elements of life, but is particularly noticeable with investments, where it can result in both unnecessary losses and forgone gains. A very perceptive reader of these blogs, while discussing the current investment scene, quoted a bunch of statistics to me from the past. I responded that the current picture is different from the past because so much has changed. He then suggested that I blog about the crucial differences, which led to this blog.

Major Changes

One can categorize the major changes in two buckets. The first are the less visible changes that have and are a continuing influence on the markets for investments. The second are the changes that are driving the broader world. While both sets of changes have their origin many years ago, their importance has been accelerating over the last ten years.

Less Visible Changes in Investment Markets Structure

One of the techniques I learned in the Marine Corps was that when planning an attack, start by looking at it from the defender's perspective and plot your attack from the enemy's position rather than from your own. I have utilized the same approach of reversing direction to the art of investing. Thus, I start with the profitability of the agents, intermediaries and principals, recognizing that return on equity, profit margins, and capital turnover have all suffered since 2007, if not earlier. Because of the generational growth of cash capital, revenues have grown. When I was an analyst at a retail-oriented brokerage house trying to build an institutional business, the return on partners capital was about 25% in normal years. Better firms probably did even better. Today, after an extended period of concentration in the industry, many firms utilizing a lot of leverage have return on equity in the single digits. Moreover, that return is earned on selling private equity and debt rather than publicly traded investments. Private sales are growing at twice the pace of publicly traded sales, although the market is much bigger.

From a customers' vantage point the lower profitability has led to a much smaller cadre of research analysts and less readily available liquidity in stressful situations. Smaller companies have lost analyst coverage, including many stocks that don't even have an analyst regularly reporting on them. Part of this decline is the result of regulation FD, which curtailed what analysts could learn from private meetings with corporate executives. With less in-depth analysis and increased media attention on reported earnings, published earnings have become a less reliable guide to what is happening. Previously it was a clue to future results.

Due to the competition for effective salespeople, those that are better get a higher percentage of the revenues they generate. This has led to a switch from selling load mutual funds to selling private equity and debt, plus the occasional initial public offering. These were less frequent occurrences in the past, as private firms remained private for longer or were acquired.

In the past some firms would accommodate good customers by absorbing the stress merchandise they held or sold. Any losses sustained were repaid in future transaction business. This kind of facility is not generally available today. Liquidity concerns may be heightened when we move out of the relatively low volatility market we have been enjoying.

Regulations addressing the late 2007 mortgage credit collapse in the US penalized the participants rather than dealing with the imbalances that were partially created by politically sponsored government subsidies. In Europe, MiFid II is already reducing both research and liquidity support for European investors.

External to the Market Changes

Central Banks have evolved from being the bank of last resort in financial crises, to stimulating economies within the term of the current political leadership. Unfortunately, they rely on government data that does not capture the reality of inflation and does not fully understand the deflationary impact of technology.

The changing structure of the banking world is not fully appreciated, financial tech providers are viewed as an aid to existing institutions. Fintech has morphed into new competition for established banks through items like electronic payment systems, electronic trading of currencies and personal loans.

Demographic changes have been identified for a long time, but not their implications. The developed world needs more workers, productive workers. Our educational system, from pre-school through the granting of Ph Ds, is not producing enough employable workers with the right knowledge and personal attitudes to fill present and future jobs. Combined, these trends along with the advances of expensive medical science and the inadequacies of social security and pension systems, will not be able to support retirement.

We have a transnational problem. Both consumers and producers have become global, but they are dealing with national laws, taxes, and regulations. To an important degree, elements of consumption and production can and will move beyond local political mandates.

Are Past Lessons Worthless?

Absolutely not, they just need to be adjusted to fit the current context. We can learn from past motivations and they should be studied, not the various statistical ratios, frequencies and measures. The statement that history doesn’t repeat, but rhymes, is more accurate than a statistical cookbook.

(*) I am a senior trustee of Caltech and a member of its investment committee, among other committees.

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