

“People suffer from an illusion of control, that even if things do go wrong, they’ll be able to sort them out.”

-- James Montier

An article in the Wall Street Journal earlier this month discussed the plight of financial advisors as they deal with clients’ unrealistic return expectations. With the SP500 generating a six year return of over 17% per annum following the great recession (which would make a \$1000 investment now worth over \$2500), clients are expecting these gains to continue well into the future.

Recency bias (the tendency to think that trends and patterns we observe in the recent past will continue into the future) has turned the 37% drop in the SP500 in 2008 into a distant memory. Yet we know that at this writing the US market is trading at 21 time’s normalized earnings and 12 time’s forward cash flow – compared to 12 and 8 times, respectively, coming out of the recession. Clearly the market is “expensive”, and future return expectations should be muted. Yet what are the alternatives?

In theory, everybody wants to be a contrarian investor. After all, Buffett tells us to be fearful when others are greedy. But it is so very difficult to sell down your winners, despite logic telling you that the party cannot continue forever.

Most investors continue to believe there is the proverbial “silver bullet” to protect against loss. Whether believing a tactical shift in allocation from one asset class to another will minimize potential loss or simply buying into the atruism espoused by various hedge funds, expectations of minimizing loss tend to surround a singular event rather than a conscious prudent approach to the management of wealth.

The expectation that a particular strategy can solve all ills is exacerbated by the constant litany of market timers. Well-known names – Messr.’s Roubini, Hussman, Faber, and Gartman to name but a few – predict with apparent confidence the direction of markets and, therefore, recommend a particular shift in asset allocation to optimize on the coming bull or bear phase. However misguided, it is the human condition that we expect outcomes to be predictable rather than random. We snort in derision at the gypsy peering into the crystal ball – yet we continue to give credence to these market prognosticators.

At Laurus, we contend the only way to effectively protect capital is through a broad portfolio allocation to uncorrelated assets. The simplest form of this is having an allocation to stocks and bonds in the same portfolio. By expanding diversification within each of these asset classes – separating corporate bonds from government bonds and large from small cap equities, for example – provides richer diversification and smoothes overall portfolio volatility. Widening exposure to other geographies and to other asset classes (real estate, infrastructure, distressed debt, etc.) further mitigates against the chance of all assets falling at the same time.

While it’s true that in large and deep markets like the US a manager can adopt a style “tilt”, in smaller markets like Canada – where there are far too few good companies being chased by far too many assets – defined manager style is less prevalent. In the Canadian large cap market, stock price movement is generally less style-driven and more irrationally driven by emotion. Hence, short term sentiment becomes a greater influence on the direction of a particular stock, or group of stocks, as opposed to whether the price is discounted or earnings are expected to accelerate.

Statistically, in Canada at least, a better strategy is to hold equal amounts of large and high quality small cap equities in an overall equity allocation. As the large cap equity product will react to the positive (or negative) noise in the overall market, a small cap investment product comprised of emerging blue chip stocks will be a better reflection of the general economy and provide the investor with access to companies less followed by analysts. Combining them equally provides better long term returns with lower volatility.

As we have written many times in the past, long term performance is more about protecting capital in down-markets than accelerating gains in up-markets. If today’s multiples are any indication, there is a strong likelihood of subdued returns in the coming years. Selecting portfolio managers with high conviction and a disciplined process across widely diversified asset classes will greatly increase the odds of achieving targeted financial goals.

Investors should be thrilled to have achieved the equity gains over the past few years but should not rely on these returns to continue indefinitely. Broad diversification within uncorrelated assets will better protect underlying capital through the murky waters ahead.