Neuro Approach
INVESTMENT NEWSLETTER

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Why The Tortoise is so Wealthy

We are all familiar with the fable of "The Tortoise and the Hare" where the faster and over confident hare challenges the slower tortoise to a race. The end result is that the tortoise wins the race with his slow and steady approach! Much has been written in the investing world about how this same "tortoise approach" could greatly benefit many investors and that is the focus of this newsletter. For starters, it must be appreciated that many participants in the stock market are wired to behave like the hare. For example, with my esteemed clientele of medical doctor's, dentist's and business owners, they have all learned that through hard work and action one can achieve high levels of repeated success in their chosen fields of work. The resulting over confidence is a common if not mandatory trait amongst this group. They have all learned to act quickly and decisively (e.g. in the E.R. or O.R.) and they often listen to their emotional "gut" for guidance.

But unfortunately these "successful" qualities are frequently a major disadvantage in the **investing world**!! Quick action/reaction is a great survival trait which has been hard wired since the Stone Age and serves us very well 99% of the time during work and social activities. Additionally, if there are escalated emotions involved (eg. fear) then we are wired to act even more forcefully and quickly. But as I hope to show you, in the investing world **LESS** action is often better than more action. In fact ideally you want to be boring most of the time i.e. more like the tortoise than the hare!

As well, repeated research reveals that the loss emotion (or fear) is felt almost 3x stronger than the gain (or greed) emotion, which makes sense from the survival view point but not with investing decisions. And because the equity markets are negative 46.4% of the days (Crestmont Research) we can expect lots of stirred emotions for the hyper hare investor who characteristically monitors the markets and his fluctuating portfolio **daily** (versus the infrequent tortoise viewing). These aroused emotions (fear) are reflected with excess trading activity seen in the stock markets. The average hold for US stocks is now 17 week and if we include ETF's it's only 4 weeks. So in essence we are hard wired for "short-termism" and this is a flawed investing survival trait. We simply can't help ourselves when we are emotionally stirred because we are wired to react!

I hope I will be able to show the reader that the "Tortoise Strategy" is the best path for most investors. The key behind the tortoise's investing success is the slow and steady action, the not too over confident viewpoint and a focus on keeping things simple- all of which help keep the emotions in check (even when being harassed by the hare).

How Important Are Emotions?

The most impressive Tortoise investor of all time is Mr. Warren Buffett who has stated that "lethargy, bordering on sloth should remain the cornerstone of investing style". Other very successful tortoise investor's would be Prem Watsa, Seth Klarman and Howard Marks. The common theme with these investors is a capacity for enormous patience and controlled emotions which allow an enhanced contrarian investing strategy.

The importance of finding a way to minimize investing emotions is clearly outlined in the annual report from the Boston Dalbar Study research firm. This review has been going on for thirty years and compares the returns of a variety of indexes (e.g. US Equity and fixed income) and US mutual funds versus the annual returns of the investors that hold those funds. The results are consistent every year with the average equity index or equity mutual fund obtaining about a 10% annual return yet the individual investor has obtained only 5% over the last 30 years! In the 2014 review for example, equity indexes obtained a 13.6% return while equity fund holders obtained only a 5.5% return (the same discrepancies are seen with fixed income funds). Dalbar repeatedly summarizes that the difference in returns is a reflection of "investor behavior" rather than fund choice or performance. Every year Dalbar comes to the same conclusion that "investor emotion based trading is counterproductive"!!

They document several irrational investment behavioral biases for this stark difference in returns but the two biggest are "Herding" and "Loss Aversion". Herding is simply the Stone Age practice of not wanting to stand alone and results in following the herd right to the top with us "buying high". Loss aversion is another Stone Age trait of over reacting during times of stress and results in panic selling. The Dalbar Study reveals that we **"repeatedly buy high and sell low"** thanks to our endogenous wiring which encourages us to over react to stirred emotions! We are wired to react and the more our emotions are stirred the more we over react! We simply can't help ourselves once our emotions are stirred. So needless to say, an important investing strategy might be to find ways to minimize our emotions and behave more like a Tortoise or a Mr. Buffett. Additionally, as we know this is a **repeated pattern**, an advantageous investing strategy would be to find a way to exploit this flawed irrational investing behavior!

Enhancing The Tortoise Strategy

We are in luck here as Ben Carlson has just written a wonderful book entitled *"A Wealth of Common Sense—Why Simplicity Trumps Complexity in any Investment Plan"* that points us all in the right direction. The recurrent theme in this book is that investors all "need an emotional intelligent strategy". He outlines many core investing principles to help us move away from the twitchy hare style of investing and more towards the slow and steady tortoise strategy but 4 stand out: #1. Patience is a must- that means doing nothing is ok and sitting on your thumbs is a good practice #2. Simplicity needs to be central so as to minimizes the emotions (and this helps #1) #3. Common Sense should prevail and starts with ignoring the unpredictable short term noise and focusing on the mid-long term trends and #4. finding a discipline that allows you to buy low and sell high.

Carlson also does a wonderful job at explaining why it is so hard "to do nothing" in the investing world versus all other walks of life but emphasizes why it's so important with investing. Your strategy really should focus on being boring most of the time! He also reviews the importance of knowing about the history of cycles (market-investing-business) and how you can make this work in your favor.

My conclusion from the Dalbar Study and Ben Carlson's book is that investors need to find a way to improve or enhance their **Emotional IQ**! There is so much truth in the old adage that most investors are "their own worst enemies"! My review of successful tortoise investor's reveals that most have a higher emotional IQ. This results in a higher level of controlled investing emotions which in turn allows greater patience and provides a huge investing edge when it comes to repeatedly buying low and selling high i.e. a contrarian strategy.

Enhanced Emotional Investing IQ

I believe with my neurology background that I might have an advantage over many in appreciating the investing benefits of this enhanced emotional IQ. From the neurology angle the tortoise simply uses more frontal lobe activity (logic) over temporal lobe (emotional) especially during times of escalated emotions and stress. Of course being aware of this neuroanatomical difference and acting appropriately during times of raised emotions may be another challenge all together. Because of this risk I have implemented a **ten step** strategy that hopefully allows me to operate with a higher emotional IQ. The idea is that 80-90% of the plan always operates under the logical frontal lobe "Auto-Pilot setting" which minimizes the emotional temporal lobe component. The other 10-20% is the tactical component which is more flexible but also requires stringent guidelines so as to minimize the temporal lobe threat!

This strategy has been covered in detail in the October 2015 newsletter and will not be repeated here but I will add a few additional comments that deserve further thought. Under Step 2—Asset Mix Allocation – on this topic Ben Carlson makes the point that since 1928 there have only been 3 times when both equities and bonds were down in the same year (1931,1941 and 1969) and then the bond returns were just down minimally. But for the other 97% investing time you had a winning asset in your portfolio so as to offset the losing one. The asset mix therefore minimized your emotions (fear and loss), protected you on the down side and most important –it provided a source of dry powder. I think the simplicity and HUGE benefit of asset mix allocation is missed by many in the investing world especially now with the threat of interest rate hikes and fears of bond losses. There are ways around this and it has been covered many times in my *Currant Generic News Report.*

Under Step 6- Rebalancing- There is the "Mini" rebalancing that takes place every 6-12 months but there is also the mandatory "Mega" rebalancing that takes place (less often) when some of your core positions drop 20%+. We saw this over the last 4 months when many energy, pipeline and Emerging Market core positions fell 30-35% requiring mandatory happy buying on our part. This action contradicts our hard wiring but is necessary for success.

Under Step 9 –Consider a Tactical Overlay - I will expand on this by pointing out that there are times when it simply makes sense to become (more) tactical and raise some cash (or "cash substitutes"). This could be as simple as using a 5-10% annual tactical call based on the Seasonal Anomaly of "sell in May and go away" or the four Year Presidential Cycle where we see most bear markets-recessions in Year 1 & 2 and then very good markets in Year 3 and less so in Year 4. What is interesting is that 2015 was the first Year 3 since WW2 which was negative for the US markets—one has to wonder why? Typically Year 3 is a very good investing year as the incumbent party stokes the fire in anticipation of Year 4 which is election year.

Finally, it is wise to consider being more tactical when we are in a Secular BEAR Market versus a Secular BULL Market. These "secular" trends last 15-25 years on average versus the shorter "cyclical" cycles which last 5 years. The majority of investors believe that the most recent Secular Bear Market ended in 2009 and that we are now in a new Secular Bull Market. However I don't buy this as that would mean that the Secular Bear Market from 2000-2009 was the shortest ever and this after one of the strongest bull markets ever! Over the 18 years from 1981-1999 the S&P 500 rose 250% or 18% per year which was DOUBLE the historical annual return! For this tremendous bull to be followed by the shortest secular bear ever does not make sense to me?! I am a strong believer in reversion to the mean and this much asymmetry does not compute for me.

Consequently, I feel there are strong odds that we remain in a Secular BEAR Market and I have chosen to be more tactical as during these sideways to negative markets we frequently see sudden market losses eg. 2000 and 2008. By being more tactical I hope to dampen any large losses and more importantly this provides me lots of dry powder should a buying opportunity present itself such as it did over the last 4-6 months.

However it is important to reiterate that even in the Secular BEAR Markets I aim to be 75-85% invested (depending upon the client) and with the AUTO PILOT fully engaged!

The last step in my Ten Step Strategy that I would like to expand on is The Macro Call.

The Macro Call 2016

Having a good feel for the big picture or the big macro trends is very important for the Tortoise Investing Strategy. Firstly, this keeps you **more focused** on the mid to long term which in turn allows you to minimize or ignore the short term noise. Tuning out the short term noise lowers your emotions and allows for a higher emotional IQ! For example, it became evident over a year ago that the US dollar would rise (the US stops QE and starts chattering about IR hikes) and the Canadian dollar would fall (re falling oil prices) and so the Macro take on this was that more US currency exposure would be beneficial and that is what we did (always wish I had done more). This was not an emotional short term call but a big picture macro trend.

Secondly, by following the macro mid-long term trends I am better able to weigh Risk vs Reward. For example, we are now into the 8th year of this cyclical Bull Market (third longest ever) and this does not mean that the markets will turn suddenly lower but it significantly increases the odds that we are closer to the end of this bull than the middle. This macro fact tells me to err on the side of investing caution now. The same could be said about the arrival of the next recession—we are closer to it every quarter (we get one on average every 5-6 years) and I know equity markets correct 35% plus in recessions. I also know that markets decline 6-8 months **BEFORE** the recession is recognized! Additionally, we have all been invested since early 2009 and so now seems like a good time to lower our risk exposure simply based on this macro data.

Thirdly, by having an increased awareness of the big picture and risk vs reward I am better able to adjust my Tactical call. However please remember that at least 75-85% of my portfolios are locked into the non-emotional and logical Auto Pilot setting all of the time (in case I am wrong).

So with this intro here are some Macro Trends that I am currently following that are influencing my positioning and tactical call:

<u>#1 Expanding Global Grand Experiments</u>

I worry about the increasing trend of unconventional and experimental government interventions in the economy and markets. It started long ago with QE in Japan (that failed) and then moved to “Abenomics Shock Therapy” in 2013, then ZIRP (zero interest rate policy) and QE in the US followed by the ECB and now the granddaddy of them all—NIRP (negative interest rate policy) in Japan and Europe!

As we have never been here before it is very hard to predict the final outcome or exit strategy from these interventions. This greatly raises the risk vs reward as we head into 2016 and Year 8 of this cycle and bull market.

<u>#2 Commodity Tailspins</u>

Up until three weeks ago this was an easy negative Macro call but now we are seeing many commodities bottom and possibly turn up. It will be important to see if this trend can continue but I have my doubts based on the tepid global economy.

<u>#3 Earnings-Revenue Recession</u>

We have now seen 3 consecutive quarters of negative earnings growth and 4 consecutive quarters of negative sales growth. A recent JP Morgan report stated that this type of negative run has been associated with a recession 81% of the time over the last 115 years. The other 19% were rescued by aggressive monetary or fiscal stimulus. Now ask yourself what are the odds of this happening in 2016-17 with the current US gridlock? But it does not get any better- Zack’s Investment Research expects negative quarterly earnings for at least another two consecutive quarters into 2016!

Brendan O’Boyle reported that S&P 500 earnings using GAAP (General Accepted Accounting Principles) declined 12.7% in 2015 and that such double dip declines are rare having occurred only 14 times yoy in the last 115 years. On 12 of these 14 occasions (i.e. 86%) the markets were in a terrible bear market-recession and declined 20-35% from his review. Again this spells risk for me.

#4 US Manufacturing Recession

We have seen consecutive weak data on both the ISM manufacturing side which has contracted (below 50) for 5 months in a row and the broader Industrial Production (contacted 4 consecutive months). A review of history says the odds of a recession under these circumstances are in the 55-65% range. Not a guarantee of course but another macro point that raises the risk vs reward ratio.

#5 Weak Global Economies

Global world trade was down 8.4% in 2015 (World Trade Monitor) and the World Bank just lowered its global growth outlook for 2016 to 2.9%. This reflects the very weak economic growth in Japan, most of Europe, most emerging markets and especially China. This geography accounts for about 60-70% of the globe's economy! The US is the only "bright" light with its 2015 tepid GDP growth of 2.4%. This economic malaise is pushing several governments to bring even larger untested "bazookas" such as the ECB just did this week and Japan did last month with its introduction of negative interest rates. The main question is whether the US economy can remain immune to the ongoing global slowdown?

#6 Currency Wars

With the introduction of NIRP (negative interest rate policy) and further unconventional action by the ECB and B of J we can expect to see further currency weakening globally. When done in aggregate this is never good for global trade or deflation risks. The US is the only major Central Bank raising rates and so we can expect more dollars to flow into US bonds going forward.

#7 Cycles as a Guide

The final year of a second term President (i.e. Year 8) has been very poor for the markets being down an average of -15% and negative 5/6 times. The last two were 2000 (Clinton) and 2008 (Bush). Additionally, when we have a negative January (i.e. The January Barometer") the odds of negative 2016 markets are 100% based on history (but I realize the small sample size). But it is another concern for me as 2016 has all the makings of a record Presidential Year on several accounts…President Trump, President Sanders…maybe time to think ahead to October-November here…

#8 Global Debt Levels

The ratio of global debt to GDP was 270% in 2007 and it is now 290%! This high level of debt implies slow economic growth for years ahead. Global debt has grown twice as fast as GDP over the last 10 years. In 2007 it was very focused around mortgage debt but now we have scary debt levels in Emerging markets, High Yield bonds, auto loans, student loans and margin debt. This is a big negative macro trend and points to slower growth and volatility!

#9 Consumer Health

Consumer spending accounts for 70% of the US economy and so one always has to keep a close eye on this. This month's retail sales were a disappointment and we saw revisions to the two previous months. Despite all the chatter about consumers eventually spending more (from the dollars saved at the gas pump) we have seen a negative trend in retail sales now for over a year once you back out auto loan expenditures and Obamacare costs. The Walmart announcement of closure of 150 US stores reflects this weakness. This is also a reflection of the fact that 90% of US household incomes are still below 2007 levels. This speaks to the growing problem of income inequality in the US where the top 5% are doing just fine but not the bottom 95%. This is well reflected I believe with the current **protest voting** on the Republican side (D Trump) and the Democrat side (B Sanders).

The optimist will point out that rising wages (eventually) and low gas prices will soon translate into more US consumer spending. But the future risk with this optimism is raising inflation and more interest rate hikes. Thus far rising rates have been a big negative for equities…we will see how this plays out in 2016 as the Fed could be torn between rising inflation data (if wages ever rise) and a tepid economic recovery.

#10 The Bond Message

Up until three weeks ago the US Yield Curve was the flattest since 2007 and High Yield spreads (difference in yield between high yield bonds and comparable treasuries) were extremely elevated indicating fear and rising risk in equities. Both of these have improved over the last 3 weeks as equity markets have soared back but these will be important to follow going into 2016 as the yield curve and junk bond spreads are leading indicators of the equity markets. Bespoke Investment Group has looked at periods where spreads narrowed by 100 bps or more in a 4 week interval (such as they just did) and over the last two decades equities have done very poorly after the initial 4 week surge falling by an average -5.6% over the following 3 months.

So despite some macro positives (US job growth, maybe US housing, cheap oil prices) the overall macro trend (globally and in the US) remains net negative which tells me that risk now outweighs reward. This in turn encourages me to be more tactical than normal BUT I still have 80-85% of all portfolios on Auto Pilot function just in case I am wrong! This was 70-80% 4 months ago but we have been happy buyers over this period as clients all know.

The Tortoise Conclusion

Using a slow and steady investing approach seems prudent right now as we head into the 8th year of this bull market—the third longest ever! It also makes me nervous (and cautious) that we have seen two 10% corrections in the last six months and that daily volatility is so high. “Sentiment Trader” reports that the last time we saw two 10% corrections in such a short period of time was 1929, 2000 and 2008! This pattern is therefore more typical of a bear market then a rebounding bull market and this has me very mindful.

My “macro barometer” senses that with increasing global government experimentation we have encouraged and created an enormous misallocation of capital around the world (e.g. High Yield debt, Emerging Markets debt, student debt, auto loans etc.). These “grand” government policies (e.g. protracted zero IR and now negative-NIRP...) have encouraged enormous risk taking and now many/most financial assets are very expensive! This has tilted the risk versus reward ratio towards the down side.

Unfortunately, these experimental policies have resulted in significant borrowing from future growth and at some point there must be a payback period! I have no idea when this might happen or even how it will play out but from my lens, risk still outweighs reward and this remains a time to be defensively invested (which has been covered in detail in the biweekly *Currant Generic News Report*). This is especially true as we head into the seasonal anomaly of “sell in May” and further into Year 8 of the Presidential cycle and the many, many unknowns of this US election… I suspect that the tortoise approach of patience, defense and minimizing emotions could be very rewarding later in 2016?! I am also reminded that the only two longer bull markets were 1987-2000 and 1949-1956 (which was only 6 weeks longer) and neither of these times ended well.

As history always repeats its-self (thanks to the endogenous hard wiring) I suspect that the two most prominent irrational investment behavioral biases (Herding and Loss Aversion) will once again be played out in 2016 (or 2017) allowing the boring Tortoise a large advantage over the twitchy and emotional Hare!

**** We also offer a bi-weekly “Curran’t Generic News Report” e-mail. If you would like to receive this no obligation e-mail, please e-mail my assistant at val.rybka@rbc.com***

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