Neuro Approach
INVESTMENT NEWSLETTER

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Peace of Mind Investing (POMI) Strategy

As we enter the summer months of 2017 under the banner of the **second longest bull** market since WW2 and the **second most expensive** bull market **ever** it seems appropriate to review what type of investing strategy will allow one to sleep safely at night these days. I have been using the "Peace of Mind Investing" (POMI) strategy intermittently for all clients over the last couple of years as the wall of worry and investor risk continues to climb to new record levels!

While one must always be aware of the risk when investing in equity markets, there are times such as now where you need a heightened sense of risk awareness for your portfolio. I believe that **risk** now far outweighs **reward** for equity investors for the many reasons covered in the last newsletter, but the main concerns are that we are now very late in this cycle and we have a Fed who knows that interest rates must adjust higher sooner rather than later so as to avoid another asset bubble burst. This scenario is always a risky time for equity markets!

During times like this, the best way to sleep at night is to first identify the escalated risk environment (vs keeping your head in the sand) and then adjust your portfolio to lower the impact of these multiple risks.

Here is my approach to preventing late cycle investment risk insomnia.

#1 WHY RISK MANAGEMENT

You always need some degree of risk management when investing in the stock market and this can be achieved through various means based on the individual investors risk tolerance and investment objectives. Unfortunately, for most investors (and money managers) the focus is often solely on the gain side of the equation. They often do not focus ("thinking about" it is not focusing!) on the risk side or loss potential until it is too late. As Jeff Gundlach has stated, "great investors focus on risk management because risk is not a function of how much money you will make, but how much you will lose when you are wrong".

There are times such as now when risk versus reward becomes **markedly asymmetrical** and slanted towards risk and this is when the competent money managers earn their keep! I am a firm believer of reversion to the mean and that markets are very cyclical. This particular cycle is both very long in the tooth and very expensive and history is clear that these long rich cycles **always end very poorly**! A chart that I circulated to all clients last week from Yahoo Finance revealed that the average subsequent decline from the "Top 7 Longest Bull Markets In History" has been 51%! Even if you exclude the 1929 crash (-86%) and the

2008 crash (-57%) the average decline of the remaining 5 longest bull markets is -33%! And recall that this is the second longest bull market ever so when history repeats we are likely in for one very large thrashing going forward.

Famed investor Howard Marks has said that his Rule #1 for equity markets is that "most things will prove to be cyclical" and his Rule #2 is that "some of the greatest opportunities for gain and loss come when other people forget Rule #1". I think it is time to focus on the length of this market and the extreme valuation. I acknowledge that it can go longer and become more expensive BUT if now is not the time to focus on risk management then when is the time?

It seems prudent to now put the focus on **portfolio protection** over **portfolio growth**. As the renowned Jeremy Grantham has said—"you don't get rewarded for taking risk, you get rewarded for buying cheap assets" and that is certainly not the case going into May 2017. Another great- Seth Klarman at Baupost has repeatedly stated that "most investors are primarily orientated toward return, how much they can make, and pay little attention to risk, how much they can lose".

There comes a time in every cycle when your focus should be more on wad protection over wad growth. That time is now. One of the benefits of becoming more aggressive with risk management this late in the cycle is that it forces you to sell high and this in turn provides you with dry powder. This is the other ultimate goal of risk management—it is a means of optimizing the golden rule of selling high and buying low!

So how do we go about lowering our portfolio risk and preventing late cycle investment insomnia?

#2 STARTS WITH AMA

Your choice of asset mix allocation (AMA) between different asset groups is the most important determinant of portfolio returns and you're risk exposure. In general terms, the more equity exposure you have the higher the returns (and risk & volatility) you can expect over longer time frames. The more fixed income-bonds you have the lower the expected returns (and less risk & volatility). A simple rule of thumb is that quality fixed income acts as an anchor to stabilize portfolios in difficult times (such as 2000 and 2008). Equity positions generally fall in bear markets and quality bonds (not junk bonds) generally rise in value and that is why it is so important to have a mixture of both in most portfolios. The reason for this difference in behavior is because equities and fixed income are lowly correlated to each other so when one goes up the other usually goes down and vice versa. But more importantly, when equities tumble quality fixed income become even less correlated so they act as an even better buffer.

We can see how fixed income acts as an anchor by reviewing 3 different asset mixes during the very negative 2008 crash. For the calendar year US equities dropped 38% but a 70% equity and 30% bond portfolio dropped only 28%. Even better was the 50% equity and 50% bond portfolio which only dropped 17% and a very safe 30% equity and 70% bond portfolio only dropped 9%!!

All clients are very familiar with AMA as it is the top line on all of your **Master Investment Portfolio Plans (MIPP)** that Val works so hard on producing every year for my clients. Determining the clients AMA is achieved by identifying your risk tolerance and investment objectives. This is a very crucial step in determining your specific AMA and a successful investing outcome. I determine this on a regular basis with a Client File questionnaire that most (**hint hint**) complete which allows me to set up the client portfolio asset mix to match the risk tolerance and investment objectives. If an investor has enormous risk tolerance then we would be mostly exposed to equities but very, very few of us fit this description. All of my clients have a set fixed income exposure that varies from 30% all the way up to 70%.

I generally stick with a **strategic** asset mix allocation which means I have a target or steady allocation to bonds, equity, real estate and gold. It is important to know that these 4 different asset classes respond differently in different investing climates and in combination lower the risk/volatility for the portfolio and enhance the returns over any one full cycle.

However, there are times such as now when I think it is important (if not imperative) to become **tactical** with the AMA where one tilts the strategic asset mix. When I see a significant escalation of market risk (such as now) it is prudent to tilt away from high risk equities and raise our exposure to low risk fixed income and cash. That is what I have done gradually in all client portfolios over the last two years and again in the last couple of months. This allows our portfolio's to become less risk exposed (safer) and provides us with extra dry powder should my tactical call prove correct.

#3 NEXT IS THE DIVIDEND FOCUS

Dividend paying stocks are the corner stone of the **NeuroApproach Investment Strategy** and specifically those companies that increase their dividends every year i.e. Dividend Growers (DG). Over the last 100 years dividends have made up about 40-45% of the overall long term market 10% return. However, there are times when dividends account for 70-90% of the market returns, and in fact it was 100% for the US markets from 2001-2010! This of course is dependent upon what happens to the capital appreciation side of the return period you are looking at e.g. in raging bull markets dividends account for less and in bear markets dividends account for the lion's share of the annual returns.

It is my standard investing practice for all clients to have the majority of their equity exposure to dividend paying stocks (and mostly DG). The reasons for this are many (safety, tax preferential treatment, better returns, low volatility etc.) and has been covered in previous writings.

What has me excited with this particular market cycle is that I believe dividends will once again make up 70-90% of the equity market returns over the next 5-10 years and is therefore a core feature of my MIPP and POMI strategy.

There are several reasons for this viewpoint:

First, the current equity market valuation is very rich and history tells us that future returns will be much lower coming off this high level and with reversion to the mean. Several qualified research groups have estimated very low annual equity returns in the 1-3% range (some asset classes even negative) over the next 7-10 years for most developed markets because of the current rich valuation (e.g. GMO, Research Affiliates). Therefore, having a focus on DG will be a benefit to your portfolio under these circumstances.

Second, we have the large number of elder boomers (who hold the lion's share of developed world equities, funds and cash) who desperately need retirement cash flow and bonds are not providing this so they will be putting enormous upward pressure on these DG for years ahead. This is all part of the TINA theme "There Is No Alternative" that central governments have created by keeping interest close to zero for so long. This has forced older investors out of bonds and into DG equities.

The important point is that this trend is just getting started. In 2016 we had the first baby boomers turn 70 in the USA (same in Canada) and now we will see 1.5 million turn 70 every year for the next 15 years! These folks are yield hungry and smart CEO's see this and will continue to focus on dividend growth to attract investors to their stocks. This will create great capital gains for DG for years to come. This also means that DG equities will remain pricey on a historical basis but elder boomers will continue to accumulate these positions until the 10 year US gov bond gets to 3.5-4%, which is a long way off in my opinion (e.g. there is little inflation, weak wage growth, weak GDP and weak velocity of money).

Third, multiple studies have revealed that returns on DG far exceed average equity market returns over any mid-long term period (this is why it is a core strategy for all my clients). A RBC review of the TSX Dividend Aristocrat Index performance from 2001 to 2013 showed a 71% gain over the broader TSX return. In dollar terms, you ended with $427,990 with the DG route in 2013 (with $100,000 at the start and dividends reinvested) vs $249,769 with the TSX. Another RBC report looked at DG returns versus the TSX all the way back to 1986 and up to 2015 and in this review DG outperformed by 5.9% annually! The same story is true for non-Canadian markets and I therefore focus on dividend paying equities here as well (i.e. in the US, EU and Emerging Markets), although I am always tilted towards Canadian DG over US or EU as they do not get the preferential tax treatment.

Finally, from the POMI viewpoint, and perhaps most importantly, most of these DG are less volatile than other equity positions (especially non-dividend payers) so they act as a buffer when equity markets sell off.

#4 FOCUS ON LOW BETA OVER HIGH BETA

Beta is a measure of a stock's volatility in relation to the overall market and by definition, the market has a Beta of 1.0. A stock that swings more than the average market move has a Beta greater than 1.0 and those that swing less or are less volatile have a Beta below 1.0.

When we are this late in the cycle it is prudent to shift the portfolio towards low beta stocks so if a market correction-crash happens these stocks will fall less than the general markets. Examples of low beta-low volatility stocks are the ones with stable non-cyclical revenues/earnings such as utilities, consumer staples and apartment REITs. They are often referred to as defensive stocks as they "defend" against market down turns. We are now over-weighted in these sectors. Additionally, I have lowered many high beta positions such as our resource exposure and small cap exposure.

A common theme amongst low beta stocks are the sustainable and often growing dividends and is the reason we focus on these as regular constituents of my MIPP. This is even more so when markets are risky, rich and ripe for a major correction!. These are the classic "tortoise stocks" that I have covered in a prior newsletter that are built for the long slow win, but will not attract a lot of attention in the doctor's lounge!

The other long term benefit to low volatility-low beta stocks is that multiple researchers have shown that they outperform the general markets over time (Research Affiliates). However, this advantage may now be watered down somewhat as passive ETFs and Mutual Fund companies have jumped on this band wagon in the last 2 years and created an explosion in "low beta-low volatility" ETFs. This has increased the valuation on many of these low beta positions making many expensive. This is a reason to stay away from the passive low beta-low vol ETFs or mutual fund versions and instead do some homework and buy the individual equity as I do with all clients.

#5 WHEN & WHY TO BE TACTICAL

The simple answer is whenever you believe the market will drop substantially and for a prolong period of time. As regular readers know, I have had a bearish viewpoint for some time and for a multitude of reasons e.g. frothy valuations, excessive debt at all levels which weakens future consumer spending, income inequality which has weakened middle class spending, the Fed raising rates at a time of weak GDP etc. etc. I therefore believe that the odds of a significant correction over the 2017 summer months is very high

There are three reasons for the why. Firstly, if done properly your portfolio losses are lower especially with large 20-30% declines (which is my expectation). Secondly, selling will provide you with lots of dry powder to buy low. Thirdly, is that selling creates a better "mind set" to allow you to buy low versus being stricken with panic over your losses.

I acknowledge that this is a form of market timing and can be very difficult to accomplish as nobody can predict the **short term** market direction! But to enhance my success rate and limit the risk of becoming too emotionally-irrationally involved I use several **rules and guidelines** with my tactical call. The first is that I have a percentage limitation to my tactical call for all portfolios. It is unusual for me to go above 20% of the portfolio value with cash or cash substitute (although in 2009 I was at 26%). This means that the other 80% remains invested on auto pilot and removed from any emotional investing flaws. Second, my tactical selling is mostly focused towards the high beta positions and stocks that have already had significant gains. This encourages me to sell high which is a good thing (when markets are frothy). The third and most important safe guard is that my tactical activity is reserved mainly for the late innings of the business cycle or in the "Over Time" period where sudden death can be a painful experience.

Using these guidelines and logic, there are times such as now when it just makes sense to become more defensive and tactical! I have reviewed these defensive reasons in prior newsletters but the bottom line is that markets are always cyclical and we are well over due for a turn in this cycle. History tells us that we get a 10% decline about once per year and the last one was August 2015! Additionally, we get a 15% decline about every two years and the last one was October 2011—that is **almost 6.5 years ago**!! A 20% decline occurs on average every 3.5 years and the last one was March 2009 or 8 years ago. So I feel that the odds are tipped in my favor that we will see at least a 10-20% correction (or more) in the near future.

Finally, my interpretation of being tactical at this late stage of this old cycle is that it is a form of **portfolio insurance** where I am willing to give up some return (e.g. like the annual home insurance premium cost) in return for safety of the wad (or the home). I cannot yet see the fire but I certainly can smell the smoke so my feeling is that now is the time to get the insurance in place!

#6 CASH VS "CASH SUBSITUTE"

There are two main risks with being tactical and raising cash. The first is that markets could soar higher for another 2-3 years as Trumphoria resurrects itself and finds a prompt way to drop the corporate tax rates from 35% to 15% or minimizes small business regulation in 2017. This is why my tactical call is usually limited to "20%" which means that the other 80% is invested and on auto pilot so as to avail of any surprise market gain. But my bet is that the markets at best will go sideways over the summer (as they usually do) and that Trumps tax and regulatory reforms get pushed way back into 2018.

The other risk or "side effect" of having high cash levels are the zero (or close to zero) returns on cash. This is a drag on performance and clients do not like this at all!

So I minimize both of these negatives by making sure that a large percentage of my client's cash is sitting instead in **"cash substitute"** positions. The two investment vehicles that we have used have provided a 5-6% returns over the last 2-3 years, which has allowed our overall returns to be very good **despite** our defensive cash position. Yes there is no doubt that these "cash substitute" positions are not as safe as cash or short T bills but they are very close and essentially have allowed us to "have our cake and eat it too".

#7 BIG PICTURE MACRO CALLS

A major focus of my investing process after the AMA determination centers on how the several big picture macro trends influence the markets and consumer spending, as ultimately it is always about consumer spending. Some examples are today's elder boom demographic influences, the ramifications of the multiple debt bubbles, the middle class annihilation and its future drag on spending, the income inequality future problems, how Amazon has killed many REITs, etc. These trends persist for long times and greatly influence my individual stock selections. I will cover more of these in detail in next week's *Currant Generic News Report* as they influence my POMI strategy, but here I will make just a few comments on some mini macro trends that I follow.

I take my tactical cues from many sources but one is where the investing Herd is heading and right now they are "all in the market" creating a market top I believe. This is reflected by the "VIX Fear Gauge" which is at record low levels last seen in 2007, and also by consumer confidence-sentiment readings which are at multiple decade highs. This data tells me that the Herd is aggressively investing or thinking about investing in equities these days. For the contrarian these are wonderful statistics and gives great comfort to those raising cash.

I also see that the latest report from Vickers shows that corporate insiders are selling 11:1 versus buying and this is a 29 year low for corporate insider buying (WSJ)! If the knowledgeable insiders see reasons to now take chips off the table in record numbers…..I think we should consider this strategy as well?

CONCLUSION

The purpose of this newsletter is to address **why** risk management is so important and also to provide some insight into **when** it is most useful. Investors need to be reminded that markets are very cyclical and when recessions hit, stock markets tumble. It is my humble bet that with the next recession markets will have an above average tumble due to this cycle's prolonged nature and rich valuation. It is very hard to predict when this will happen but my sense is that we are in the late innings of this very old cycle so risk management should now be core to any prudent investing strategy.

We know that a 15% correction occurs every two years and this lasts 215 days on average and a 20% bear market happens every 3.5 years and lasts for 341 days (Capital Group). **We have not seen either since October 2011**!! Additionally, if there was a recession associated with the next bear market we would see even larger and more protracted declines. This is when smart money managers earn their keep if they can minimize these losses BUT this requires forward thinking risk management rules such as the POMI strategy.

Although one can never be 100% certain, the odds based on history are now very much tilted towards risk over reward going into the summer of 2017. Consequently I have once again become more defensive by lowering our equity exposure to extremely overvalued sectors and countries (and added gently to cheaper valuation countries such as Emerging Markets), and have raised our cash/cash substitute positions. My hope is that we get an opportunity to be buyers over the summer as I expect (at least) a 10-15% correction!?

The Risk with Too Much Risk Management

The main risk with the POMI strategy is that markets could soar if President Trump is able to get some of his tax or regulatory reforms passed in 2017. If this happens then I will revisit my strategy. The other risk is that the global economy picks up and carries the US multinationals with it which would also lift global equities. The final risk is that we do not get a recession in 2017-18 (a rare event however as 90% of the time it happens in the first 2 years of the 4 year Presidential term and we are way overdue) and this would be a big positive for equities. Also, we have some very big names saying there will be no recession in the next year—Jeff Gundlach, Prim Watsa, ECRI, RBC Jim Allworth etc. and so I will be keeping a close eye on the recession indicators over the summer and will adjust our AMA if need be. But for now the focus is peace of mind and restful sleep!

**** 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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