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PORTFOLIO WATCH

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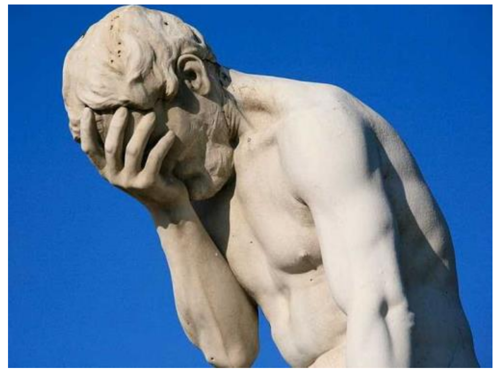
The Right Amount of Wrongness

There have been instances in the distant past when my wife and kids accused me of always wanting to be right. I can understand how it would seem that way given the number of times that I am right, but that's just a burden I must carry. In general, I doubt that many people want to be wrong, and investing is no different. There is enormous pressure on investment advisors to be right most, if not all, of the time. After all, we're professionals. If we do make a mistake, meaning that some investment is not keeping up with a benchmark or under-performing the other parts of a portfolio, it would seem to make sense to get rid of the offending investment and go with something that's working. "It would seem…", but it's not always the case. So why would it make sense to be intentionally wrong?

Being Too Right

The S&P 500 has averaged about 16% per year since the depths of the financial crisis in 2009. That is an impressive recovery, and no other asset class has come close to U.S. stocks. This means that any amount of diversification would have cause you to under-perform stocks, leading to embarrassing BBQ conversations and that dreaded feeling of missing out. This could also explain why investor sentiment (how positive people feel about stocks) jumped to the highest level in Q1 since the dot-com bubble. This brings up the logical question, "How have stocks done since the last time people felt this good about stocks?" Leading up to the peak of the tech bubble, anyone who wasn't fully invested in stocks seemed like an amateur. In fact, amateurs were doing better than the professionals at the time. The annualized returns are a little surprising (at least they surprised me), but here they are going back to Jan 1, 2000 (17.25 years ago). I used daily prices from the S&P 500 and Fidelity Investment Grade



Bond fund (FBNDX), with distributions being reinvested. Returns are for the period 1/1/2000 – 3/31/2017.

Annual return of S&P 500 (stocks): 2.85%

Annual return of FBNDX (bonds): 5.08%

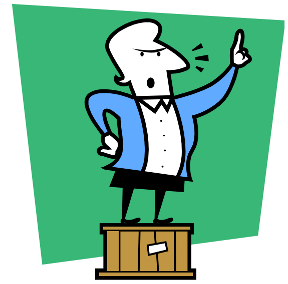
Annual return of 60/40 portfolio: 3.83%

Annual return of Harvard Endowment: >10%

If you are keeping up with the stock market, or are even close to it, it could be that your portfolio is "too right."

Adding Some Wrongness

An investment of $100K earning 2.85% since 2000 would be worth $163,521 today. At a 10% return, it would be worth $530,117. How does the Harvard endowment outperform the market by such a wide margin? By having the right amount of wrongness. Endowments do not invest in just stocks and bonds. They use a lot of different asset types that all perform differently, and since only one of them is "right" at any given time, most of the portfolio is wrong. The Yale endowment (as another example) has an average annual return of 12.6% over the last 20 years. So, did it beat stocks last year? In 2016, the Yale endowment returned 3.4% and was a top-performer among endowments. By all common measures of personal portfolios, this would be a wrong portfolio. A right portfolio should have nothing but stocks, and yet the Yale endowment has a current allocation of 4% in U.S. equities. That's pretty wrong, and they don't seem to be too worried about it. They know that over the long-term, which is what most investors say they are concerned with, it's better to be appropriately wrong than 100% right.



Market Comments

The market has been roughly flat now for the last 1.5 months, with a few ups and downs in between. There was a lot of optimism that the new administration would quickly bring about some economy-improving changes. Then healthcare reform fell apart, indicating that maybe Congress can't get anything done no matter what the President would like to do. That dropped the market for a while until the promise of tax cuts drove it back up. With the rise in stocks since November but nothing really changing fundamentally, I would think stocks are not on a very firm footing, but that hasn't seemed to deter people from buying every dip.

Russell Investments recently published their opinion that the stock market is "deeply over-bought" and likely poised for a pullback. They consider U.S. stocks to be "very expensive" and think that investors are being too optimistic. Opinions, including mine, get thrown around all the time and don't mean much on their own. I'm sure I could find an opinion from some mutual fund manager that stocks are cheap and there's never been a better time to buy. There was something about the Russell analysis, though, that I found interesting. They mentioned that the U.S. economy is "near full capacity," meaning that any further improvement in the economy due to tax decreases or other stimulus would likely result in the Fed raising interest rates more aggressively. So even if Congress can agree on some form of tax cuts or infrastructure spending, Russell's opinion is that it won't help the stock market much because the Fed will keep the economy in check. I'm not an economics expert, but that seems to make sense given what the Fed has been saying.

I talked last month about the Catalyst Hedged Futures Fund (HFXIX). This fund is a fairly large holding in my practice, and it had a tough couple of months following the election. That's because its vulnerability (all strategies have one) is a violent move higher in the S&P 500. Although the fund's purpose is to guard against a big market drop, the fund doesn't mind flat markets either and was up 2.3% in March. It has a ways to go before it recovers completely, but the point is that the fund's strategy is not broken.