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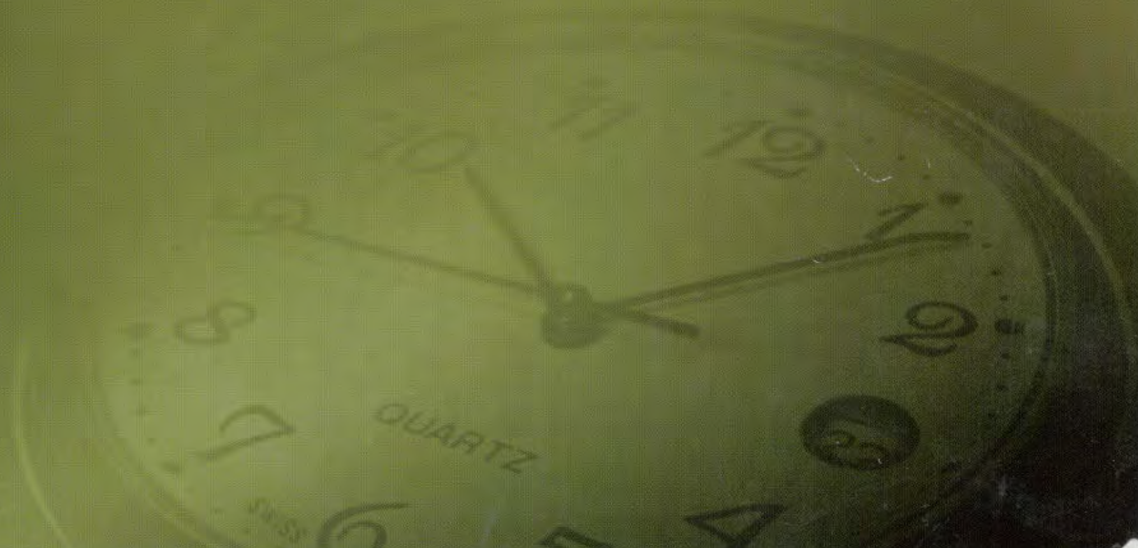

Jeopardy Investing: Dare to Challenge Market Opinion by Asking the Right Questions

By Steven Holt Abernathy

Steven Abernathy discusses the main obstacle to retirement security, portfolio risk. Mr. Abernathy explains that the most important consideration is not how much a stock will earn but what is the risk to the portfolio.

Advisors tell me the first question clients invariably ask about their retirement portfolio is, "What will my investment returns be?"

That's a legitimate concern, but it's the wrong question. The first questions should be:

1) "How much risk does my portfolio have?"
2) "How many years will my retirement be set back if I lose 25 percent or 50 percent of my investment principal?"

Risk should always be evaluated before potential return. It is not a new idea.

Savvy institutional investors have used this approach since the beginning of time. Banks, insurance carriers and other large institutions never consider the performance of any investment for their portfolio until they have first evaluated risk and market correlation. If you doubt this, check out who owns the biggest buildings in large cities; it's the banks and insurance companies.

This perspective is a more intelligent way of building an investment strategy because risk leads to loss of capital, and without capital there is no investment, no future.

Because capital preservation is so important, the primary goal of most institutional investors is to avoid losses. Keeping their investment capital safe and intact during down markets allows them to take advantage of eventual market recoveries, and the power of compounding returns from a higher starting point. This is when the easy money is made.

Individual investors tend to miss this point. Instead, they make rushed, emotional investment decisions, chasing unrealistic returns that seldom materialize. During down markets, they suffer losses to their investment capital and are unable to participate fully when the recoveries come, as they always do. This is one reason why Dalbar[1] research reports that individual investors consistently underperform the funds they invest in.

Retirement portfolios can especially benefit if investors adopt the mindset of successful institutions by asking the right questions. "How much risk am I taking?" versus "How much money can I make?" usually results in consistent and superior performance, with the added benefit of reduced emotional stress.

Dreams vs. Reality

It is impossible to watch Sunday football without being bombarded by brokerage firm advertisements. They all portray contented retirees golfing, sailing, traveling the world, and enjoying their retirement without a care. The message is unmistakable: Let us manage your retirement assets and all your dreams can come true.

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But as advisors, we know the harsh reality. Most people will not have enough money to retire in such a lavish environment. There are a variety of reasons, most of which have been documented in other articles. The one impediment rarely discussed is that most retirement portfolios suffer occasional—if not frequent—losses that throw all those rosy performance projections right out the window.

In fact, most portfolios fail to outperform the most basic indexes, and that is before management fees (1-2 percent/year), expenses (1-2 percent/year), taxes (15 percent for long-term gains, 37 percent for short-term gains), and inflation (3 percent/year) are factored in. That's a 20-44 percent reduction!

Of course, retirees are not alone; most money managers fail to outperform the indexes as well. Historical data tells us that the markets are up approximately 65 percent of the time, which means 3.5 days out of 10, the markets are down. It is during these down periods that portfolios suffer the losses that erode investment principal and recovery opportunities.

"What happens to my retirement portfolio during down years?" is the first and most important issue clients and advisors should be discussing. Down years are a certainty, yet few take time to develop an investment strategy that addresses this reality. It is the issue most frequently overlooked and avoided.

An Unpleasant Topic

The problem with trying to discuss risk or potential losses with investors is that they do not want to talk about it. It is no fun talking about something that might jeopardize their dreams. Clients want to see themselves as that happy retired couple in the advertisements; they do not want to imagine a diminished lifestyle or delayed retirement. It is just like planning what to do on your vacation if the weather turns sour, your flights cancelled, luggage lost or worse. Everyone knows those things happen as often as not, but prefer not to dwell on what might go wrong. It is human nature.

Despite the fact that discussing risk may be unpleasant for clients and let us face it, dicey for advisors, retirement planning is inextricably linked to *controlling risk*. Clients have to understand that no one can control investment returns, but anyone can control investment risk. There is a broad spectrum of parameters and products available to satisfy any level of client risk tolerance. The difficulty is getting clients to accept that controlling risk is the one area where they can be masters of their own fate.

Broaching the Question of Risk

While avoiding losses should be the primary investment consideration, there is no need to make client discussions "gloom and doom" sessions. Obviously, a balance of risk assessment and performance considerations is necessary. I often tell new investors that two-thirds of the time, the markets will be upbeat and their retirement portfolio will do just fine, but they must be protected against the ravages they might suffer the other one-third of the time. If we do not create that portfolio defense, their retirement plans may be without foundation. So while we both hope everything goes smoothly, we know that there are going to be some hiccups along the way.

The first thing we have to do is craft a strategy that guards against those losses and preserves what is already in place for retirement. We want to make sure that under any circumstance, we do not lose our investment capital, even if it means accepting somewhat lower investment returns. We do not have to spend all our time discussing what happens if the world implodes, but we do not want to delude ourselves by assuming the future is nothing but roses and ignoring the historical volatility of the marketplace.

We do not have to look very far on the economic timeline to find ominous signs of instability. Historically, the markets reel after three consecutive interest rate hikes by the Fed. Currently, we have experienced not 3, but 17 consecutive rate increases without a recession.

Now consider our inverted yield curve, which traditionally has a high correlation to recession. The combination of these two indicates the Fed is fighting inflation but they almost always over-restrict. It is not their fault necessarily; it usually takes 18 months for interest rate changes to wiggle their way through the economy. Of course, no one knows with certainty what effect an interest rate increase will have on the economy 18 months in the future. But the signs are in place that we are approaching a recession. If it happens, will client portfolios be protected?

Guarding Against Losses

The simplest way to hedge against market downturns is the classic 50 percent stock, 50 percent bond or cash equivalents mix. No need to pay fees for this strategy. If the market takes off, the stocks make money, the bonds and equivalents do not. If the market falls, bond and equivalent investments are protected so there is money available to buy more stocks on

the downtick. On a very basic level, the portfolio is practically hedged, but not optimally so.

Another alternative is to allocate a portion to equities and hedge the positions with options that guarantee the downside risk is reduced. Stop losses on each stock are another option and may help minimize losses and provide an exit strategy.

Another option would be to invest in undervalued companies and sell short overvalued companies. This is the strategy employed by many institutional investors. They know that over time, undervalued companies will appreciate to fair value and vice versa because the markets only remain inefficient for a short time.

Everybody has an Opinion

One pitfall in this strategy is that for every analyst who thinks a stock is undervalued, there is another who thinks just the opposite. For example, there is certainly no shortage of disagreement among astute investors as to what constitutes an attractive valuation. Many investors and analysts consider a company with a price-to-book value of 1 "cheap" by current market standards. On the other hand, partisans of EBITDA multiples say 7 or 8 is more like it. Oddly, these multiples sometimes move in opposite directions. A stock might look overpriced to one investor because of a high PE multiple but another investor thinks the same stock is cheap because it's EBITDA multiple is low. So whether an investor thinks the stock is a buy or a sell, there is research that will support either opinion.

Advisors and their clients who can suspend judgment for as long as possible tend to make better investment decisions. Suspending judgment allows the big picture to materialize before one or two data points steer them in the wrong direction. Too often, investors get it backwards: They form investment opinions first and then seek data to support those opinions. The problem is there will always be compelling data to support any opinion about virtually any investment. Look hard enough and you can find data to support any idea. Invariably, decisions made this way are poorer ones, subject to greater error and subsequent investment loss.

Asking the right questions helps us challenge market opinions. Do I have an investment thesis that differs significantly from market expectations? If so, what makes me believe I am right? On the other hand, what data suggests I might be wrong?

In the end, intelligent investors must answer at least four questions about their investments:

- What future earnings and cash flow has the market priced into this stock?
- What level of future earnings and free cash flow are reasonable for this company over the next 5 years?
- How much am I likely to lose if the company does not achieve its current expectations?
- How do I structure an investment to protect my capital if my expectations are wrong, yet allow me to achieve the lion's share of the upside if I am right?

Challenging Popular Opinion

Investors and advisor who think this way tend to be contrarians, willing to bet against the market's opinions when supported by facts. At its core, this investment philosophy has the continuous search for market inefficiencies and the discipline to follow the facts, not the herd. It challenges the market's collective intelligence. The subtlety of this insight can make a huge difference, borne out by the success of institutions and astute value investors, Warren Buffet being the most obvious example.

Naïve investors are easily romanced by a good story. New products, new customer bases or newly-launched businesses are frequently accompanied by breathless press releases suggesting a rosy future for stocks—not unlike the rosy retirement predictions we see in the commercials. Unfortunately, they are seldom true.

Investors often confuse a good business with a good investment. The problem is that most investors tend to extrapolate events forward in a linear fashion. They believe if a company is doing well, it will continue to do well and if a company is performing poorly, it will continue to perform poorly. There is no better example of this phenomenon than Cisco Systems in the late 1990s. Cisco had been growing so rapidly during the previous five years that the investing public bid the stock up to levels that were impossible to justify by future cash flow and sales levels. But investors forgot to ask the right questions. The stock implied growth expectations meant that Cisco would require more revenues than the entire U.S. GDP in order to justify its current valuation.

Many good businesses have expectations imbedded in their stock prices that are unreasonable. Changes in expectations—not earnings growth—move stock prices. This leaves investors with the task of defining the expectations priced into a stock, then following

solid facts even when they are unpopular. It is vital to understand the deficiencies in current expectations, whether too optimistic or pessimistic, something few are able to discern consistently.

What's the Solution?

The solution to this dilemma lies in asking:

- How do I determine what is expected of the current price of a stock?
- How do I determine what the investing public expects?
- How do I form an investment thesis which is different than the markets?

The Value of Uncorrelated Investments

In an effort to abate losses and decrease volatility, portfolios typically pay the price of having an asset with a negative return profile. One way to decrease volatility is by shorting an index. But indexes historically increase in value an average of about 8 percent a year. When you short something that produces an 8 percent positive annual return, the cost is 8 percent a year. Using an asset with a zero return but with perfect negative correlation to the other assets in the portfolio greatly reduces volatility and provides greater planning flexibility.

For institutional investors, investment return may not even be a consideration because getting any amount of return by adding an uncorrelated asset to the portfolio mix creates "opposing sign waves". When one wave trofts, the other peaks. This creates a zero effect, eliminating volatility without cost.

It is far easier for advisors to plan a retirement portfolio at 6 percent consistent annual growth than one subject to erratic annual performance—up 15 percent one year, down 10 percent the next. Nobody plans to suffer losses in 3 or 4 of the next ten years. Clients do not think in terms of up two years, down one; they think linearly. Using *average* investment returns over a given period helps keep the discussion in linear terms. The client's reaction might now be, "I can average 6 percent a year for the next ten years? Well, that is less than what I hoped for but at least I know I will not lose money and I can rely on a certain amount being available for my retirement."

Investors are unwilling to accept losses, but they may be willing to accept a comparatively slower rate of growth if the risk component is explained properly. The core of a retirement portfolio has traditionally called for government or AAA corporate bonds combined with a large-cap equity or value-based equity fund. In recent years, however, institutional investors have been converting their large-cap equity funds to less risky funds that are hedged and can produce positive returns in both up and down markets. The reason is they are less correlated to the market and more likely to achieve absolute returns each year, albeit at a somewhat lower rate of return.

Retirement portfolios diversified with a long/short strategy have lower risk profiles and lower market correlation. A simple example: Being long $100,000 in a diverse set of undervalued stocks and short $90,000 in a diverse set of overvalued securities. In a worst case scenario, the portfolio will lose $10,000 (the longs and shorts will each go to zero). Absent that, over any reasonable period of time—3-4 years or more—being long undervalued assets and short overvalued assets cuts risk significantly because it is shielded against unexpected system shocks. Traditional portfolios lack the ability to short, participate in bad markets, or guard against crippling losses.

Summary

Are clients willing to forgo some upside for the sake of protecting their retirement assets? Most clients regard their retirement assets as sacrosanct and hold their advisors responsible for any losses. Regardless of how well retirement plans are crafted, if the asset allocation delivers "average" portfolio performance in an average market environment, clients are unlikely to be satisfied. What they are likely to do is blame their disappointment on their advisor.

As Yogi Berra said, "It's tough to make predictions, especially about the future." When making investment decisions, it is vital for advisors to understand and correctly interpret the expectations imbedded in stock prices. Changes in expectations alone will cause changes in stock prices. Being a good business—or even a great business—is not enough because the market does not reward you for investing with the consensus. Successful investing on a consistent basis is the result of asking the right questions, developing a correct contrarian thesis, and then acting on it.

Endnotes

[1] A recent Dalbar study of 20-year investment returns, 1986-2005, is revealing. While the S&P 500 rose an average of 11.9 percent annually during the two decades, Dalbar estimates that the average stock fund investor only earned 3.9 percent.