

Implementing Economic Risk Based Asset Allocation (ERBAA) with MOS

9/06/2011

“Financial Advising is a prescriptive activity whose main objective should be to guide investors to make decisions that serve their best interests.” Daniel Kahnemann

Executive Summary

This regular update is intended to be used as talking points with investors.

- Economic Risk Based Asset Allocation (ERBAA) offers incredible potential but in order to reap this potential we have to take advantage of the call in a change in the Economic Growth Rate Cycle.
- Main obstacles to taking advantage of the call include the call being wrong, missing the call, or the call not producing the desired results.
- We are confident calls will be “right” and that we can take advantage of them in a timely matter. The main problem is that calls may not produce the desired results.
- The primary risk during Expansion is that stocks will continue to fall; therefore valuation should be compelling before using more volatile investments, especially for Risk-Averse investors.
- Two key risks during Slowdowns. 1. Stocks continue to rise before a subsequent expansion. 2. Stocks fall, with much of the drop occurring *before* a subsequent recession. Looking back at history, the best way to ride through both is to own a diversified portfolio of quality (not cyclical) stocks selling at relatively low valuation multiples (e.g. LTLV managers or a suitable surrogate ETF).
- During recession the lowest risk is to not own risky assets such as stocks, for Risk-Averse investors. Risk-Tolerant investors should own only strategies emphasizing quality companies selling at a discount to their intrinsic value.

Taking Advantage of the Call

While there are likely to be some regrets, as discussed last week, ERBAA has incredible potential to enhance risk-adjusted returns. Remember, there are three key phases of economic growth: Expansion, Slowdown, and Recession. This won't work if:

- The Call is Wrong
- We Miss the Call
- The Call does not produce the Desired Results

The Call is Wrong: For ECRI to make the call, they must see a pervasive, persistent, and pronounced change in leading indicators. ECRI has tested data back to the early 1900s and followed the data since 1950 to confirm the accuracy of these indicators. We have been following this in real-time since 2009. We don't believe the call is fundamentally wrong.

We Miss the Call: We examined the historical ECRI publications and found upcoming changes are well foreshadowed. For example, in March of 2011 they underscored the continued expansion but began talking of a likely slowdown in April. Similarly, their expansion call in March of 2009 was foreshadowed beginning in January. While there is some nuance in reading this, we believe we have become adept at seeing their call, as demonstrated in our previous communication with you on a slowdown in May or June of this year.

Nonetheless, we have to be vigilant and ready before the call in order to act on it. For this reason we have purchased a sophisticated trading system called Trade Warrior that will enable us to trade all accounts at the same time based on pre-determined allocations based on client risk tolerance and tax status.

The Call does not Produce the Desired Results: For the call to produce the desired results, during expansion stock prices should go up, during slowdown they should go down then sideways and during recessions they

should go down. This is not always the case and may occur for a number of reasons. Two main reasons where this can happen include changes in government policy and exogenous events. Government policy can be stimulative or restrictive and can have an impact on earnings which then impacts stock prices. Exogenous events like terrorist attacks, which cannot be predicted, may have a short-term effect but generally do not create lasting damage unless they are sufficient to damage economic fundamentals. However, the Middle East oil price shock of 1970s was not an exogenous but an economic event. This event caused input prices to go up and for company profits to suffer finally resulting in a severe recession. One might argue the financial crisis of 2008 was a similar event causing uncertainty over the banking system that may take years to heal.

Let's examine how Calls worked during the three differing phases of the economic growth rate cycle.

Expansion

For this to work, during expansion risky asset prices (stocks, high yield bonds, etc.) should rise. Since 1950, there have been 18 periods of economic expansion. On two occasions the S&P 500 ended the expansion period lower than it started: November of 2001 (-2%) and January 1987 (-10%). Taking on more risk during these calls would have not been comfortable. However, remember the MOS strategy does not always move with the market. During both economic expansion periods where the S&P 500 lost, for example, the First Eagle Global fund (representative of global MOS) was up 17% during the 2001 expansion and 9% in 1987 due to its global diversification among small and large companies.

The other cost is that stock prices may start going up before an expansion is called. In every instance since 1950, an upturn in the Long Leading indicator has anticipated an upturn in stock prices. This typically occurs about one month before the trough in stock prices giving us substantial warning to take more risk.

Conclusion: Taking more risk during expansion has worked well historically and is well signaled in advance. The key risk is that stocks will continue to fall before resuming an upward trend therefore more caution will be exercised during expansion for Risk Averse than for Risk Tolerant investors. However, more volatile investments typically outperform during expansion and may be warranted for both.

Slowdown

During slowdowns risk is more ambiguous. While many slowdowns result in positive returns by the end of the cycle, quite often there is a drop of 10-15% (sometimes much more) before the cycle ends. There have also been multiple slowdown periods where stock prices rose substantially. For example, between 1980 and 2000, there were three periods: January 1984-January 1987 (68%), July 1990-February 1991 (44%), January 1998-September 1999 (54%). Clearly missing these opportunities bore an enormous cost in opportunity for strategies de-risking too early, i.e. it paid to be more Risk Tolerant.

On the other hand, slowdowns which precede a recession can result in deep losses. The best examples are the slowdowns which occurred in 2001 before the recession which began in November (-20%) and the slowdown which began in 1973 before the recession which began in March of 1975 (-17%). The Margin of Safety strategies we examined produced positive returns during 2001 but negative returns during the 1973 slowdown into the subsequent recession. Of remark, Less Volatile managers captured substantially less downside.

Conclusion: Reducing risk during slowdown can come with substantial opportunity cost. Moreover, the bulk of the drop in prices can occur during slowdowns that precede recessions. Less Volatile Margin of Safety investments (LTMV managers or low valuation ETFs) are typically a better choice during this period than not taking risk at all. Moreover, a wise selection of Short-Term Volatility Control managers can also mitigate opportunity cost.

Recession

During most periods, stock prices fell during recession and did not begin to rise until economic expansion was forecast. However, since 1950, there were two periods where stock prices rose, from January 1954-May 1955 (5%) and from December of 1960 to November of 1961 (7%). Since the opportunity cost is low, the key question is what the best method for reducing downside risk is.

We examined the history of the Margin of Safety managers since 1970 and found the Less Volatile managers, emphasizing broad diversification in quality companies selling at a discount to their intrinsic values to be generally superior during these time periods sometimes capturing positive returns (3 of 7 periods) and having substantially less downside during every period.

Conclusion: There has historically been low regret from eliminating downside risk when a Recession Call is made. However, especially for more Risk-Tolerant investors, owning less volatile managers or ETFs makes sense to mitigate other risks in timing the call.

Next Call

We believe we will receive a call before the end of October on whether a recession is expected. Going forward it appears the economy and markets with it will continue to be volatile. We have our allocations ready and are prepared to reallocate when this occurs. Our clients generally find this comforting.

We have also begun working on an ETF strategy to take advantage of ERBAA. We believe this will be very attractive to investors tired of buy and hold strategies. Our challenge is to fully incorporate the Margin of Safety principles into this strategy and we believe we can overcome this challenge with the wide array of fundamental indexed ETFs now available and a fundamental understanding of the duration of Margin of Safety, i.e. if the duration is sufficiently (say 20 years) typically even an index strategy will avoid permanent loss of capital. We already have a straw man for the ETF strategy and should have this completed before the end of September as we implement our new trading software, Trade Warrior.

We do not anticipate moving our current clients into the ETF strategy as we continue to believe the best returns will be from a combination of MOS RSP and LTP (Risk Tolerant) going forward but understand some clients, particularly those referred from T.D. Ameritrade, may have a greater interest in the ETF strategy.

Past performance is not indicative of future results. Not intended as specific investment advice which is a subject for one on one discussion with a client. Performance numbers in this paper must be considered hypothetical and may not represent actual client trading, especially since model dates may predate the formation of Global View as a Registered Investment Advisor.

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