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PORTFOLIO WATCH

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Fee FO Only®

Market Predictions

> *"It's tough to make accurate predictions, especially about the future." – Yogi Berra*

As I'm writing this newsletter, the temperature in Sacramento today is predicted to be slightly less than the surface of the sun. We were told not to look directly at the eclipse, and now we're being told to not open our eyes at all when outside or our eyeballs may evaporate. And yet, here I sit on the tarmac of Sacramento airport because of a fog delay in Los Angeles. This is not what I would have predicted this morning. Melted tires maybe, but not a fog delay. In retrospect, the airline didn't need to schedule their flight so early. Or I could have taken a later flight and slept in a little longer. There was a more efficient way to spend my morning, so I should have used a different strategy to get to LA. Although that idea is crazy because a fog delay could not have been predicted, it seems to be how many in the financial community view investment strategies.

Risk and Infinite Possibilities

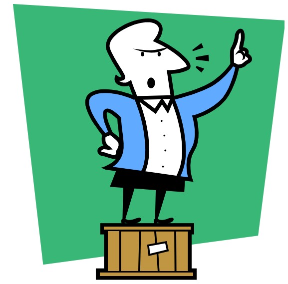
In last month's newsletter, I mentioned the fact that risk is always and only forward-looking. I have no idea what the market will do next week, much less next year or next decade. Risk management, therefore, needs to take into account as many of the infinite number of potential outcomes as possible. Will the Fed raise interest rates? Will they start selling bonds to reduce their balance sheet? What will President Trump tweet next and how will that affect the market? Different types of assets will do well under some conditions, less well under other conditions, and just about any investment will downright stink under its worst-case conditions. But here's the key point…we don't know what will happen in the future. With all of the variables in the global markets, the possible outcomes are endless.

The Obviousness of Hindsight

When measuring performance or justifying an investment strategy, we don't have to worry about all that pesky uncertainty. Out of the vast number of possible scenarios, we only have to look at the one that actually did occur, and then pretend that the correct strategy is obvious…which it is in hindsight. Unfortunately, the strategy that worked for the one scenario that played itself out over the last week, year, or decade really doesn't mean it's the right one for the infinite possibilities going forward. The "future performance" warning is in every disclosure, and yet financial professionals probably ignore it more than anyone.

Does It All Come Down to Cost?

The best risk management strategy for the last 8 years turned out to be no risk management. That does not mean that risk wasn't there. In fact, quite the opposite. But stimulus packages and interest rate cuts and gobs of money-printing all managed to keep the stock market going higher. This is the scenario that ended up happening, and it feeds right into the theory that cost is everything when it comes to investing. Another way to state the cost-is-everything theory is "risk management has no value," since risk management doesn't come for free. With interest rates being extremely low and stock valuations being extremely high, it seems that being conscious of different ways that risk could play out would be worth something, and yet building portfolios entirely out of risk-unconscious index funds is the fastest-growing strategy. Maybe ignoring risk will work and maybe not. I'm not willing to bet my own retirement on it.



Market Comments

One of my favorite market analysts is Jurrien Timmer from Fidelity. Part of it may be because the guy can wear lime green pants and a polka dot bow tie and still manage to look cool. The other reason, though, is that he's brilliant. He speaks a lot at conferences and will always give his view of the market, but never from a perspective of "here's what I think is going to happen." Jurrien's approach is always to develop strategies based on multiple scenarios. "If the market does A, we'll do this. If the market does B, we'll do that. If the market does C…" I could keep going, but I'll stop there. And his approach is not simply a reaction to stock prices. He's looking at Fed strategy, foreign interest rates, global political actions, etc. Jurrien will have an idea about which scenarios are more likely than others, but as an investment strategist he covers as many potential scenarios as is practical. I love this approach. There's a certain humility to it, even though he is, more often than not, the most informed guy in the room.

I just read an article that expressed an idea that significantly influences what I think are likely future scenarios. "…there are times when things are cheap and offer a lot of future upside, and there are times when valuations are expensive and the risk of allocating capital may guarantee a negative return." The article was pointing out how many respected analysts are now predicting negative stock returns over the next 5 or 10 years. I sometimes may come across as a pessimist because I'm constantly harping about risk, but that's because almost the entire industry is migrating to a "ignore risk" strategy, simply because this is the strategy that worked best for the last several years. If a negative 5-year or 10-year return scenario plays itself out in the future, it's going to devastate a lot of retirement plans. But I also want to be clear that one of the scenarios I take into account is the possibility that stocks continue to go higher and stock valuations, for whatever reason, permanently stay at high levels. This is a potential scenario. If your goal is to beat the market, then you should optimize for this scenario and go with the lowest cost, least risk-managed investments you can find. If your investing objective is to meet financial goals, then the scenario of stocks continuing to march higher is just one of many potential scenarios. It needs to be considered and planned for, but other less-rosy scenarios also need to be considered as part of an investment strategy.