

Perspective

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The Fine Art of Wealth Management

This issue offers Perspective on several items related to the years approaching and living in retirement. During retirement years, bonds occupy a larger portfolio allocation. DHR has recently executed a change in its bond portfolio construction, which we discuss. We also comment on two stories recently appearing in the news – the departure of “the King” (Bill Gross, PIMCO’s bond manager) and the volatility of recent stock market behavior. These days, many worry about whether the retirement of all the “boomers” will mean a market price decline from their mass selling of stocks; we comment on that. We also discuss market risk today and pass on some wisdom from Joe Davis, Chief Economist for The Vanguard Funds Group.

Throughout it all, indeed throughout everything we do at DHR, we try to accumulate and pass on knowledge. At first, I was tempted to say “pass on information,” but we hope to do more. We want to combine new with existing information, draw upon experience – ours and others’ - interpret it for current circumstances, and pass it on in the form of knowledge.

There is a problem in that process, however. How do we know, when we pick up a piece of “information,” that it is what we think it is? Should we believe everything we think? What about “noise?” Noise is the technical term for any signal that impinges upon communication or information. It is random, which means that separating it from actual information is very difficult. High levels of noise can mean that there is no way to discern or recover the message.

For those discerning readers, the implications for securities’ market pricing and investment should be clear.

Recent Changes in DHR Bond Portfolios

DHR has recently traded between bond funds in many accounts. We have sold half or more of the position in the DFA Five Year Global Bond Fund, with proceeds to purchase the DFA Investment Grade Bond Fund. Because it is not strictly a “re-balance” trade, I thought it would be helpful to describe a few details behind the change.

An important characteristic of both funds is the high quality of the underlying bond investments. Two principal characteristics differentiate the two funds: 1) The Investment Grade Fund has no or minimal global exposure; 2) The Investment Grade Fund has moderately longer average maturity than the Global fund.

Whether one has held it in banks, money market funds or short term bond funds, all of us have felt the pain of very low yields on “short” money. This has had a particularly bad effect on income oriented portfolios, especially for retired clients. For DHR, the short maturity investment posture has been defensive – defending against losses from falling bond prices when interest rates rise. When selecting maturities in a bond portfolio, an investor must find a balance between the actual receipt of current yield (seeking it or giving up some) and potential loss of principal. We have decided to strike a slightly different balance between those two risks than has been our strategy in the last several years. We expect the Investment Grade Fund to generate higher yields than does the Global fund, with the possibility of moderately higher price volatility at some point in the future.

The Investment Grade Fund buys only investment grade domestic bonds, with varying maturities which, on average, run a couple of years longer than the five year limit in the Global Fund. Because of the longer maturities, we expect it to generate higher yield.

I have outlined our thought process below.

1. The Federal Reserve’s policy of low short-term rates is expected to continue.
2. An increase in inflation is not in the forecast.
3. The probability of a rate increase is relatively low in long-term bonds.
4. The economic conditions in Europe make it unlikely that interest rates there will increase meaningfully in the near term.
5. In bond markets today, credit risk (the possibility of failure of the issuer) is higher than duration risk (the possibility of principal loss from rising interest rates). In other words, if one maintains low credit risk by buying high quality bonds, one can seek yield with longer duration or maturity.
6. For long term investors who hold their positions, disciplined bond funds recover from moderate price volatility reliably and often fairly quickly.

If you have questions about these transactions, please let us know.

“Le Roi est Mort! Vivre le Roi!” (PIMCO Loses Bill Gross)

Well, the King is not dead, but the kingdom might have fallen apart. Bill Gross managed bond funds for the investment company PIMCO for over three decades. In the last twenty years or so, he was known as “the King of Bonds,” because he had accumulated a very strong performance record – so strong that his main fund, The PIMCO Total Return Bond Fund, became the largest bond mutual fund in the world (\$250B). His company, PIMCO, managed over \$2T. (That’s “trillion”). He coined the term “New Normal” after 2008, reflecting his view that the paradigm for expectations in the world of finance had shifted. Much of the professional investment community regarded him as a guru for all financial markets. Being King didn’t make him immortal, so several years ago, he brought in a promising successor to his throne – Mohamed El-Erian. Then last year, El-Erian suddenly left, claiming “family.” Well, “family” was, shall we say – only part of it. There was trouble, right there in PIMCO city. This autumn, continuing his well-known abrading ways, Bill upbraided his senior portfolio managers rather seriously, leading each of them to say to the company’s CEO: “It’s him or me.” As a result, on Friday September 26, with no preceding announcement, “The King” abandoned his throne. (Gross literally “moved across the street”, joining Janus). Given the size of his fund, his reputation and his company, this was a major event, which set off a firestorm of concern throughout the bond markets and even rippled stock markets. Some DHR clients had a small amount of money invested

in the Total Return Fund, which, after consultation with the invested clients, we sold. There is now speculation that the world has changed to the extent that there will not be another “king.” You can know that the loss of a kingly active manager does not shake our faith in the rule of the markets. None of us is as smart as all of us.

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Recent Volatility

The last several weeks have offered an interesting opportunity to consider behavioral finance. In mid September, nothing seemed dramatic – except the apparent investor complacency read into market prices and its contrast with global economic and political issues. Nothing like a party to dull one’s senses. Then came October, the opening days of which *were* dramatic. On September 18, the S&P500 closed at 2,011, its high for the year; on October 15, it closed at 1,862, for a decline of 149 points, or 7%. This prompted both emotional reactions and strong temptations to act, which challenged rational considerations.

The emotional reaction came first. Fear. Once bitten – 2008 – twice shy. Back away. Something bad is coming, so avoid being hurt. What to do?

Action? Sell equity, of course! As though in an exercise in meditation, it was interesting to notice these feelings run through me. They are natural and commonly experienced. Feelings cannot be prevented by deciding not to feel them. However, action can be taken or avoided, after rational consideration. Thomas Jefferson advised that, if one is angry, one should count to 10; but, if one is *very* angry, count to 100. That advice works here, too. So, metaphorically, while counting to 100, what rational considerations helped prevent action?

1. A long term, goal focused outlook.
2. An allocation policy.
3. Awareness that, if sold, equity would have to be re-purchased later.
4. “Corrections,” typically considered to be declines of 10%, are inherent in investing.
5. Knowledge that buying back in is far trickier than selling out.
6. Corrections are to be tolerated.
7. Statistical studies of historical evidence support holding through time and volatility.

Our readers have seen this quote before (it is one of my favorites): “Don’t just do something. Stand there.” Non-action can be very difficult. Nervousness and anxiety can be powerful motivators to “do something.” But, by standing

still, one avoids a “whipsaw” - the very frustrating outcome of a timing decision that goes wrong. In this case, a “whipsaw” would have come from selling, only to see recovery come so quickly that the second reaction comes too late. Many of the worst days in market history were closely followed by some of the best daily gains. No bell rings to announce upward moves and they often regain a lot of ground very quickly. The rapidity of the recoveries makes the attempt to time the market an almost sure loser.

We do know that declines will come and that recoveries will follow. We have no power to prevent that. However, we do have the power to prepare ourselves to act appropriately and then manage our own reactions.

This discussion of a brief episode applies not only to short period volatility, but also to longer periods of bad markets. Some investors hold contradictory beliefs about strategy in their heads – believing that they are “not timing,” but are simply “selling to avoid losses.” However, the two plans simply have different names. If we compare the last several weeks to a longer term context, for example 2000-2002, or 2008-2009, only the length of time changes. Nothing inherent in the decision process is any different.

More volatility awaits us. Although we know neither their timing nor magnitude, we do know that declines will come and that recoveries will follow. We have no power to prevent that. However, we do have the power to prepare ourselves to act appropriately and then to manage our own reactions.

Will We Go Bust on Boomers?

For a number of years, I have heard the idea expressed that the retirement of the baby boom generation will trigger a significant decline in stock market prices. The thinking goes like this: Boomers have bought equities throughout the long bull market and they will want more financial stability in their retirement years, so they will sell that volatile asset class. The younger generation behind them has less appetite for risk and less money, so sellers of shares will outnumber buyers. Supply will exceed demand and prices will fall until that basic axiom has reversed.

In a recent paper, Daniel Wallick, a principal in Vanguard's investment strategy group, worked with his team to investigate this matter. Their work finds no causal link between the age of the baby boomers coming to retirement and a potential negative impact on stocks. They don't say that a price decline will not happen. Declines can happen any time, for any of many reasons. However, they say that they find no causal link between the two factors. That means that, if a decline coincides with the age group retiring, it is most likely only accidental – what we call an anomaly and not

what we call a pattern. Anomalies are random. Our advice? Don't listen to the noise – pay attention to the signal.

Economists describe stock returns with mathematical equations. You can appreciate that, if one sets up an equation to calculate the probability of an effect, where changes in the causative side (e.g. retirements) will cause changes on the effect side (prices), the sheer number of variables on the causative side will make it nigh on impossible to isolate one as causal.

However, Wallick and his team cited three principal characteristics of the boomer generation which disincline them to believe in a wave of withdrawal selling.

First comes the actual timing of the retirements. Boomers, by one definition, were born between 1946 and 1964, which makes their retirement at “normal retirement age” run from 2011 through 2029. However, that is certainly stretching out as many people age 65 have chosen and presumably will continue to choose not to retire then. Correspondingly, the period of time over which that event is supposed to cause selling is considerably longer than a “trigger.” A variety of economic changes will happen in the next two decades, diluting the effect of this factor.

Second, they discovered that the boomers own about the same percentage of stocks in their portfolios as have previous generations. They found no “wave,” unique to this generation, about to tumble.

The Wallick team also found a concentration of wealth. The top 10% of all equity owners own almost 88% of the equity in the market. They doubt, which seems reasonable, that that relatively small portion of the population will need to sell large amounts of equity in order to replace income.

In addition to the characteristics of the boomers, they considered the “buy side.” Our market has become increasingly globalized. In the last twenty years, the amount of our domestic stock owned by overseas investors has tripled, from 7% to over 20%. In 2009, foreign investors put over \$100B into the US market. They have a strong appetite, which, given the current and expected difficulties of European economies and markets, seems unlikely to abate.

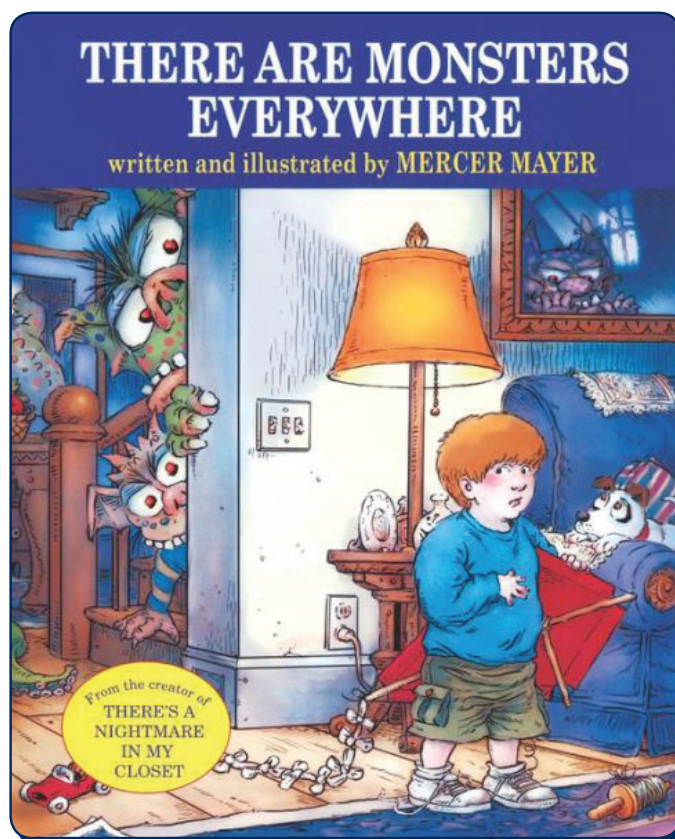
The team then studied the direct correlation between age and the percentage of ownership of equity, over rolling ten year periods. They found a correlation of 5- 6%. That’s low. That’s a further indication that no wave is building up over the horizon.

The final part of their analysis pursued the question of that relationship between age and equity ownership around the world, by studying it in 45 countries. They found no strong relationship.

We grant that these conclusions might seem counter-intuitive to an investor. Indeed, a number of economic studies reach counter-intuitive results for financial decisions. When we make our investment decisions, we must choose between intuition and statistical demonstration. Sometimes

it’s a real challenge. Nevertheless, in this particular case, when print or broadcast headlines, or even the “wise comments” from dinner party guests pronounce the coming death of equities as a result of the aging of the boomers, think about whether it’s noise or information.

In addition to that – what should an investor do? We recommend that you consider the advice in the “Recent Volatility “ part of this *Perspective*.



“The Greatest Risk in the Market Today Is ...”

Readers can easily understand that The Vanguard Funds Group, one of the largest financial institutions in the world, and which is exclusively concerned with investment matters, would employ economists with a serious amount of seriousness

and intelligence. Joe Davis (hereinafter “Davis”), their Chief Economist, has remained in his position with them for a number of years. This writer respects his views. His most recent article bears the title: “The Greatest Risk in the Market Today Is ...”

Davis points to charts of historical market prices and yields and shows what many have thought – prices are high. We all understand what that means in the stock market. However, in the bond market, investors don’t always understand that low yields (today’s lament) are concomitant with high prices. Investors want price appreciation in stocks but they want generous yield from their bonds. So, today’s high prices in both markets basically mean the same thing – we probably don’t have far to go before things turn around, or in other words, when prices start to fall. However, that is not what Davis refers to when he points to “the greatest risk.”

Davis uses a term you have seen here before – “complacency.” He worries that investors are choosing to remain ignorant of the price risks, especially in the bond markets, as they continue to seek higher yield in ever more risky areas of the market. Of course, “more risky” also includes stocks, REITs, long term debt, junk debt and more. They continue to buy, seemingly believing that their end of the seesaw will always go up. Well, if something cannot happen, then it will not happen. At some point, direction will change. Davis is concerned about investor behavior, and to be fair, their losses, when that happens. Nevertheless, his point is that the risk is not the externality – it is the behavior.

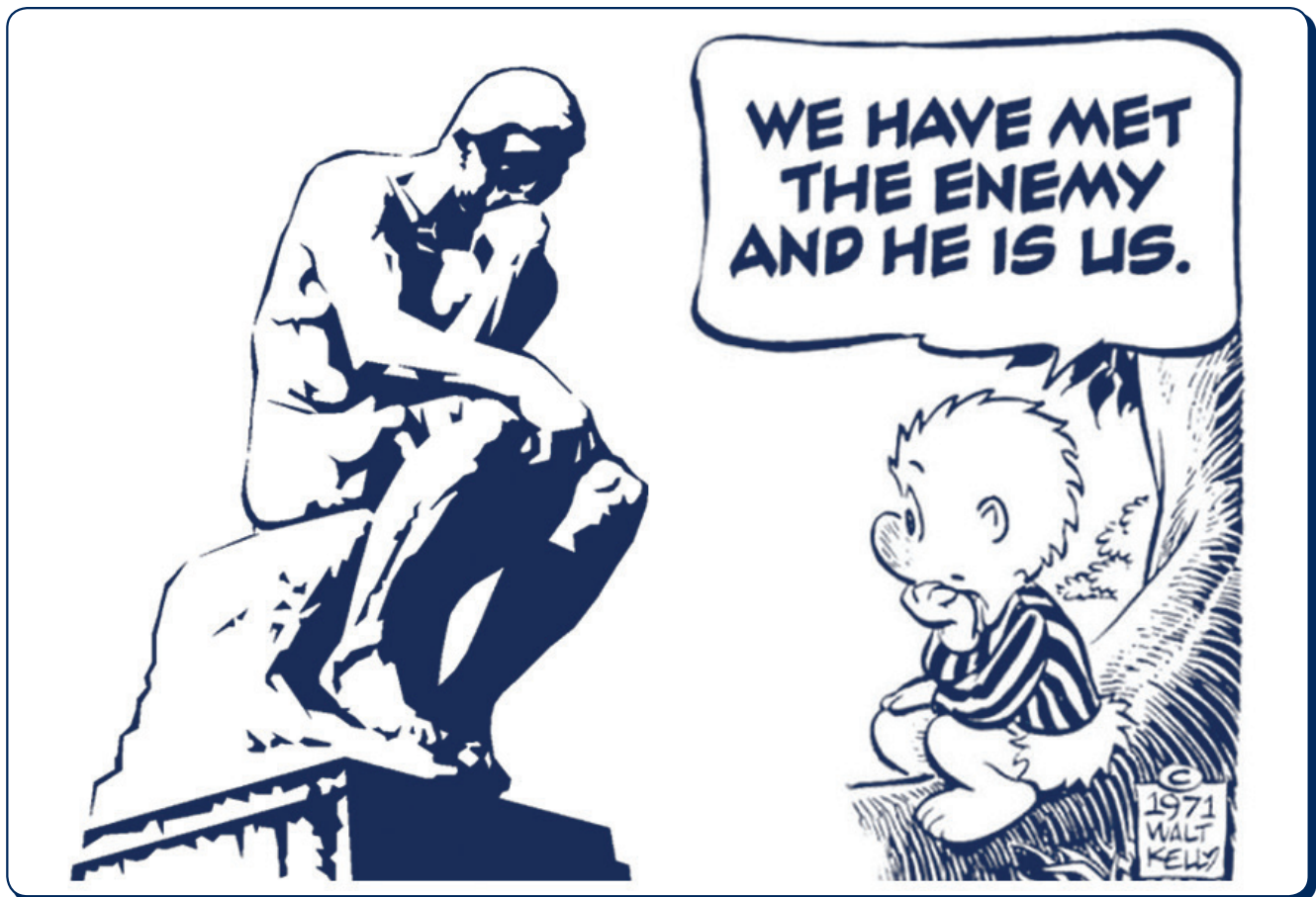
He goes on to show a perennial link between market prices and investor behavior. Readers see historical price charts all the time. Less common are charts showing investor behavior, measured by the amount of money that they put into various investments each month. These “flows” are published by the mutual fund industry and by various other market reporting agencies. They show clearly that, as stock market prices reach their peaks, investors put increasing amounts of money into equities. As stock market prices reach their bottoms, investors pull out.

As yields on bonds decline toward their bottoms, investors put increasing amounts of money into ever riskier alternatives. One can understand – people need income and large portions of our population rely on investment yield for income. Nevertheless, they do not serve themselves well in this behavior, for their short term gains are often followed by significant losses.

“The fault, dear Brutus, is not in our stars, but in ourselves, that we are underlings.” (Julius Caesar (I, ii, 140-141). Actually, I prefer a downscale version of that idea, from Walt Kelly’s Pogo: “We have met the enemy and he is us.” (This is derived from the famous statement of the older brother to Matthew Perry, Commodore Oliver Hazard Perry, on the War of 1812: “We have met the enemy and they are ours.” To digress further - Kelly went on later to say: “There is no need to sally forth, for it remains true that those things which make us human are, curiously enough, always close at hand. Resolve then, that on this very ground, with small flags waving and tinny blast on tiny

trumpets, we shall meet the enemy, and not only may he be ours, he may be us.”) Forgive our tendency to compare the recurring warnings in our media enterprises to “small flags and tinny trumpets.”

As difficult as it is to do at times, the best course of action for an investor is still to remain allocated in a portfolio strategy designed to reach the long term goal. Changes in strategy to anticipate or react to short term market movements can contain the blueprints of one’s own destruction.



This *Perspective* has interwoven a few items of news, change, noise and signal, risk and behavioral finance. By closing with the item on “The Greatest Risk,” we hope to illustrate – and confirm – that indeed, one must be very careful when forming conclusions in finance and investment. The problem might well appear in the mirror.

As always, we welcome your comments.

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