Patience

A year-end memo for my OMEGA clients

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"Patience" is a word whose simple meaning is understood by all. In practice somehow becomes complicated and then is exercised only by the few. This past week, it was uttered by one and felt by the many.

At the conclusion of the December two-day Federal Reserve's Open Market Committee meeting, Janet Yellen, after outlining the future of the Fed's interest rate policy in characteristic "Fedspeak" terms, seemingly concluded and publically uttered that the Fed would be…well….
…"patient."

The financial markets, bonds and stocks alike, which become obsessed with increasing levels of panic over falling energy prices (crude oil and refined products) for days up until that point……
…rallied...

...Creating an explosive move of 700 points of the Dow Jones Industrial Average rally in just two days.

In the course of one week, investor emotions, which more often than not in the short term can mislead the uninformed and unaware, while governing the short-term movement of markets and men, went from oil soaked despair to downright giddy.

For me, as your Portfolio Manager, perhaps more so than those of you taking the time to read this year end memo, the actions of this past week seem to have summarized this past year as it nears its end: contradictions, changing market currents and mixed messages of "good" and "bad."

In many ways, it has been a good year for all of you who have been part of the OMEGA portfolio management program. For the most part, dividends, interest and realized capital gains have been in plentiful supply and should keep your tax professional busy in the months ahead.

However, if there is an area in which each of you may have or had a sense of contradiction, unease, puzzlement or downright frustration, it probably lies in the realm of individual portfolio overall performance against what appeared to be a backdrop of never-ending all-time market highs (as portrayed by the popular indexes), especially during these past few months.

So, in hopes of clarifying, illuminating and providing some perspective on this past year, I shall ask and answer in this memo some of questions that you may have been mulling over. After all, who said that investment has not been, on some level, based on a certain degree of assumption?

Q&A

Q1) For the past 3-4 months, I have noticed that my account(s) seem to be going down in value while I hear and read that the "market," although it corrected in October, has now been setting new all-time highs. What gives?

Answer: You have been exactly correct. However, the answer and, I hope the resolution to the apparent contradiction between "Market" performance and "Portfolio" performance during this period lies in the understanding of two things. First is the blind belief of the popular indexes in measuring short term performance (months) and the market impact of dramatic changes in the investment climate.

If you asked the question that, when measuring personal account or portfolio performance against the "market" (usually measured by indexes like the Dow Jones Industrial Average, or the S&P 500) in the short term, could those popular indexes be unduly influenced by small segments of the broad market or even individual stocks?

The answer would be "yes." In fact, a great deal of market data covering these last 3-4 months would show very little upside participation (and many with a lot of downside) by an increasing number of stocks within many of the popular indexes since July of last Summer. To put it another way, fewer and fewer stocks within that index have been leading it higher and higher. Why would this be?

If we are to understand, let alone assess, what appears to be a short-term flaw in market performance as interpreted via an index, it may help to consider 2014 as being made up of two distinct periods of time in terms of market perspective.

During the first period (2014 through August), equity accounts under my management for the most part went in the direction of those popular indexes (S&P 500, DJ Industrial Average, etc.), namely up. However, starting between July and September, two major forces, global in nature, emerged. These forces wound up first creating investor confusion, followed by crosscurrents within for the financial markets. A sharp rally in the US dollar, making US multinational corporations potentially less competitive and less profitable abroad while there was an equally sharp fall in most major commodities, the most notable of which has been crude oil. The impact on certain sectors of the overall equity "market" in the form of lower share prices was just as swift and, in some cases, just as severe. In sum, the market itself fragmented. For most of you, this is what you witnessed in the behavior of your portfolios in September and October. As for the popular indexes, most were not affected in a similar manner until October; when a sharp drop in prices from which they recovered by month's end was produced.

For you as clients and investors, the upward trend of the first eight months of 2014 (actually for the better part of these last two years|), which had felt calm, smooth, almost a sense of predictability, came to an abrupt halt.

"…calm, smooth, almost a sense of predictability…"

Think about this phrase. It seemed to characterize not just the first eight months of 2014, but also these last two years of market and portfolio gains. During this time, did you ever think: why does the market seem to be going up, but not my accounts?

I would be surprised if you said "yes" because most, if not all, accounts under my management seemed to exhibit and reflect the nature of the very phrase I used above.

Worth repeating "…calm, smooth, almost a sense of predictability…"

Keep in mind that past performance is not indicative of future results. I have been in this business for over thirty years, and this phrase has very rarely been what I have felt as a Portfolio Manager. Market trends which feel like this are rare. Trends that last for almost two years are almost nonexistent. When they do occur, they are ripe for interruption in some form, from some source. There were a number of such sources in 2014: Ebola, Russia, ISIS, global economic weakness in the Eurozone, Japan and China to name a few. By October, Brazil joined the list. When such market interruptions do occur, they are not commonly seen ahead of time. In addition, their impact tends not to be spread evenly within the market itself, or among the components of a given index. Furthermore, once emotions become involved, it is hard to assess these trends fairly in terms of asset prices.

It is these last thoughts (which I have underlined for emphasis) that I believe are the key to understanding a perceived disconnect between a "portfolio" and the "market," especially the most recent disconnect over these last 3-4 months. In this case, the market interruptions were the rapid rise in the US dollar and the sharp drop in the prices of most commodities. These two events impacted specific sectors within the equity and bond markets in an equally sharp and swift manner. As said above, the reaction was not "evenly spread." Only time will tell if the price drops were "fairly assessed."

Q2) Why this year, more than in the past, do you seem to have an unusually large amount of the portfolio dedicated to cash? Last time I checked, cash was earning practically nothing.

Answer: Over the course of my career, I have found that the use of "cash," more specifically, my use of "cash" within any portfolio has been more misunderstood by clients than the markets themselves.

The answer actually is quite simple. Ideally, I would always love to have all my accounts fully invested and have the efficiency of performance potential be at a maximum. The last such occurrence of such a stance was March 2009. Theoretically, from this standpoint, both the client and the Portfolio Manager should win; the former in the form of asset appreciation and the latter in the form of rising fees. However, to take such a stance of theoretical performance maximization, one must assume two things: 1) the markets are predictable and efficient, thereby providing the Portfolio Manager the proper signals and clarity of when to get "in" and when to get "out" without wasting time or performance, 2) human emotions have no impact on market behavior, especially in the short term, and therefore one need not be concerned that severe market moves down or up should occur. (I shall simply mention: October 1987 and more recently the DJIA moves, up 700 points in two days.)

I view the financial markets as neither efficient nor predictable especially when analyzed with only a short-term perspective. Additionally, I believe that globally we are living in one of the most unsettling periods of time since the years of the Cold War. The potential for market disruption is therefore quite high and the potential consequences quite severe. Furthermore, I believe that when markets feel "…calm, smooth, (with) almost a sense of predictability…" they and all who tout their merits should be looked upon with suspicion and caution.

Therefore, I see the potential for great market volatility, but also due to that volatility, the potential for great market exploitation in the days, weeks and months ahead. In order to participate in such exploitation from a portfolio perspective, an investor must be both liquid (cash) and flexible (diversification) while assuming the short-term cost (performance) of taking those positions. The battle between maximizing portfolio performance (or even allowing for the possibility of temporary non-performance) and be able to exploit market volatility has only two requirements…..

Keep in mind that diversification does not guarantee a profit or protect against a loss.

Cash. And, patience (ahhh, there is that word again).

Q3) You have allocated a portion of my assets with Oppenheimer toward bonds, yet all I have heard from the "experts" is that interest rates are going to rise and my bonds may suffer with a loss in value. Also, of late, I have heard that the fall in energy prices could result in companies in that industry defaulting on their bonds. So why do you have me exposed to such risks?

Answer: I have always felt that bonds should be a component in every investor's portfolio regardless of age. What I have written above demonstrates that one of the most conspicuous characteristics of my portfolio management style is that I seek, above all else, balance. I generally always weigh the potential for uncertainty (as seen by my levels of portfolio cash) and market disruption against the emotional and fundamental backdrop of the financial markets.

Bonds are a form of that balance. Simply put, over the longer term, equities outperform most other forms of investing. However, the tradeoff is that, in the short term, stocks can be volatile and highly unpredictable. Bonds, in general, trade off long-term outperformance for short-term predictability. More specifically, bonds with short maturities enhance liquidity. Bonds are a contract between issuer and owner with a specified maturity, at a specified price, for a specified return. No matter the condition of the financial markets, or the direction of interest rates, at maturity, those bond-specific terms are fully in force.

Speaking directly in light of the current severe bond market reaction to falling energy prices, I see opportunity at a time when many see and feel panic. I believe that the fall in prices of those affected has been overly harsh and from a broader perspective, indiscriminant. For all of you who have bond portfolios with me, yes, you have been affected in terms of the prices of many (not all, and not necessarily most) of your bond holdings due to current market conditions that have combined fear that the Fed may raise rates and fear of falling energy prices and their impact on energy companies.

However, given that I always allow for market interruptions to occur by being both flexible and liquid (see above), bonds become a very large part of that process. Unlike stocks, I can be both fully invested and flexible by simply controlling maturities. Currently, and for quite some time now, all of my bond portfolios have a very large percentage of their total allocation in very short-term maturities (less than 1 year). So with the recent rise in interest rates, for whatever reason, be it the Fed or crude oil prices, or something else as yet unseen, there will be bonds constantly maturing by some degree over this next year or so to take advantage of these market disruptions in the form of lower prices and higher yields.

Q4) I have observed, especially in these last 3-4 months that you seem to avoid those stocks which I hear about every day in the news that are setting new highs, yet you start or increase the allocations in my accounts toward sectors and stock which seem to be doing the worst and whose names I just don't recognize? Shouldn't we be doing the exact opposite?

Answer: Pure and simple, I am a value investor. I always seek the downtrodden, the misunderstood, and most important, specific investments that I believe have been mispriced by the market. These judgments of mine, of course, take place within the critical context of sound fundamentals and the assumption of some level of predictability by those investments. As a result, it will therefore be quite unlikely that you will ever see me buying the latest and greatest in the "popular" names that tend to retain their popularity about as long as a hit movie.

I seek "to buy cheap and then to sell dear."

From a broader market perspective, I believe that as markets rise they become more risky and more prone to reaction from interruptions. Conversely, as markets fall, I believe that they become less risky and less reactive to the unexpected. Yet, when we analyze short-term investor behavior we tend to find quite the opposite. This seems especially true during times of momentum and liquidity driven markets such as what we have seen these last two years. In periods such as I have just mentioned; higher prices beget even higher prices with no regard for the actual "value" that lies under those prices. Also, as these markets move higher, what was once broad participation in a wide swath of names and sectors begins to increasingly focus on the few. (Historically, please note the existence of the "Nifty Fifty" of the early 1970's and the "dot com" bubble of 1999 and early 2000)

The process and discipline under which I operate quite often guide me to buy during times of great market stress and disruption and falling asset prices, even if these stresses occur in specific sectors, as we have been seeing these past 3-4 months. What I bought even just a month ago could probably be purchased today at an even lower price as the market's reactive emotions and the execution of year end considerations (tax loss selling) play themselves out.

There is always a short-term expense that, as a value investor, I am willing to bear in positioning for the long term those investments that I believe are currently grossly undervalued by the markets (both equities and bonds). That expense is a potential client portfolio disconnect (underperformance) from the overall market, at least as it appears on the surface). (See answer to Question #1.) Most of you will note that equity account cash levels have fallen since September as lower prices in key stocks and sectors have increased my desire to buy what I have determined are ultimately long term values.

I hope that the questions and answers I have provided will serve initially as some level of guidance as to how I see things currently, both in terms of the overall markets and your portfolios. But more importantly, and with a little bit deeper insight than you may be seeing on the surface in the realm of short-term performance, nothing has changed in my investment process and value-oriented discipline.

For the short term, as I reflect and rely on my over 30 years in this business, I can without hesitation tell all of you reading this now that one of the most critical ingredients in being successful as a Portfolio Manager and as an investor……

Hardly needs to be uttered from the lips of our Federal Reserve Chairwoman.

However, from a market perspective, its utterance this past week served a purpose she hardly intended in the form of a sharp rally in financial assets.

We have a "patient Fed"….
It is my sincere hope that for the New Year ahead….
I will have "patient" clients.

A very healthy and joyous holiday season to you all and my best wishes for a Happy New Year.