LWM Commentary - Regime Change

April 27th, 2018

Strong market regimes (long term trends) tend to find their way into social consciousness. They become part of the cultural narrative. Let me explain.

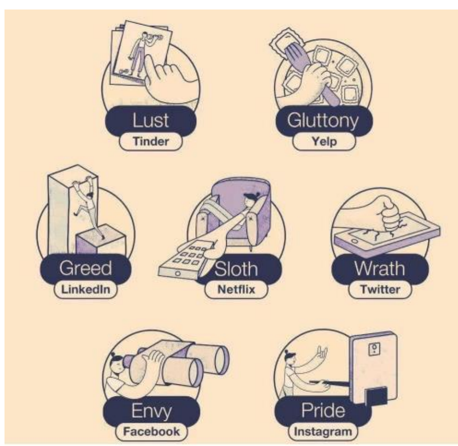
Do you remember just prior to the dot.com bubble how "day trading" your investment account was all the rage? Everybody was doing it. And people who quit their day job to trade full time were looked at as super-cool. Eventually that changed. Day traders still exist, but you don't hear much about them anymore.

Or what about the real estate market before the crash in 2008? I can remember being jealous of a local school teacher that was printing money in real estate. I wasn't flipping houses three at a time --- and I felt like I was missing out. Virtually everybody was in the real estate game. Ironically, that narrative went away too --- but then actually came back again.

Over the past decade, investing in tech stocks has been the wise decision. So much so that we invented a new term for it --- FAANGs (Facebook, Amazon, Apple, Netflix, Google). Naming it FAANGs means that this phenomenon has also risen to the level of a "cultural narrative". And here is the point: **I think that narrative is changing.**

The idea that Mark Zuckerberg would be summoned to a congressional hearing to defend why Facebook isn't an evil empire would have been unthinkable even a year ago! And just when exactly did celebrities begin thinking it was cool to de-list from Facebook? To quote the inimitable ~~economist~~ / philosopher / poet Bob Dylan --- "The times they are a-changin…"

I think the following meme, which has been circulating around social media, sums up the new mood quite well:



Since the Great Recession of 2008, the following market regime has been in place:

Good news is good news. And even bad news is good news.

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There are several reasons why this regime took hold --- but the big idea is that the market has largely gone up on good news and bad news. A can't lose proposition…

I think that era is likely gone. Consider Google's quarterly earnings announcement earlier this week. Note the following year over year comparisons:

- Annual Revenues: +23%
- Annual Profit Margin: 22% versus 27% prior year
- Total Annual Profit: +6.6%

And the market reaction to these numbers --- down almost 4.5% on the next trading day. Ouch.

You can certainly argue that the market was disappointed by shrinking margins --- even though Google made a larger annual profit overall. But that is exactly my point --- the market is now focusing on the "bad news" it wants to see and seemingly ignoring the overall "good news" in plain sight. After all, wouldn't you like a 6.6% pay raise this year? I think we are going to increasingly move toward a new regime in the markets:

Bad news is bad news. And even good news is bad news.

Translation: substantial negative price action in both the stock and bond markets is likely. Don't know exactly when this will happen. Just makes sense to me that it should. Market regimes are affected by cultural phenomena --- and vice versus. Consequently, it becomes even more important to find ways of investing capital that are not correlated with the overall markets.

Let's talk briefly about correlation. Diversification is achieved by finding investments that are not correlated to each other, meaning they don't go up and down at the same time. This correlation is typically analyzed across the longest available time frame in an attempt to ensure the reliability of the findings. Consequently, correlation analysis is often based on 10+ years of return history…

That creates a problem because underlying correlations between investments are not constant over time. In fact, the opposite is true. Asset classes behave very differently in bear markets than they do in orderly, functioning markets. And since the whole point of diversification is to protect against losing money --- the only correlation statistics that actually matter are the ones that apply during a bear market!

Intuitively, this makes sense. Investors looked at pretty, multi-colored pie charts of their "diversified" portfolios in 2007 --- only to realize by 2009 that everything went down all at the same time. I don't mean to make light of a painful situation. It is very hard to find investments that are uncorrelated even/especially in a bear market. But it is NOT impossible.

At LWM, we are committed to finding uncorrelated investments --- especially in bear markets --- to complement our traditional portfolio allocations. We have highlighted some of these strategies in past letters. Click here and scroll to the second page for a list of examples.

And as always, please feel free to reach out with any thoughts or questions.

Kind Regards,

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