Elgin asset management

investment commentary monthly

Monthly Commentary 3rd November 2017

October was a very good month for equity markets, with world equities as measured by the MSCI World Index (Local), up 2.6%. All major regions were up, with Japanese equities the star performers with a gain of more than 8%. Government bonds were either side of flat and commodities were bolstered by another strong monthly gain in crude oil. In currencies, the USD index gained 1.6% but is still down a hefty 7.5% so far this year.

Worries and expectations

It is quite natural that after another strong month in the markets and with portfolios looking healthy, that there is concern that we are increasingly closer to a large market drop. The media is not short of daily warnings from one expert or other that a sizeable fall is imminent. Some of these warnings are backed by logical arguments, which makes it difficult to dismiss them.

Below is an email we received from a client that resonates universally, and we shall thus dedicate this month's newsletter to addressing it.

Whilst I am optimistic about the short term we can never be certain and there will always be a lingering doubt about a possible Stock Market crash. To avoid my funds halving in value what is your plan if this was to appear on the horizon?

I would obviously want to safeguard my funds in this eventuality, as I would hate for me to start again after spending so many years getting to this level.

Our first comment is on what "plan" we have should the markets crash? This assumes that we indeed have a crystal ball that will give us plenty of warning so that we can make the appropriate changes in client portfolios in order to safeguard their value. As much as we would love to have such forecasting insights, we are afraid we do not posses them. Thankfully, we are in very good company as neither do the best and brightest in the world of finance. {At the end of this newsletter we present a recent article on forecasting by Barry Ritholtz who articulates the subject quite eloquently}.

There are two main issues here. The first is quite subjective and it has to do with the indicators we follow with regards to the possible direction of the markets.

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The second is objective and has to do with each client's tolerance to risk and how it is manifested in their current and future portfolio composition.

Do we see a crash in the horizon?
As we have stated many times in the past, market crashes are always followed by economic recessions. Note however that economic recessions are not always preceded by market crashes. So if one were to predict a crash, they would have to, in the least, predict a recession. This is about probabilities rather than certainties. From the subjective data that we (and thousands of other economists) currently have, a recession is unlikely in the near term. Some of the reasons are well known. These are: the global economy is undergoing a reasonably synchronous period of growth, monetary policy is still stimulative, corporate earnings are growing well, credit is widely available, inflation is contained, employment is strong etc etc. There are many other indicators that are followed such as high yield spreads, currency rates, energy prices, equity & bond valuations, investor sentiment, etc.

The fact is that no matter how well we (or any other forecaster) are aware of these, it is still not possible to say with certainty that a recession is not around the corner. So if a long awaited correction comes, do we sell out despite most indicators not pointing to a crash? When does one "pull the plug". In the last few years there have been a few corrections, but the market has come back. When will it be different? Frankly, we do not know.

And this leads us to the second issue.

What does tolerance to risk have to do with it all?
Everything.
The reason we give our clients investor questionnaires is to ensure that their portfolio structure reflects their risk profile. Risk profile has to do with long-term investment objectives and not with market outlook. If one is happy to take on more risk, for potentially more gain, then they should expect that in the short and medium term, their portfolio values might fall. If one cannot tolerate falls, they should be invested very conservatively.
As an example, if an investor has a "balanced" risk profile, they can expect that their portfolios will move about half as much as the equity markets move, both on the upside and downside.

Should we (the Elgin Investment Committee) fear an imminent big fall in the markets, all we would do is take our risk to the lower end of the spectrum of each risk profile.

For example, a balanced risk profile normally has 50% in equities. We would take it down to 45%. Conversely, if we are bullish, we would move it up to 55%. What we cannot do is take far more radical steps as we would be violating our clients' mandates for keeping within a certain risk profile and achieving their long term investment objectives.

We cannot attempt to time the markets as we only have about a 25% probability of getting it right. That is, a 50% chance of getting the timing right to sell, and a 50% chance of getting it right to buy back in. Almost inevitably, this will lead to losses for the client.

As managers, we attempt to add value by investing in what we consider are the best securities/funds available within each client's risk profile. As Miles Johnson from the FT recently put it:

Short-term thinking and market timing are the enemies of successful investing. Professional investors should focus on doing the best job they can for their clients, not trying to predict the monthly direction the markets cork will bob in the macro sea.

10 points about forecasting, by Barry Ritholtz

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10 Points About Forecasting and Why We Stink at It

Even though predictions are almost useless, we persist in making and listening to them.

By Barry Ritholtz
November 1, 2017, 6:33 PM GMT+2

No. 1. ***Not everything is a forecast****: This is especially true in terms of markets and the economy, and so a reasonable definition of a forecast is as follows: It pertains to a specific asset or asset class and/or economic data series, at a given price or level and a specific time. It also must be disprovable. Making a statement that can't be proven or disproven is not a forecast; it's a theoretical academic debate.*

Consider the following statements: "Stocks tend to go higher" or that "recessions are cyclical." These are not forecasts because they lack specifics. The statement, "The Dow will hit 25,000 by the second quarter of 2018," on the other hand, has all the elements of a forecast and it will either be proven right or wrong.

No. 2. ***We are very bad at forecasting****: Examples are everywhere: Economic forecasts, earnings estimates, market forecasts, expectations of future technologies, not to mention election predictions. The data overwhelmingly show that as a species, we are simply awful at this.*

No. 3. ***We are even worse at predicting our own behavior****: I have been highly critical of those surveys that ask people to describe what they plan to do in the future. Whenever you see someone forecasting their own behavior, what you are getting is a read of their emotional state. Whether it's holiday shopping, company hiring plans, voting intentions -- people say what they are feeling at the time the question is posed, and it is not predictive of what they are* actually going to do*.*

No. 4. ***Random and unforeseeable events ruin forecasts****: Try going back and looking at the record of forecasts made years or decades ago. Most of them are inaccurate for the simple reason that they were overtaken by random or unforeseeable events.*

No. 5. ***Technology is tricky****: We are particularly bad at making predictions about technology. This goes back a long ways, to claims in the late 19th century that no one would ever need or want a telephone, or that cars would never replace horses and buggies. And folks are still at it, despite their inability to get it right. Check Microsoft Inc. chief Steve Ballmer's 2007 prediction that Apple Inc.'s iPhone would never catch on.*

No. 6. ***Forecasts are marketing****: If forecasts are so useless, why are they so prevalent? I don't know of a clearer way to say this: A forecast is usually accompanied -- directly or otherwise -- by an effort to sell something. Predictions are inherent in marketing campaigns. It's as simple as that.*

No. 7. ***Random luck****: People tend to overfocus on the* outcome *rather than paying closer attention to the* process*. This leads to an overemphasis on guesses that were merely lucky and therefore cannot be replicated.*

*No. 8. **<u>Asymmetric risk</u>**: Bad forecasts are quickly forgotten, while those who make accurate predictions that are nothing more than the result of luck or random chance get elevated to stardom. This is the entire underpinning of why people make forecasts -- and especially radical scary ones -- in the first place. The potential rewards for being right can be significant, while being wrong has little downside.*

*No. 9. **<u>Failing to acknowledge a mistake</u>**: Many people engage in the sort of ego-driven decision-making that leads to bad outcomes. Rather than admit error, they prefer to stay invested based on their predictions rather than do what's best as an investing strategy. Renowned technician Ned Davis literally wrote the book on this and the title says it all: "<u>Being Right or Making Money</u>. "*

*No. 10. **<u>Making better predictions</u>**: There is some hope for improvement in forecasting: Phillip Tetlock, author of "<u>Superforecasting: The Art and Science of Prediction</u>," explored how forecasters can use data and logic to improve the probabilities of reaching a desired outcome. Note the word "probability" instead of prediction.*

Now, if only investors would pay heed

If any of our clients believe that they have the wrong risk profile, they should immediately alert their advisor.

The Elgin Analyst Team

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