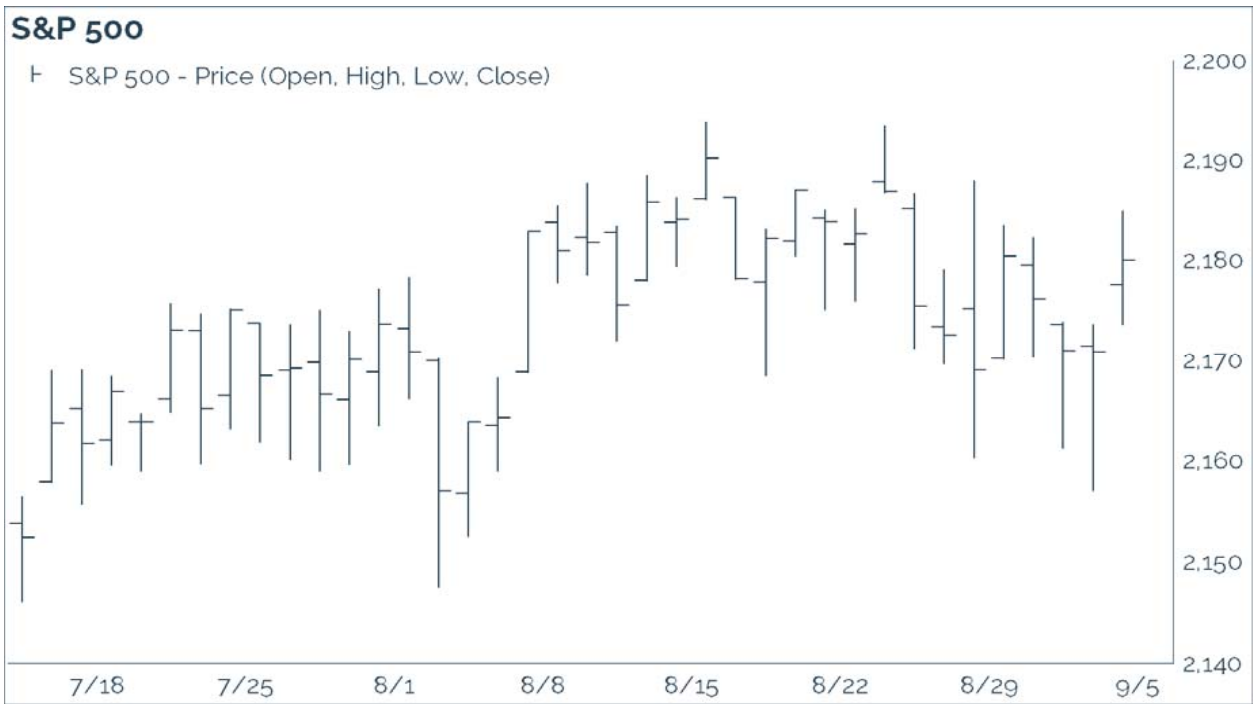
Patience

Over the past two years, everything from research to trading and even writing this monthly column has been nothing short of an absolute grind. Outside of a few events - the Ebola scare in October 2014, the Chinese currency devaluation in August 2015 and a brief global growth scare in January 2016 - the investment landscape has not changed one bit. But, I believe it is in times like these that you can learn and better understand the virtue of patience.

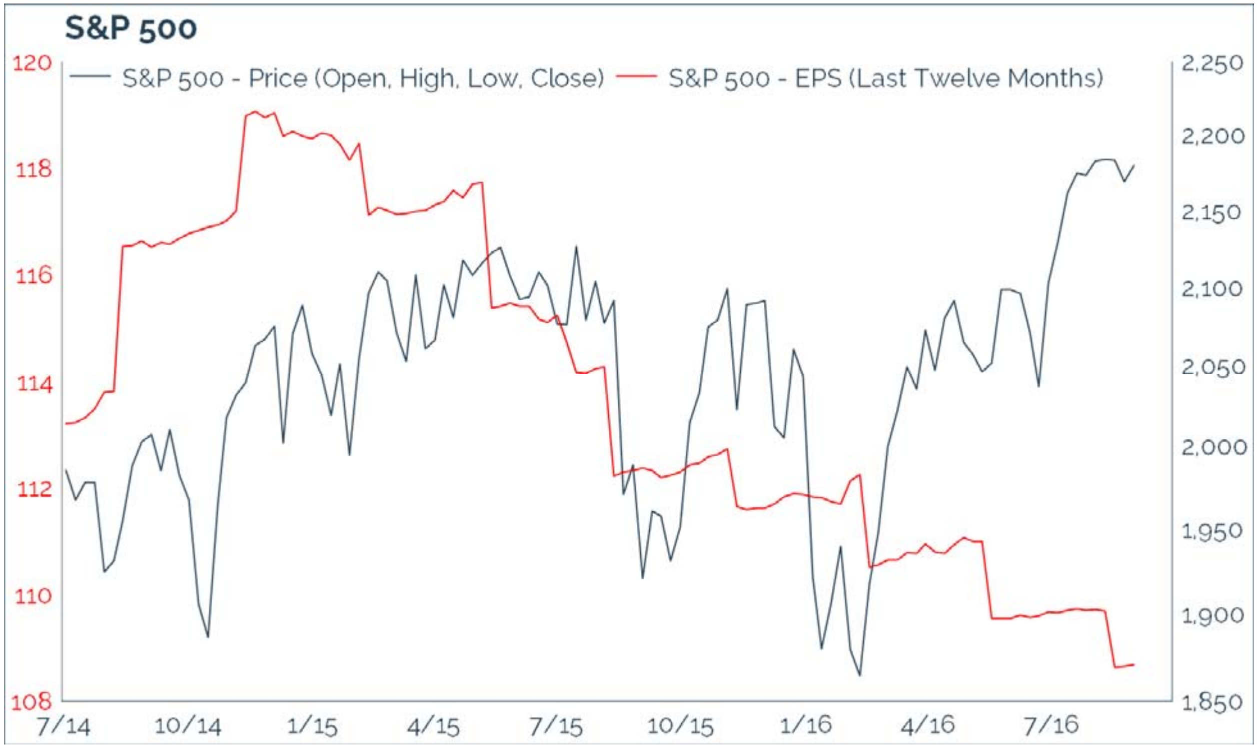
Roughly one year ago I wrote a column titled *Groundhog Day*. If you did not happen to read it, I'm sure you can figure out what it was about. Over the past month and a half, the S&P price action, Fed commentary and earnings estimates made me realize again how much I feel as if we are still reliving that movie. After Brexit was sorted out, the S&P 500 finally broke out of a two-year trading range to set all-time highs. We were off to the races… for two days. The S&P 500 closed at a record high of 2137.16 on July 11th. On July 12th, the S&P 500 made another record close at 2152.14. Since that day, the stock market has traded between 2146 and 2193 on record low volume and inter-day volatility.



Source: Factset

As far as Fed commentary goes, every day the financial media has to dedicate a portion of the day to what the Fed is possibly thinking or saying. This has become the ultimate exercise in futility. The stock market is literally conditioned to move based on what a member of the Federal Reserve says that day. If a member comes out hawkish, the market sells off. And if a member comes out dovish, the market goes higher. It's really as simple as that. Being a portfolio manager who quantifies fundamental data to direct our investment decision making, it has become increasingly frustrating to trade stocks. That is because you can't quantify "Fedspeak", which has been one of the largest contributors to the fluctuation in stock prices.

With "Fedspeak" dominating stock prices, actual corporate earnings have had very little to do with the direction of the stock market over the past two years. And nearly every quarter has been the same. Several quarters in advance, S&P 500 earnings estimates start out at a much higher level only to come down over time to where they are finally reported. This has always been the case as analysts are typically too optimistic; however, the magnitude of the decline and lack of recovery is what's most concerning. As seen below, the corporate earnings picture has not matched up with the price action.



Source: Factset

There is an acronym that has gained a lot of popularity over the past few years that absolutely makes me cringe - "*TINA* (**T**here **I**s **N**o **A**lternative)". *TINA* has become a direct byproduct of the actions of central banks around the world over the past eight years, especially the last two. By taking interest rates negative, fixed income investors are forced into riskier assets to make up for the loss of income on their traditional bond investments. An investor who would typically receive income from bank CDs, government bonds or AAA-rated corporate bonds now must go further out on the yield curve, move down in quality toward junk bonds or swap out fixed income for equities. What used to be a relatively safe and stable security is being replaced with a security exposed to greater interest rate risk, issuer risk and principal risk. Unfortunately, this type of investor doesn't realize the amount of risk they are taking on until it's too late. They just see that their junk bonds are yielding them 5% and their equities continue to appreciate. And, they have lost all patience over the past few years with their bank CDs and savings accounts earning practically nothing.

I would be willing to bet the investor who used to rely on the 3% - 5% income generated from their CDs and savings accounts are not prepared to withstand a 20% or greater decline in the junk bond and equity markets. I'm not saying we are on the precipice of a decline of this magnitude, but you have to understand that the risk is always there when you invest in these types of securities. Far too many people ignore risk for the sake of an incremental increase in potential return. It is vitally important to assess the risk profile of an individual security or investment strategy before making any investment decision, especially in the environment we find ourselves today. The different ways to measure risk-adjusted returns and risk in general, such as Sharpe and Treynor ratios for risk-adjusted returns and standard deviation, beta and downside capture for risk in general are extremely important to analyze. Just because you may have become a little impatient with generating nothing on your cash over the past few years doesn't mean chasing yield is your only option now. Understand what it is you own and what you could lose or gain before diving in head first.

The ability to exude patience is much easier said than done, whether you are a professional money manager or individual investor. Information is available to you 24 hours a day 7 days a week, so there is no getting away from it. And the explosion of social media has created countless platforms for pundits to be heard. Not to mention the technological advances created over the past several years that allow almost anyone to analyze price changes across practically every asset class around the world in real-time, whether it be on their desktop or phone. Add all of this together and sometimes you just feel compelled to act, when most of the time doing nothing is in everyone's best interest. In 1989, Axl Rose, lead singer of one of the all-time greatest hard rock bands, sang it best - "All we need is just a little patience".

--Billy Little, CFA

"It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it." ~ Ralph Waldo Emerson