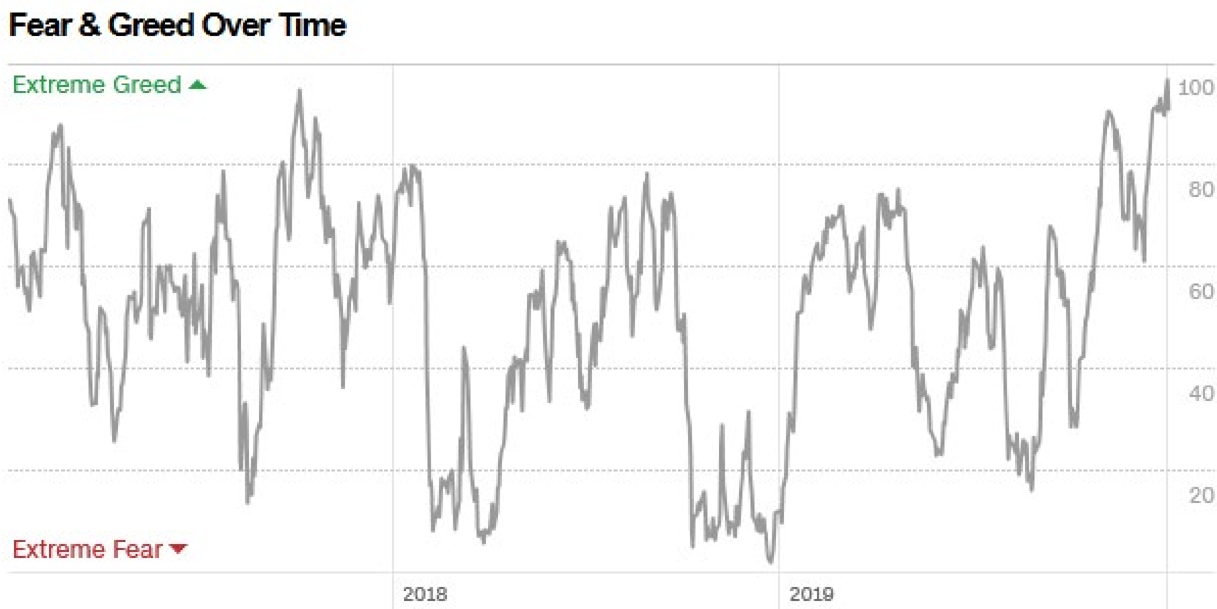
OBSERVATIONS – January 6, 2020

Markets, Valuations and Tandem

As the ball dropped in Times Square this past week, the mood on Wall Street could not have been any more different than a year ago. A chart showing the CNN Fear & Greed Index says everything you need to know about the state of the investor then and now.



Source: https://money.cnn.com

As 2018 came to an end, nearly every major asset class, except for cash, had gone down in value. In 2019, the script was flipped, and you would've been hard pressed to lose money.

Asset Class Returns

2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
EM 34.5%	REIT 35.1%	EM 39.8%	HG Bnd 5.2%	EM 79.0%	REIT 28.0%	REIT 8.3%	REIT 19.7%	Sm Cap 38.8%	REIT 28.0%	REIT 2.8%	Sm Cap 21.3%	EM 37.8%	Cash 2.0%	Lg Cap 31.5%
Int'l Stk 14.0%	EM 32.6%	Int'l Stk 11.6%	Cash 1.4%	HY Bnd 57.5%	Sm Cap 26.9%	HG Bnd 7.8%	EM 18.6%	Lg Cap 32.4%	Lg Cap 13.7%	Lg Cap 1.4%	HY Bnd 17.5%	Int'l 25.6%	HG Bnd 0.0%	REIT 28.7%
REIT 12.2%	Int'l Stk 26.9%	AA 7.6%	AA -22.4%	Int'l Stk 32.5%	EM 19.2%	HY Bnd 4.4%	Int'l Stk 17.9%	Int'l Stk 23.3%	AA 6.9%	HG Bnd 0.6%	Lg Cap 12.0%	Lg Cap 21.8%	HY Bnd -2.3%	Sm Cap 25.5%
AA 8.9%	Sm Cap 18.4%	HG Bnd 7.0%	HY Bnd -26.4%	REIT 28.0%	HY Bnd 15.2%	Lg Cap 2.1%	Sm Cap 16.4%	AA 11.5%	HG Bnd 6.0%	Cash 0.1%	EM 11.6%	Sm Cap 14.7%	REIT -4.0%	Int'l Stk 22.7%
Lg Cap 4.9%	AA 16.7%	Lg Cap 5.5%	Sm Cap -33.8%	Sm Cap 27.2%	Lg Cap 15.1%	AA 0.3%	Lg Cap 16.0%	HY Bnd 7.4%	Sm Cap 4.9%	Int'l Stk -0.4%	REIT 8.6%	AA 14.6%	Lg Cap -4.4%	AA 18.9%
Sm Cap 4.6%	Lg Cap 15.8%	Cash 4.4%	Lg Cap -37.0%	Lg Cap 26.5%	AA 13.5%	Cash 0.1%	HY Bnd 15.6%	REIT 2.9%	HY Bnd 2.5%	AA -1.3%	AA 7.2%	REIT 8.7%	AA -5.6%	EM 18.9%
Cash 3.2%	HY Bnd 11.8%	HY Bnd 2.2%	REIT -37.7%	AA 24.6%	Int'l Stk 8.2%	Sm Cap -4.2%	AA 12.2%	Cash 0.1%	Cash 0.0%	Sm Cap -4.4%	HG Bnd 2.7%	HY Bnd 7.5%	Sm Cap -11.0%	HY Bnd 14.4%
HY Bnd 2.7%	Cash 4.7%	Sm Cap -1.6%	Int'l Stk -43.1%	HG Bnd 5.9%	HG Bnd 6.5%	Int'l Stk -11.7%	HG Bnd 4.2%	HG Bnd -2.0%	EM -1.8%	HY Bnd -4.6%	Int'l Stk 1.5%	HG Bnd 3.5%	Int'l Stk -13.4%	HG Bnd 8.7%
HG Bnd 2.4%	HG Bnd 4.3%	REIT -15.7%	EM -53.2%	Cash 0.2%	Cash 0.2%	EM -18.2%	Cash 0.1%	EM -2.3%	Int'l Stk -4.5%	EM -14.6%	Cash 0.3%	Cash 1.0%	EM -14.3%	Cash 2.1%

Source: https://novelinvestor.com/download-returns-tables/

The two images above remind me of a quote from Seth Klarman – founder and CEO of Baupost Group. The last time I wrote about this quote was nearly one year ago to the day…*"On several occasions throughout 2017 and 2018, I used a quote from Seth Klarman who is the founder and CEO of Baupost Group. In those cases, it was used to iterate how the pervasive bull market and lack of volatility presented great risk to investors. Today, we are in a very different environment. Our process and quantitative model have identified that now is the time to selectively start deploying some of our clients' cash as the long-term risk/return profile is much more favorable today than in the past.*

> *'When share prices are low, as they were in the fall of 2008 into early 2009, actual risk is usually quite muted while perception of risk is very high. By contrast, when securities prices are high, as they are today, the perception of risk is muted, but the risks to investors are quite elevated.' – Seth Klarman, Founder, CEO, and Portfolio Manager of Baupost Group"*

Human nature wouldn't have you believe this, but actual risk is much higher today than it was 12 months ago. After a nearly 20% drop in Q4'2018, the perceived risk was off the charts, which is clear as day in the Fear & Greed chart; however, the actual risk of losses escalating from that point were quite low. It was at that time and during Q1'2018 that our quantitative model had us investing our clients' cash. The exact opposite can be said right now. The perceived risk is very low after a 31.5% return in the S&P 500 Total Return Index, because our recency bias says markets will continue going higher. In reality, the actual risk is quite high right now.

A couple of months ago, I wrote about valuations being stretched and specifically highlighted future returns when the Price to Sales (P/S) ratio was at the then current level of 2.14. With future returns being a function of the price you pay today, it was not a surprise to see that future returns were mostly negative over the ensuing 1-year, 2-year and 3-year time periods. Today, the P/S ratio stands at 2.27. The S&P 500 is 3% away from trading at the same valuation we last saw in January 2018, right before the market fell nearly 12% over the span of 10 days. The current P/S ratio is also roughly 10% away from valuation witnessed at the height of the Tech Bubble.

I bring attention to these things, not because my goal is to instill fear in the individual investor, but rather to shed light on where we are in the most recent market cycle. It is very easy to get caught up in the moment and lose track of your surroundings. Watching an investment pay off is a lot of fun and extremely rewarding; however, it is equally, if not more rewarding, to not give it all back. It is impossible to predict the market's next move, which is why you shouldn't be "all in" or "all out". As discussed last month, seasonality and momentum can trump rationality and valuation any day of the week. And for this reason, it should come as no surprise to see the market continue to climb higher. However, at some point the risk begins to outweigh the reward and I suspect we are inching ever closer to this point.

At Tandem, we've been net sellers for a few months now. As many buy signals as we had in December 2018, we are getting an equal number of sell signals today. Discipline drove our investment actions a year ago with us putting cash to work and it's that same discipline that has us taking some money off the table. Patience will ultimately be rewarded and without dry powder available, it's hard to take advantage of attractive opportunities when they arise. This is true at the strategy level and at the new account transition level. In Ben Carew's recent edition of *Notes from the Trading Desk*, he gave an update on our transition process with new accounts, which highlights our discipline and patience with putting money to work. It is currently taking nearly 6 months to fully transition new accounts into our core strategy. Whereas in December 2018, accounts were mostly transitioned in roughly 30 days. At the end of the day, we made a promise to each and every client that we would follow our investment discipline and some things are just not going to change.

- 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