

Emotional Market Extremes Require Discipline

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The masses should be feeling pretty good and pretty smug right now. They have had the investment wind at their back, momentum has been favorable, pullbacks have been really brief, and the world's central bankers have been performing historical accommodation. What could possibly go wrong in the days/weeks/months ahead?

“The stock market is filled with individuals who know the price of everything, but the value of nothing.”

Philip Fisher

Many things that are going on today are unprecedented. The efforts of the Federal Reserve (Fed) to backstop the economy is just the tip of the iceberg. The amount of leverage in the system is unparalleled, the speed with which trading takes place has resulted from advancements in technology, everything is more global, and interest rates (an important building block of any economy) are at low levels not previously seen in the modern era. All of this (and more) has certainly changed the investing landscape enough to where some of the prior “limits” of speculation have now been made much more elastic, but at the end of the day, investing is, and always has been, all about math. The price paid today for the cash flows expected to be received in the future are both determinants of your expected return. The higher the price you pay today, the lower the expected future return. This isn't a clever axiom, it is just basic math. Price is what you pay, value is what is received.

“Buy not on optimism, but arithmetic.”

Benjamin Graham

The arithmetic of today is simple. Bond yields are exceptionally low, and for some, they may not make good business sense. Worse, the general public is so desperate for yield, any kind of yield, that they have compressed the “spread” between the yields for high-quality bonds relative to “junk bond” returns, now at a historically narrow difference. In other words, an investment in low credit quality bonds provides a very thin reward for very high relative risk. This sort of endeavor is permeating throughout the markets and is another potential sign that over-bullishness and potential investment recklessness have become pervasive. Further, over in the stock market we have been witnessing a repeat episode of speculation that was highly prevalent in the final days of the Great Tech Bubble of 1999-2000. “Shooters,” they were called. Stocks that went vertical, not because the fundamentals of the business were sound, but because a story could be spun of great things to come that gave a stock “juice,” momentum, and thrust. Shooters would rocket up the charts, climax, and then come crashing back to earth. We have had innumerable instances of shooters in early 2021, but for those paying attention, many appear to have crested and are making their descents. Some of this activity, however, has been out of sight to the more casual

market observer because the biggest and most liquid of stocks have remained buoyant, and by virtue of their gigantic influence on the leading indexes (such as the NASDAQ 100 and the S&P 500), they have perhaps overshadowed the declines of the shooters. That doesn't mean this bull market is coming to an end tomorrow or the next day, but it is a **BIG RED WARNING SIGN** for those who choose to heed it. This might matter somewhere ahead.



“The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell.”

Sir John Templeton

I believe that we are witnessing one of the greatest, most speculative, and most egregious eras of market history. Optimism is pervasive. It seems to be everywhere. My sense, from talking to many people in many parts of the country, is that there is no fear. Lots of bravado, no fear. Further, look at the anecdotal evidence of exuberance in other markets. In many communities around the country there are offers to buy homes at prices that are wildly above the asking levels. Why? New car inventories are tight because of temporary disruptions in the supply chain for parts, notably microchips, and that has pushed certain car buyers to pay over the list price of the vehicle. Who does that? I can cite many areas where money is sloshing about and there is little concern for what prices are being paid for lots of object d' art.

It is another sign of the times that many have benefitted from the current market froth. It often happens this way, and for those who had some good fortune on the one end, what does it matter what they pay on the other end. Easy come, easy go. History has taught us that periods such as this are not usually the norm, they are the exception, but this too shall pass. The time may be near when some will rue the day that they spent their winnings in foolish and frivolous ways.

“Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria.”

Sir John Templeton

Euphoria is always most easily identified with the benefit of hindsight, but not so easy to gauge in real time. Further, like everything, there are degrees of euphoria. It seems that with each new

bull market everything seems to go to greater levels of excess than the one before it, and sometimes we get lost in the marvel of that. However, the late Sir John Templeton proved to be a master of understanding the significance of heeding the signs of the time. He employed a discipline that proved to be prescient by understanding these dynamic progressions of bull markets as illustrated above. Most notably, he was particularly adept at taking courageous positions in the darkest hours of great bear markets. Today we are seeing very steep ascents in many assets. Seeing certain stocks going into overdrive and rising at three to four times the “normal” rate is simply another “tell” of a very mature bull market cycle. One must certainly be wondering the sustainability of this, and what happens when the next “black swan” comes drifting by?

“The four most dangerous words in investing are: ‘This time it’s different.’”

Sir John Templeton

Not to overuse the wisdom of one notably successful investor, but Sir Templeton was not only an astute observer of the markets, he could explain the pathology of them in simple-to-understand terms as well. I can tell you from the many conversations that I have every day with a wide swath of people of different ages and from different places, many are convinced that we are in a different era today and in a very different place from everything that has preceded us. Many seem convinced that, yes, **“This Time It’s Different!!!”** One basis for this belief is the current ultra-low interest rates. (Note: I have been on record that low rates are a syndrome of a slow growth economy, not the other way around.) Another belief is that there is so much more money today due to the recent but massive government handouts. Then there are the 401(k) accounts, inheritances, etc. I get it, there may be some truth to that, but is any of this really particularly new? If it were true, why did we still have a housing price collapse a decade ago? Why have most commodity prices been so dormant up until just a few months ago? At the end of the day, it is my belief that Sir John Templeton had it right, and that it is never different this time or at any time. The laws of supply and demand are just as relative to the investment markets as they are to the consumer markets.

“I can calculate the motions of the heavenly bodies, but not the madness of people.”

Isaac Newton, The Royal Society

Herd behavior is well documented. The sense of euphoria at the height of bull markets isn’t something that is special to only a few, it is pervasive. The masses have been pulled in, and that herd behavior has fully expressed itself. The madness of crowds very well could be on full display today. It will also be on full display again in the next market phase where, somewhere ahead, when this current bull cycle has ended and we are firmly entrenched in a massive bear market cycle, there will be a gripping fear that has replaced today’s euphoria. At that point in time, when everyone wonders if it can get any worse, it will. That is when “herd instinct” prevails again but where the masses are likely to be panic selling rather than panic buying.

“The time to buy is when there’s blood in the streets.”

Baron Rothschild

When is it the best time to buy stocks or other securities? Of course, like any other consumable product, the best time is during a fire sale. However, those points in time are relatively rare, and most individuals simply don’t have the patience to wait, nor do some believe that such a time will come again. History has taught us otherwise, but the timing of such events cannot and shall not be announced in advance. One must manage their asset base to their own levels of comfort and often that results in some decisions that are later regretted. When one is fully invested for the short-term satisfaction of participation in the good markets, they are left without the much needed spare capital to take advantage of rock bottom prices that avail themselves when the next down cycle is upon us. You have a choice, but you cannot have it both ways.

“In bear markets, stocks return to their rightful owners.”

Old Proverb

When it comes to all securities, they are more or less “rented.” Every security ever issued must be owned by someone at every point in time until those securities either mature or are retired. Therefore, for everyone who has investments and who decides where and how they want to invest, each day is a new opportunity to decide what to hold and what to trade, but at no time should there be the illusion that “there is a lot on the sideline” or that “there will always be liquidity to sell.” For every stock buyer there needs to be a stock seller. For every dollar issued of “zero percent” cash there must be a holder of that cash. For every hot potato of low-yielding securities, someone must own them until they are retired. So in all of the markets, what changes is the price one is willing to pay for every security at any point in time. The most astute and patient of investors knows inherently that ultra-low prices in the depth of a bear market is likely just as transitory of a condition as it was at the height of the prior bull market that preceded it when prices (for them) were too high.

And finally,

“We don’t have to be smarter than the rest. We have to be more disciplined than the rest.”

Warren Buffett

Investing is all about discipline. It always has been and it always will be. High returns to some today could vanish rapidly. There will always be a time when frustration sets in because the markets, or a poorly conceived portfolio, or individual investments, did not perform to expectations. This will always be the case, but ***investing is not a sprint, it is a marathon***. Hyper-trading is a sprint. Day-trading is a sprint. There are many who are caught up in that activity and that is fine for them, but for those who are not actively trading for short-term profits or gains, they can’t punish themselves because someone else realized higher returns in the heat of a speculative bubble. Conversely, investors may find consolation if they suffer the deep losses that can be portfolio killers during a selling rout because they were chasing all the “hot meme stocks” in the last bull market. As one friend said to me many moons ago, “singles and doubles

are where the game is won.” If you are in this for the long haul, it is important to stay focused on the long objective. Most “investors” want to see gradual gains, an increase in their investment income over time (enough to stay ahead of inflation), and never take the “big hit.” That adequately describes a large swath of folks today.

All of this is food for thought. I have not been shy about advising caution in portfolios for quite some time now, even though this bull has kept chugging along. This one has broken many prior records, some by significant levels. I have taken this stance knowing that underperformance is not only a likely short-term outcome, but a probable outcome. I also know from a great deal of personal market experience and market history (as should be obvious from the quotes above) that once markets do in fact peak, there is little time and little chance for most to change positions rapidly. When it comes to successfully navigating the markets over the long cycle, positioning must be a proactive exercise, and proper asset allocating must be done in anticipation of what comes next, not after-the-fact. It is extremely difficult, if not impossible, to get out at the exact top or back in at the exact bottom. However, it is quite possible to “reduce” exposure near tops and “increase” exposure near bottoms. That is a far easier endeavor in my opinion, but it takes tremendous discipline and conviction.

I hope this has been beneficial. I usually end my message with a portfolio overview and an updated asset allocation recommendation. Not much has changed since last month. The “Dog Days of Summer” are here, and so it is our wish that all of you have a wonderful wind down of your summer of ’21, particularly those in the northern region where summers are too short anyhow!

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Past performance is no guarantee of future results. Index returns include the reinvestment of dividends but do not include adjustments for brokerage, custodian, and advisory fees.

The NASDAQ 100 is a modified capitalization-weighted index that is comprised of the largest non-financial companies listed on the National Association of Securities Dealers Automated Quotation System stock market. It includes both foreign and domestic companies, and does not include any financial or investment companies.

The Standard & Poor’s 500 Index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market.