September 23, 2014

And the Band Played On

"When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."

Charles Prince, CEO Citigroup, July 9, 2007

I recently saw this title and quote in a piece from our friends at BCA Research. Talk about ironic. Little did Mr. Prince know how right his statement would prove to be a year later. To say the least, the music stopped, as did the dancing. While we don't believe the world's economy, banking system and capital markets are anywhere near as levered as they were in 2007, it is still productive to stop and see where we are with the major upward move in asset values we have witnessed over the last 5 years.

Wall Street is rife with old sayings – such as "don't fight the Fed," "don't fight the tape" and "sell in May and go away." All of these sayings are generalizations regarding maxims which, on balance, have been reasonably accurate. However, on Wall Street, as in life, absolutes exist but are normally not … well, absolute.

Wall of Worry – High and Getting Higher

Let's look at another old saying on Wall Street – that is "bull markets climb a wall of worry." Goodness knows the current bull market has been facing such a high wall of worry – this bull seems to be wearing lederhosen. Let's count the negative issues today's stock market investors are facing. Any of these worries would be enough to drive stock prices downward during a cyclical bear market.

- Military and terrorist activities in the Mideast.
- A seemingly systemic economic growth slowing in China.
- Europe back on the edge of economic

recession.

- A choppy U.S. economic environment – accompanied by a systemic slow growth environment.
- Equity valuation levels 1 standard deviation above long-term averages.
- Investor sentiment at high levels.
- The world's largest IPO (Initial Public Offering of Alibaba) being priced at high levels, indicating possible market "froth".
- Upcoming U.S. national election – Will policies change if one chamber or the other changes majority hands?
- Will Russia continue its aggressive actions in the future?

Any one of these issues would probably have the capability of moving stock prices downward during a cyclical bear market. But, we are not in a bear market. Indeed, our research shows we are in a secular (long-term) bull market, and a powerful one at that. So, this bull has been climbing a very high wall of worry – and has been doing so for a number of years.

Are We Due for a Stock Market Price Correction?

Based on historical data, the U.S. stock market is well overdue for a price correction. Going back to the year 1925, data shows that during the typical secular bull market, a 5% price correction occurs every 84 trading days on average. Currently, it has been 150 trading days since we last saw a 5% price correction. Additionally, it has been 736 trading days since the last 10% price correction. Typically, a 10% price correction occurs every 331 trading days during a secular bull market.

So, yes, we are "due" for a correction, which, when it happens, could be driven by one of the factors mentioned above – or by something wholly unknown at this time.

When will the correction take place? We don't know. However, it is important to understand that with the issues mentioned above, we are entering the time of year when the market has historically struggled. The U.S. stock market has tended to display some odd seasonality to returns.

Per the old Wall Street saw "Sell in May and Go Away," the period of May 1st to October 31st has not been a good time to have extreme levels of equity exposure. Since 1952, if an investor had been unfortunate enough to have bought the S&P 500 index on May 1st each year and sold the investment on October 31st of the same year, the average annual return that investor would have realized would have been 1.27% annually (price only, does not include dividends).

Conversely, if an investor had purchased the S&P 500 Index on November 1st of each year and sold on April 30th, that investor would have experienced an average return of 8.74%. The return difference between the November-April period and the May-October period is striking.

We are coming into the last section of the "Sell in May and Go Away" phenomena. Let's take a look at the history books as to what has happened to stock prices during the September-October time frame. Again, going back to 1952, the data shows that the S&P 500 generated an average *negative* price return of 0.22% over that 2-month period. The other ten months? On average, the market generated a *positive* return of 8.26% over that 10-month stretch.

What To Ask

Will the world's markets eventually correct? Yes, they will. The markets do not rise forever without some type of giveback. They never have (obviously). When will the correction take place? Again – we don't know. In my mind, these aren't the operative questions investors should be asking.

Rather, what should an investor do if indeed we experience a 5%, 10% or even a 20% price correction? Run for the hills? I think not. The investor needs to understand the concept of "deep" relative to "shallow" financial risks one takes when investing capital anywhere.

Deep vs. Shallow Risks – a Quick Rehash

We have written on this subject twice over the last year or so. The art and science of investing capital should be focused not only on making money – but, also on not losing money. In many cases – particularly in the high-net-worth space - not losing capital may be more important than making top dollar. The reason? Most high-net-worth investors tend to be facing three issues that many institutional investment organizations, like pension and endowment funds, don't face.

First, most of us retire and live off our investments. Pensions and endowments also have liabilities to fund, but the liability stream for the high-net-worth investor tends to be shorter and more withdrawal-intense. Second, due to the fact that we all die – sooner or later – the time horizon under consideration for personal investment plans are usually shorter than the typical pension or endowment fund. Lastly, people pay taxes – normally, pensions and endowments don't. So, the art and science of investing capital for high-net-worth investors is significantly different than for institutions.

When we are anticipating a shorter-term capital market price correction, the urge by many investors to move money out of the market following a price reduction can be intense. A market moving down by some percentage (say 5% - 20%) is not atypical. The famed investor, Benjamin Graham, labeled this type of risk a "quotational" risk. Quotational risks tend to be temporary in nature vs. risks that ***erode capital over the long term. These types of long-term eroding risks are classified as "deep" risks. One of the worst actions an investor can take during these periods of temporary price weakness is to sell at depressed values. This action converts what should have been a "shallow," correctable risk into a "deep," potentially irreversible risk.***

What To Do

So, when we do face a price correction (note, I didn't say if), what should an investor do? First, work with your Wealth Advisor. They know your situation better than anyone else. I would urge most investors not to sell assets in the middle of a price correction. ***On the contrary, it may make sense to add to existing quality positions in the face of weakness and market anxiety. Again, it is the wise investor who works directly with their Wealth Advisor during periods of market stress and uncertainty.***

We will be back next week.

William B. Greiner, CFA
Chief Investment Officer
Mariner Wealth Advisors

More Information

[FirstPoint Financial]

[FirstPoint TV]

[Market Insight]

P. S. Please feel free to forward this commentary to family, friends, or colleagues. If you would like us to add them to the list, please reply to this e-mail with their e-mail address and we will ask for their permission to be added.