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What Will You Do in the Next Crisis?

NO, WE ARE NOT PREDICTING AN IMMINENT MARKET CRASH. . . .

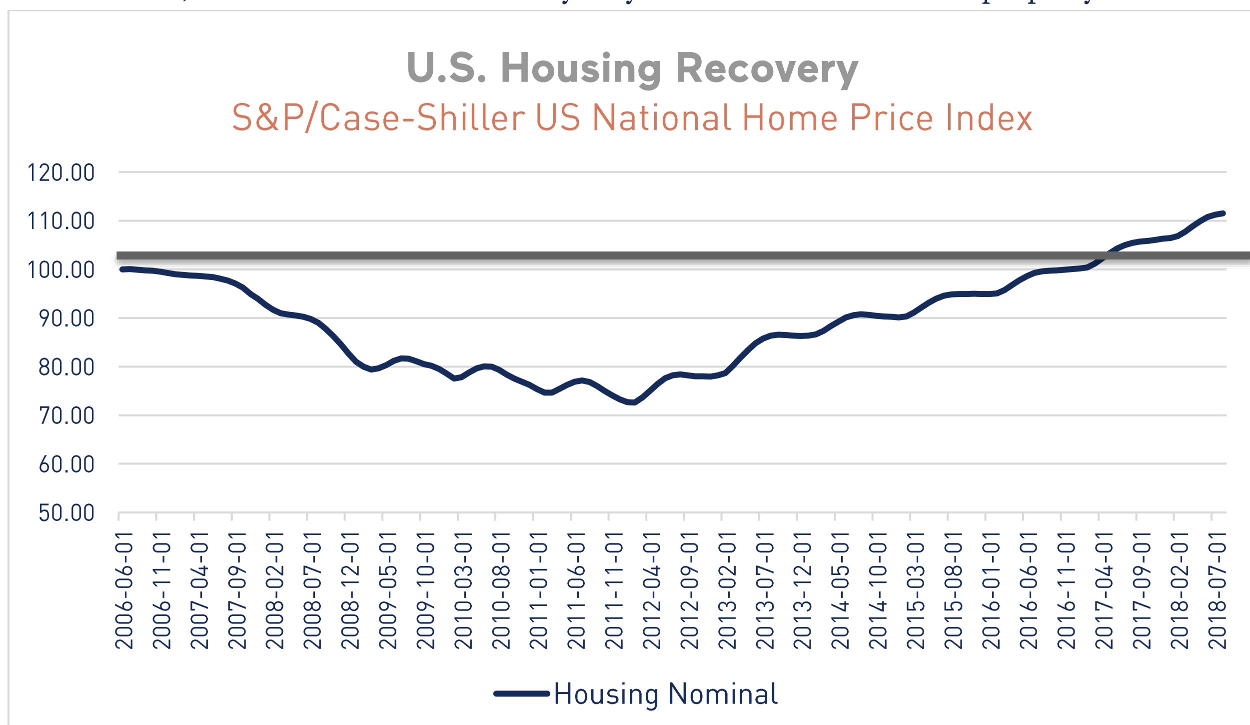
However, we do know that markets don't go up forever – and a very sharp (greater than 20%) correction is inevitable. And, as this bull market (already the longest in US history) gets long in the tooth, we think that thoughtful investors should make sure that their portfolios are well prepared for when – not if – this sharp downdraft occurs.

Another reason this post might be timely – though not *too* timely, we hope – is that asset prices, virtually across the board, are high relative to historical norms:

→ Equity prices are rich, especially in the US – if one considers that we are probably near (or at) peak earnings growth and the nadir of interest rates.

→ Bond yields, even after the recent US Treasury run-up to over 3%, are historically low (especially for non-US developed markets) – and will be under pressure from large government deficits and aging populations.

→ Real estate prices, on average, are above where they were before the Great Financial Crisis, with residential affordability very strained and commercial property overbuilt.



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And there are other factors as well:

→ Equity market volatility has picked up sharply (as it often does late cycle) given the multiple areas of uncertainty (e.g. US/China relations, trade tariffs, central bank policy, Brexit, Italy etc.) have the potential to dampen business and consumer confidence, capex and spending.

→ The yield curve (the spread between 2- and 10-year yields) has flattened significantly (often a leading indicator of recession) – while corporate credit spreads have begun to widen, though they remain very tight by historic standards.

→ After a decade of incredibly easy-monetary policies, the Federal Reserve has been raising short-term interest rates at regular intervals and shrinking its balance sheet for over a year. Other global central banks may look to follow suit in 2019 - further tightening global liquidity and financial conditions.

We could go on, but you get the point – asset prices are high, yields are low, we are in unchartered monetary territory globally, US fiscal stimuli will be rolling off next year . . . and many investors have forgotten what visceral, stomach-churning risk feels like.

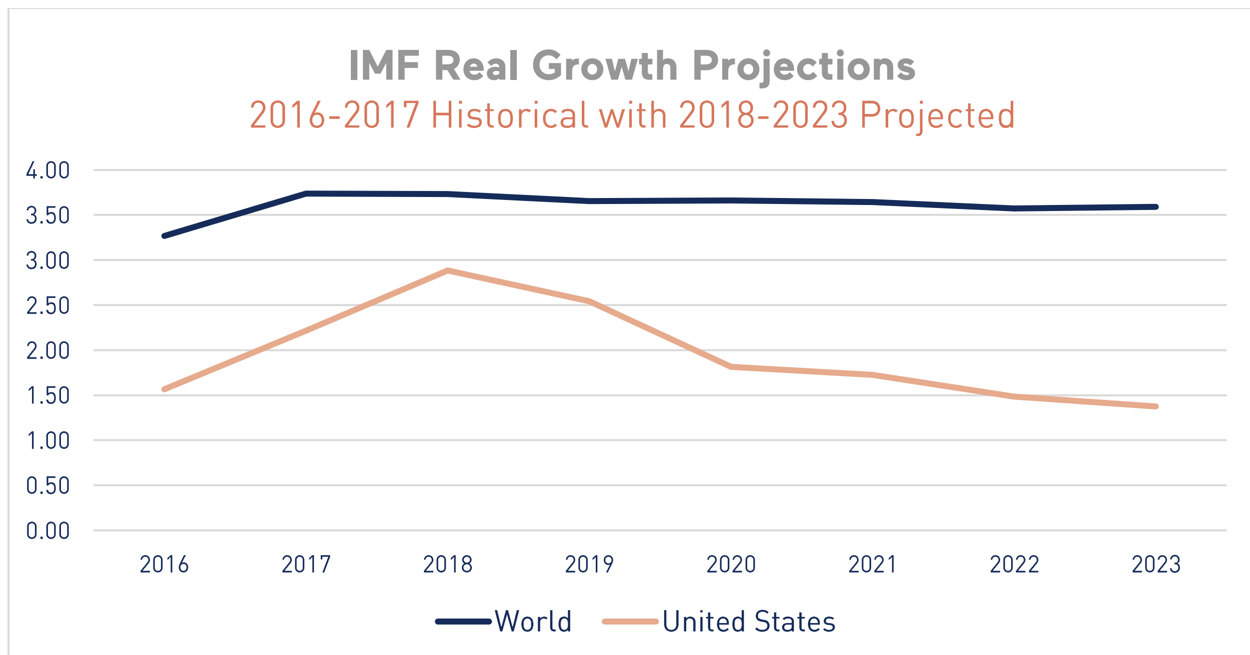
If all the above is true, why aren't we calling for an imminent crisis? Because, as always, there is another side to the story – which, in this case, is decent economic growth and continued moderate inflation.

Let's start with inflation. When you purchase a financial asset the only *tangible* thing you get is the promise of a future cash stream, called dividends for equities and a coupon or interest payment for bonds.

To calculate the current (i.e. *real* present) value of these future income streams, one needs to estimate how high inflation will be over the holding period of the asset – as inflation eats into the *nominal* value of earned cash flows. When inflation is very high (as in the 1970s and early 1980s), then the future value of dividends or coupons must be "discounted" by a larger amount (and vice versa.) The fact that inflation and inflation expectations have been unusually low for the past decade has helped stocks and bonds to trade at higher valuations than long-term historic averages. In the past year, inflation and interest rates in the US have moved up – putting pressure on financial asset valuations. That said, we agree with prevailing consensus expectations that inflation is likely to remain moderate for the foreseeable future (i.e. neither too high, *nor too low*) – which should be supportive of financial asset prices.

Turning to GDP, the current US market backdrop of strong economic growth, 2%-ish inflation and still accommodative monetary and fiscal policy, is reminiscent of the "Goldilocks" economy of the 1990s which supported long equity and bond bull markets. The US economy in 2018 grew above what is considered its long-term, non-inflationary trend growth rate - supported by de-regulation, tax cuts and the lagged impact of a weak US dollar in 2017. Change is afoot however. While we do not foresee a recession for some time, we do expect to see a little less "Goldilocks." After all, the Fed, has reached both its inflation and employment mandate, and is tightening; the US dollar is stronger; the cost of capital and labor inputs are rising; and equity earnings and profit margins are most likely peaking.

While US and global GDP growth estimates for next year and 2020 have been moderately reduced, the International Monetary Fund 2018 forecasts of above 2% growth for the US and about 3.7% for the world is still near decade highs. Accurate estimates of China's 2019 growth are difficult to predict – but for now, most observers believe the Chinese authorities will be able to engineer a soft landing from 6-8% growth levels, down to 4%-5%. To the extent these forecasts are well above recession levels, we take comfort.



So, what could bring on a market crash? Unfortunately, many things. The Fed could make a serious policy mistake; we could have a political crisis in Washington; the Chinese economy, the second largest in the world and a significant source of global demand, could slow precipitously; European growth could falter under pressures from Brexit, Italy and France, or

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the situation in North Korea, the Middle East could deteriorate badly.

Our point is that while there are good reasons to think this exceptionally long bull market has longer to run, there also are plausible reasons for thinking it may end sooner than expected. At a minimum, with an economy operating at full employment and much of the fiscal and monetary stimulus behind us – we know that we are getting closer to the terminal point of this economic cycle. Therefore, whether the markets "crash" next week or a few years from now, it is not too soon to begin thinking about how we will navigate the next crisis and about making some changes to our clients' asset allocation. With equities and credit markets as fully valued as they are, and investor complacency still high, we would be foolish to assume everything will be just dandy.

So how to prepare ourselves and our portfolios for a sharp market downdraft? Below are several suggestions.

MAKE SURE YOU'VE COVERED YOUR SPENDING

Do you know what percentage of your investment portfolio you spend every year? If it's 3% or less (good for you!), just make sure you are holding 15% of your portfolio in cash, Treasury bills, or rock-solid municipal bonds – i.e., five years of spending. Why five years? Because most bear markets are far shorter than that. Even in the Mother of All Bear Markets – following the Crash of 1929 – the markets only went down for four years (1929 – 1932) and then recovered spectacularly in 1933.

Even in the most recent Great Financial Crisis, markets plummeted from 2007 to 1Q-2009, but were above prior highs (in no small part because of Fed and government policy choices) within four years. To this latter point, we note that even though a market "crisis" may be relatively brief, there can be prolonged periods of market malaise (e.g. the 1970s) where markets basically move sideways for many years. We aim to fortify client portfolios so that they can not only support their spending needs and maintain purchasing power over a prolonged period - - but also, for a little icing on the cake, potentially allow them to buy assets at steeply discounted prices, when less prepared investors may be forced sellers.

But suppose you spend 5% of your portfolio, as charitable foundations are required to do? Many large endowments (and families) spend even more. According to our rule, 5% spenders should have 25% of their portfolios in very solid cash and/or fixed income. Few endowments have anything close to that, but that's because they are often investing with a **relative** return mindset. If they held 25% in bonds while other endowments held only 10%, they could

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underperform their peer group – and their CIOs would get fired.

But family investors aren't playing a relative return game because that game is usually only played with *Other Peoples' Money*. Since family capital is your own, you need to play an **absolute** return game. In absolute terms, getting killed during bear markets isn't deemed okay just because other people are getting killed. Unlike many endowments – most families cannot count on new sources of capital such as donor contributions, to replenish capital losses. We suggest that investors accept the modest reduction in returns during the later stages of a bull market in lieu of larger reductions in assets during bear markets.

REBALANCE WITHIN ONE'S LONG-TERM STRATEGIC ASSET CLASS (AND MANAGER) RANGES

Rule number one in investing is to be diversified across multiple asset classes (at least stocks and bonds or cash) and to have a long-term investment plan which includes acceptable asset class and sub-asset class/manager ranges. Such a framework provides asset allocation "guard rails", based upon long-term and non-emotional (i.e. reasonable) risk and return expectations. This is certainly necessary for long-term pools of capital that will be relied upon to meet future spending needs. So, a first step in bullet proofing one's portfolio for a crisis would be to re-examine the various asset classes and investment style allocations to ensure that no framework bands have been breached – and to check for any sub-asset class opportunities (e.g. unloved, uncorrelated and defensive) or particular risks (e.g. high beta or levered) where it makes sense to re-balance with the end of the cycle in mind.

It's true that this sort of portfolio rebalancing will likely incur tax costs, but this late in the economic and market cycle taking a tax hit to preserve gains likely makes sense.

RAISE CASH

One obvious possibility is to lighten up on exposure to the most highly valued assets. In recent years, when cash to two-year notes earned close to nothing and Treasury yields were far below earnings' yields and even dividends – investors pleaded "TINA": There Is No Alternative to owning stocks.

This plea ignored the fact that cash – unlike almost any other asset, at least holds its nominal value in a downturn and provides dry powder with which to invest when markets get cheap. But cash holds a stronger investment argument today with short rates roughly in line with inflation and intermediate-term fixed income securities even a little higher.

By gradually raising cash in portfolios until one arrives at their strategic minimum allocations

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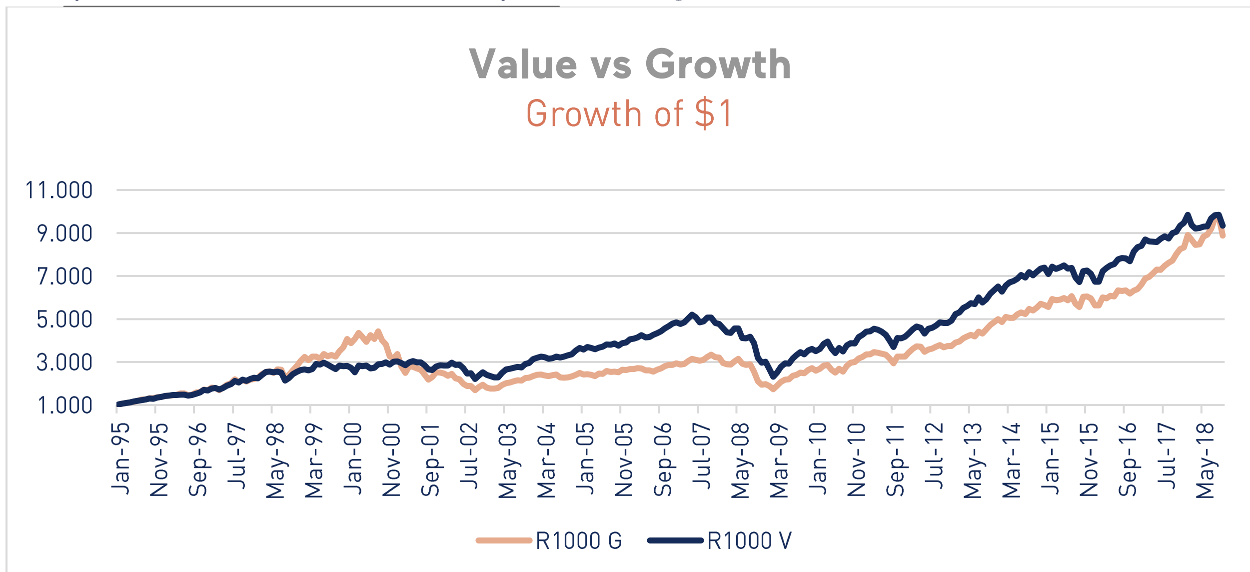
to both stocks and bonds, we can stay invested, but with lower risk. If the markets remain strong, we'll do well enough as we remain within long-term strategic allocation ranges. If the markets fall sharply, we'll maintain more purchasing power and have dry powder to reinvest at better levels.

BUY VALUE

If we can't bring ourselves to sell equities, we could at least sell or trim from the high-flying growth sectors/stocks and add to value. Since the Great Financial Crisis through 3Q2018, growth investing outperformed value by almost 1,600 basis points (the largest amount since 1985.) As we have seen in recent market pullbacks though, growth stocks have been the hardest hit.

If you still feel hesitant – it may be helpful to keep in mind that during the late 1990s Tech Boom nobody – literally *almost* **nobody** – wanted to own value stocks. Tech and growth were all the rage with tech annualizing at 54.6% between January 1995 and March 2000 versus 22.0% for the Russell 1000 Value index. Yet, in the Tech Bust - Growth fell -80% from 2000-2002, while Value barely entered "bear market" territory @-22%. Ergo…



BUY PUTS

Forget it. Unless you're an experienced investment professional this is what will happen:

You buy a put.

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The put expires unexercised.

You buy another put.

That one also expires unexercised.

You realize how much money you've wasted, and you stop buying puts.

The market crashes.

STRESS TEST YOUR PORTFOLIO

Sometimes, it is helpful to take our existing portfolios and "stress test" them by subjecting them to various historical events. How, for example, would our current portfolio have done in the crash of 2008? In 2000-2002? In 1973-1974? And what about in the overlapping sideways markets of 1968-1982?

Then, while cognizant of these potential devastations, we need to ask ourselves three questions. First, could our life-style and philanthropy survive a similar calamity? Second, would we be able to withstand the pressure to sell out and go to cash at the very bottom of the market? And third, how much do we really believe the answers we just gave ourselves to questions 1 and 2?

> *I'm less interested in the return* on *my money than in the return* of *my money.* -Mark Twain

The fact is that nearly every investor has one risk tolerance when markets are strong, and another, very different, risk tolerance when markets are collapsing. Therefore, although stress testing can be useful, we need to take it with a grain of salt.

THINK BACK TO HOW YOU BEHAVED IN 2008

Be honest, your future wealth depends on it! Then grade yourself like this:

"I went into the crisis with lots of cash, sold nothing during the crisis, and when markets got cheap I bought everything in sight." Give yourself an A+. (For real??!!)

"I was frozen into immobility and was sure the world was coming to an end, but I didn't sell, just rode it out." Give yourself a B+.

"I bought on the dips right up until Lehman went bust and then I panicked and sold like crazy." Give yourself a C-.

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(No, there aren't any Ds or Fs because this is the era of unhinged grade inflation.)

> *Would I say there will never, ever be another financial crisis? I hope that it will not be in our lifetimes and I don't believe it will be.* -Janet Yellen

In addition to the steps we've just outlined above, another way in which investors can prepare themselves for the next market crisis is to: **write down a plan for how you will invest through the crisis**. Today markets are great, the economy is strong, volatility is low, we're calm and serene. Now is the time to memorialize our best thinking about how to behave in a market crisis. If we wait until the crisis is crashing down around our ears, it will be too late – we'll be terrified, sleep deprived, certain we're going broke, and unable to think straight. So, let's prepare a memo to ourselves and attach it as an exhibit to our investment policy statements. (You **do** have a written investment policy statement, don't you?) Our memo might look something like Exhibit A, attached to this paper. All that remains is to read it, memorize it, and sign it in blood.

This paper was written by Ann Thivierge, Managing Director, Gregory Curtis, Chairman, and Chris Fineburg, Director, of Greycourt & Co, Inc. Please note that this presentation is intended to provide interested persons with insights on the capital markets and is not intended to promote any manager or firm, nor does it intend to advertise their performance. All opinions expressed are those of Greycourt & Co., Inc. The information in this report is not intended to address the needs of any particular investor.

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EXHIBIT A: Managing Portfolios During Significant Capital Markets Dislocations

The purpose of this memorandum is to set forth now, while markets are calm (and so am I) an outline describing how I plan to manage my portfolio during the next market crisis.

THE LIKELIHOOD OF ENCOUNTERING SEVERE MARKETS

If investment returns were truly randomly distributed along the familiar Bell Curve, then extreme market conditions would be quite rare and most investors would have little reason to worry about them. In fact, however, investment outcomes are **abnormally** distributed, that is, they have "fat tails." Extreme outcomes are much more common than we might expect.

Just within the last half century, extreme market outcomes occurred in 1973-74, 1987, 1997, 2000, and 2008. Some of these negative markets were, if truly random, 25 standard deviation events – that is, they would not have been expected to occur even over billions and billions of years.

Successfully managing portfolios through market crises is key to the preservation of the family's capital, since mistakes made during such periods can be catastrophic. For example, most investors who panicked and converted their portfolios entirely to cash during the severe market conditions mentioned above never recovered from the losses they incurred.

NAVIGATING TREACHEROUS MARKETS

The process of navigating treacherous market conditions consists of a series of steps beginning before the crisis happens and continuing well after the crisis has passed:

a) **Market crises don't happen out of the blue.** They almost always begin with a long period of appreciating prices which eventually exceed reasonable valuation levels as measured by historic metrics. Thus, the first step in dealing with treacherous markets is not to "drink the Kool-Aid" in the first place. As prices rise well above historic norms, thoughtful investors will begin to take profits off the table, reinvesting in lower-risk assets and maintaining their long-term asset allocation targets. It is important to remember that as equity prices increase and, therefore, equity allocations in the portfolio increase, the risk level of the portfolio increases far beyond the level originally established as appropriate for my family.

b) **Prices eventually lose touch with reality.** As equity prices continue to rise, losing touch with any sense of economic reality, I will begin to sell enough stocks to move below my target equity

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allocations and toward my minimum equity allocations. With pricing at extreme levels, the risk is all on the downside, and therefore even target equity allocations are dangerous to the health of my portfolio. I also recognize that losses are more harmful to my capital than gains are helpful. To take an extreme example, if a $1 million portfolio rises 80% it will be worth $1.8 million. If it then declines by 80% the capital will be worth only $640,000. (This exact math occurred to investors in technology stocks in the late 1990s and early 2000s.) Of course, it is difficult to measure precisely when markets are approaching extreme levels of pricing. However, traditional metrics such as the price/earnings ratio (or the Shiller P/E ratio), price-to-book ratio and dividend yield are all useful indicators.

c) **Being patient is key.** Patience is required during stages (a) and (b) because markets will still be rising and other, less thoughtful, investors will be making better returns than I am. As noted, however, the risk they are exposing their portfolios to is growing rapidly. At the same time, I will remember that it is typically unwise to allow my equity allocations to fall below their minimum range, as this puts my portfolio too far out of the market. In addition to lightening up on equity exposure, I will also consider engaging more defensive managers and avoiding capitalization-weighted index funds or ETFs.

d) **Market crises always present opportunities.** Eventually, equity markets will reprice, that is, they will decline in value, and investors who have continued to own – or worse, have continued to buy – overvalued stocks will get clobbered. In the broad panic, investors will sell stocks in large quantities and equity prices will often plummet far below fair value as measured by historic norms. At this point, most investors will be in a state of shock and unable to think sensibly about market valuations. However, investors who were less exposed to equities (as I will be) will be presented with an opportunity to buy back into the market at attractive prices.

e) **Buying back in.** I will begin to repurchase equities at approximately the point when stock prices have fallen below their long-term averages and will continue to buy as stock prices decline until I have reached my target equity allocations. I may even continue to purchase stocks until I am above my target allocations (though not above my maximum allocation), so long as attractive pricing remains available.

By the time the economic crisis is over and stock prices have resumed their normal valuations, I will – by following these steps – have outperformed the great majority of other investors and will have significantly increased my wealth while others were losing theirs.