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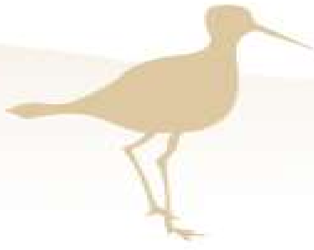
Sandpiper Capital

Gleanings



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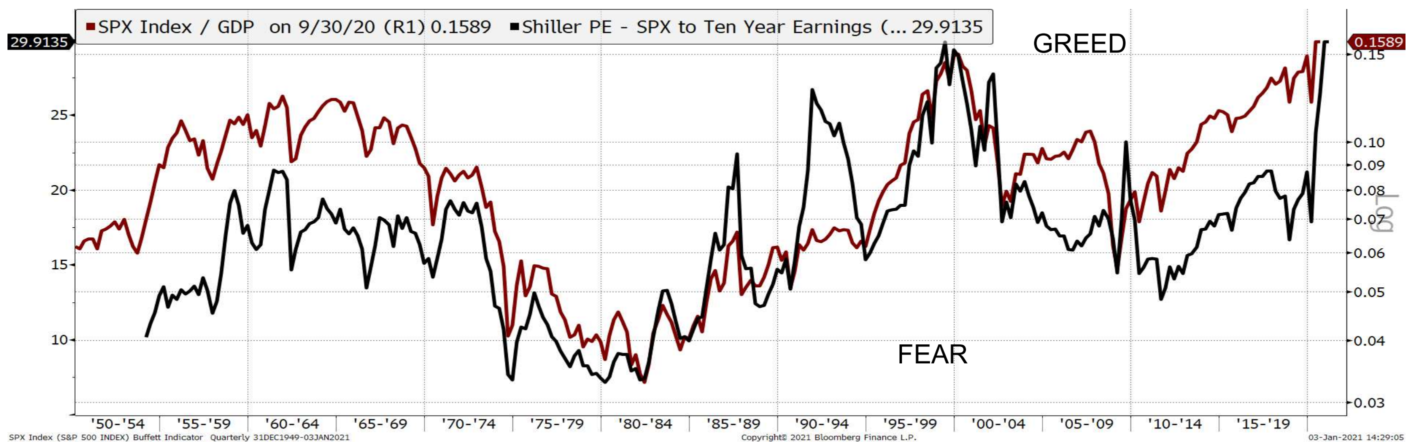
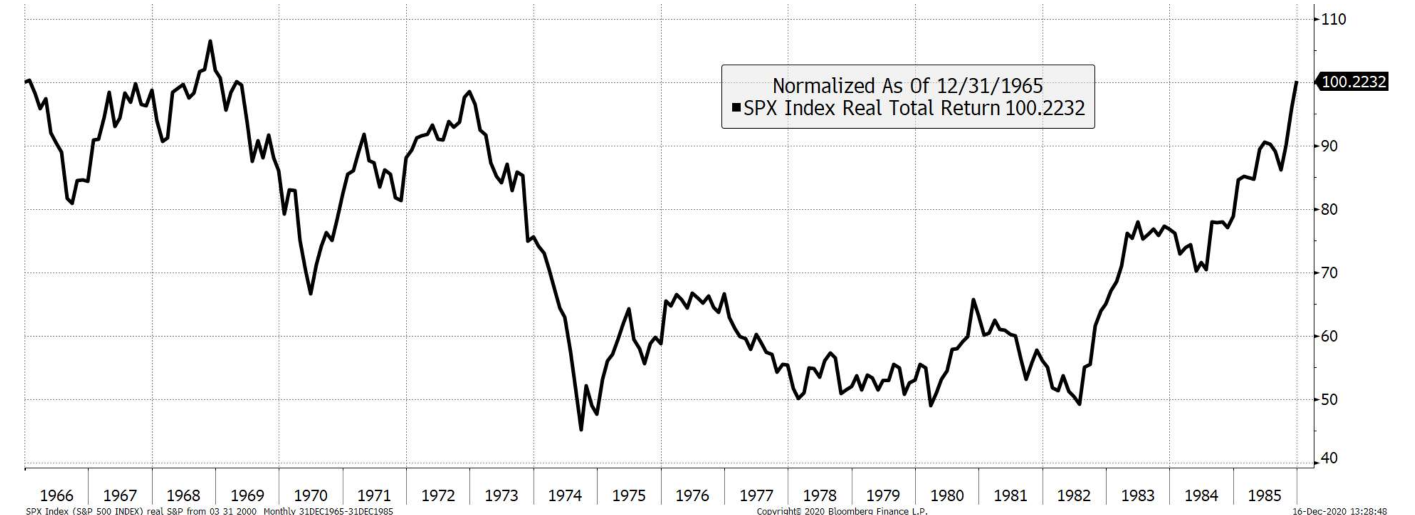
Eyes on the Horizon

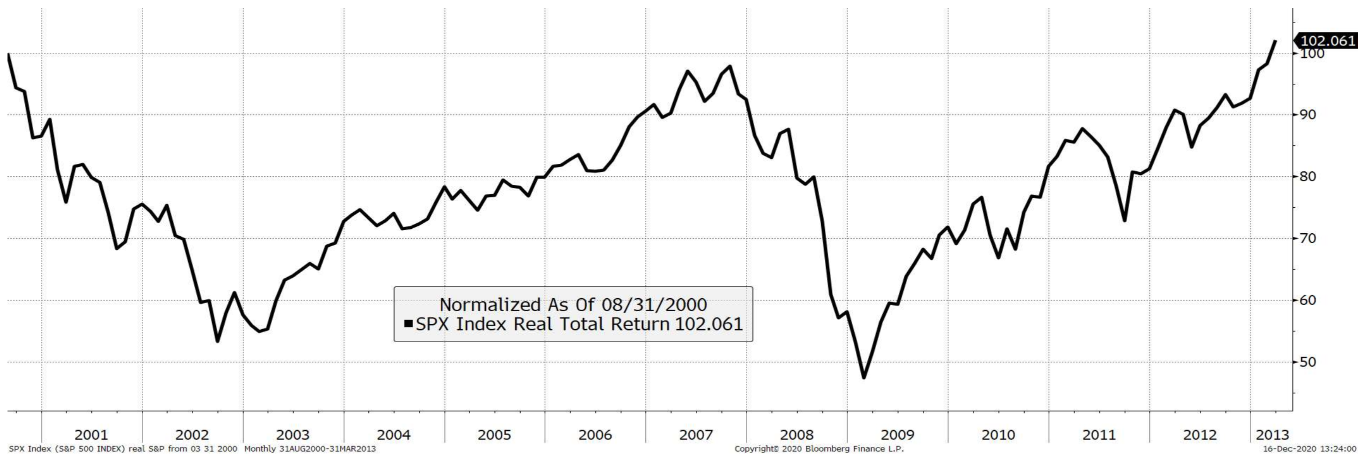
Market Returns Annually

Index	2017	2018	2019	2020
S&P 500	21.8	-4.4	31.5	18.4%
ML 1-5 yr Gov't/Corp	.4	1.2	5.1	4.7%
EAFE (Dev Fgn Mkts)	25.1	-13.8	22.0	7.8%
Emerging Markets	37.9	-14.5	1.0	18.5%

Taking a break from exploring the problems in the economy and the markets that we are likely to see in 2021, I thought I would re-visit the rationale for holding a small portfolio of attractive stocks through the dips and flips that will inevitably come to pass. While it is evident that the stock indexes will move to unsustainably high (or low) valuations depending upon the over-arching mood of market participants, the transition from greed to fear and back are an inevitable part of the human emotion that affects the decision making process. In the current environment the prevailing sentiment of complete confidence in the government's ability and willingness to support securities' prices has pushed valuations to seven decade highs. (See the chart immediately below.) The obvious concern is that when that confidence fades, so too will valuations. In the past, the S&P 500 index has faced challenges in continuing to produce positive returns while enduring a large shift in sentiment. The next two charts illustrate the past performance (in inflation adjusted total returns) for those who invested in an S&P index fund at the only two previous dates when valuations were this stretched. In one case, it took twenty years to break even, in the other; thirteen. In both cases, holding through a -50% downdraft was required. While we don't know what the future holds, this is certainly a time to be cautious.







So again, I find myself being super-cautious when everyone else is being aggressive and primarily invested in safe money waiting for better prices while everyone else is "all in" for the equity market. Which in an ultra-low interest rate environment is a challenge in itself. Working on the solution to the problem of managing the risks that the market faces and the mandate to maintain the value of the principal that clients have invested with me, I think it's reasonable to assume that having a little exposure to stocks makes sense even if I have doubts about the market. A 50% drop in the value of your stocks is a lot easier to take if your portfolio only has a 15% to 20% in stocks. You'll also find that the fairly significant positions in Treasury funds you own benefit from the "flight to quality" that happens when the market drops. For your account that means taking advantage of opportunities that may come up at year end when good companies with temporary challenges often see their stock prices come down on tax loss selling. In the chart below are back-tested results for a portfolio that is 80% bonds and 20% stocks from my year end bargain screen. Obviously, these are just back-tested results, without fees or commissions or the market impact of buying and selling, but I think the point is clear. If by reducing your percent allocation to stocks, you can limit the drops to manageable levels, you are better able to stick with the stocks you do own, benefiting from the upward trend in the markets. I do have a few potential buys that look attractive and in coming weeks will be investing a (small) proportion of your account to see if the twenty year history illustrated below can extend out in the same way in spite of the market's challenges. You may see drawdowns like the few I've marked on the chart, but I believe the long term potential returns are worth it.

Tom Lukic