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Sandpiper Capital

Gleanings

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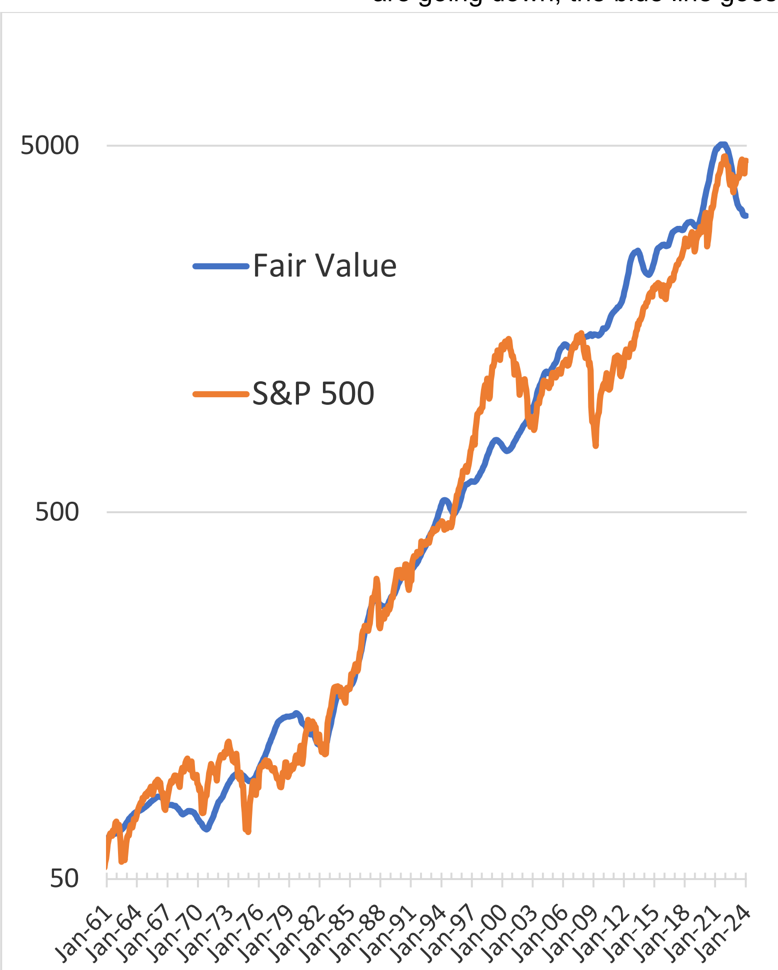
Market Returns Annually

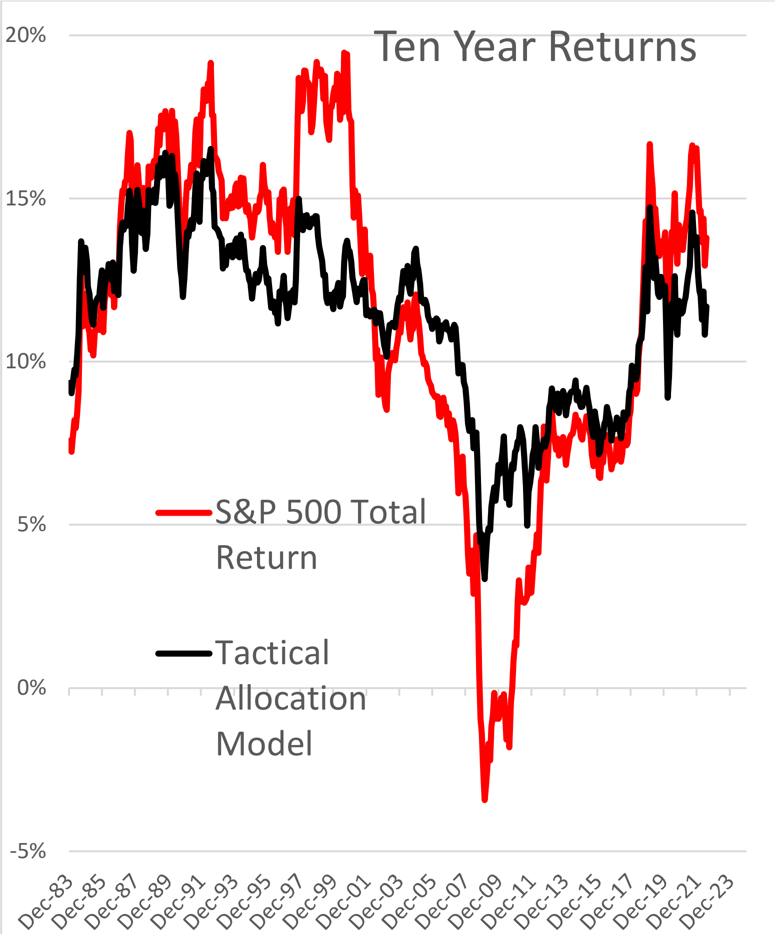
Index	2020	2021	2022	2023
S&P 500	18.4	28.7	-18.3	26.3%
ML 1-5 yr Gov't/Corp	4.7	-.9	-5.5	5.2%
EAFE (Dev Fgn Mkts)	7.8	11.3	-14.4	18.2%
Emerging Markets	18.5	-2.5	-20.9	10.1%

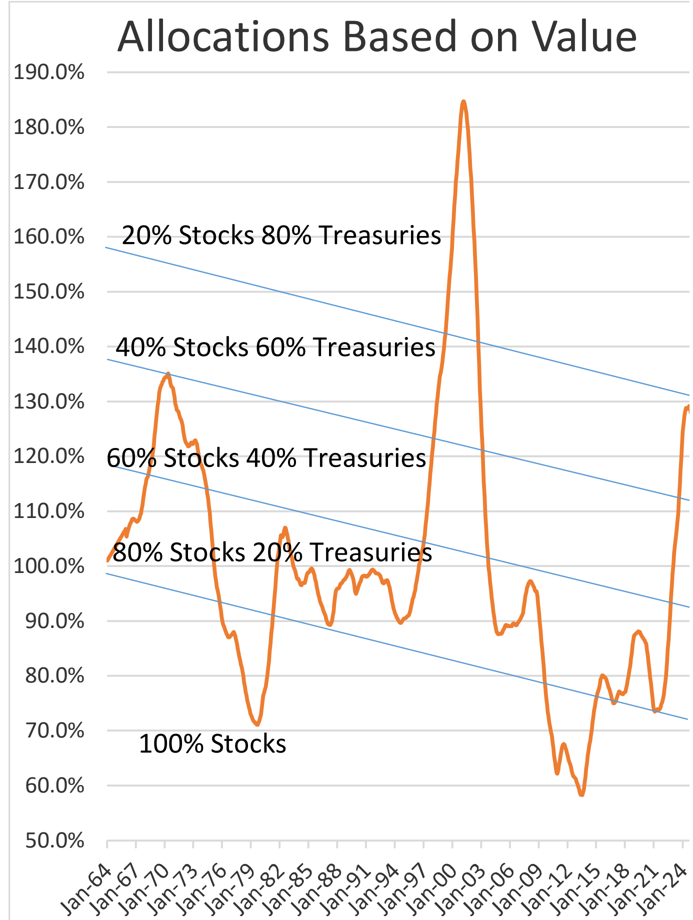
Professional judgement

While economic reality changes very slowly, the markets often make wild swings month to month, sometimes day to day. The herd that constitutes market participants are (mostly) humans, facing all of the challenges that we find in living In an uncertain world. Unfortunately, this means that we tend to let our biases impact our judgement and collectively, we will err in our assessment of complex systems like the markets. Blue Chip economic forecasters are notoriously bad at predicting market metrics like interest rates and stock market changes, with those who are accurate one year totally missing the mark the next. The conclusion of researchers into these failings (Tversky and Kahneman* come to mind) is that simple rules applied diligently will outperform expert judgement routinely and they have a lot of evidence to back that up. With that in mind, Sandpiper Capital is adopting a simple rule for taking stock market risk. That is; when the stock market is richly valued relative to the economy we will own fewer stocks and visa versa. The chart below shows the S&P 500 in orange and the economy (personal consumption spending weighted by interest rates) in blue. When times are good with people having money to spend and especially when interest rates are going down, the blue line goes up. Sixty-three years of falling rates and increasing consumption have increased the value of the economy by a factor of 100 with the stock market reflecting that growth with a similar gain. But the trip has not been smooth. Anyone who bought an S&P index fund during the go-go years of the early sixties or during the market euphoria of the late 90's found themselves still underwater ten years later. That's a long time to wait for something to work out. Conversely, even though the headlines were pretty scary in 2009 and there was substantial doubt about the integrity of the markets after the great recession, rates were very low and consumers quickly amped up their spending pushing the value of the economy substantially higher. (The peak value at 5000 in 2021 was a combination of exceptionally low rates and exceptionally high stimulus financed consumption.) With rates approaching more normal levels and consumption beginning to plateau, fair value has dropped while the market has levitated. If we don't want to predict the future, objectively a simple approach that makes modest, infrequent changes to your stock allocation based upon objective, sensible measures seems warranted. In the two charts on the reverse, you'll see how that's applied. With only fourteen changes since 1964, acknowledging discrepancies between market price and market value would have eliminated those failing ten - year index events, with the worst ten year returns much less frequent and severe. It also would have kept you in the market (an average of 80% invested for "Growth" accounts) so as to capitalize on all that economic growth.

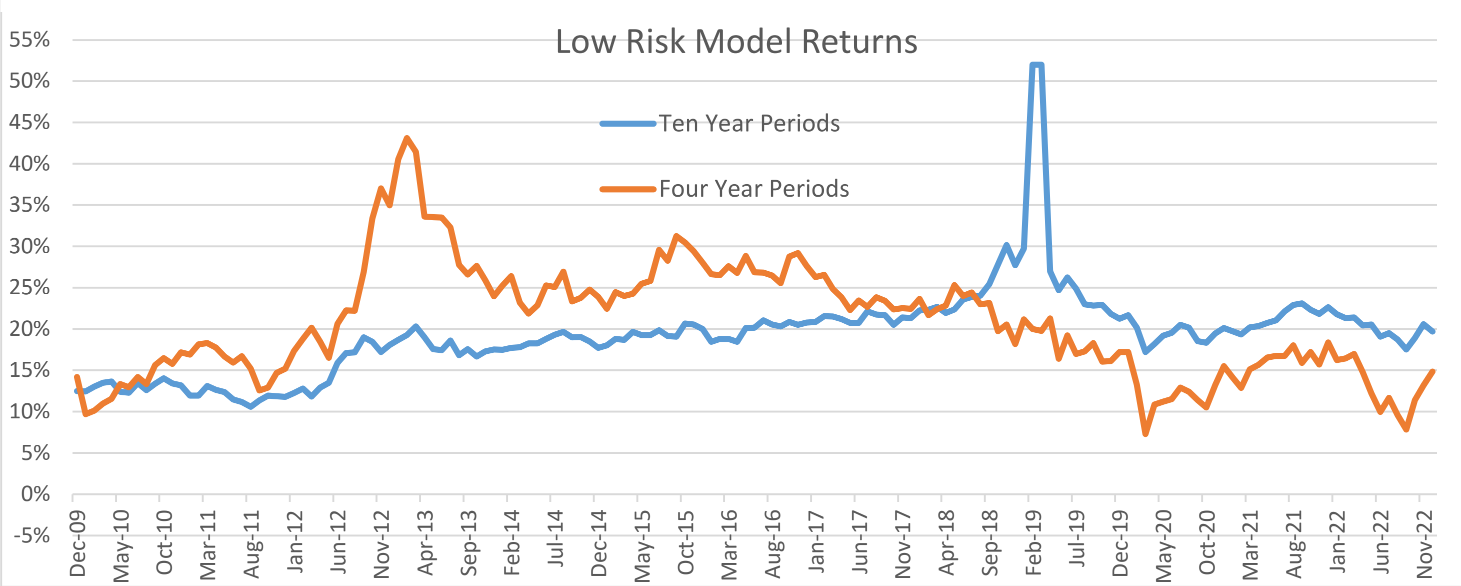


*"Noise - A Flaw in Human Judgement" by Daniel Kahneman is a long but groundbreaking work.





The results above illustrate model returns for an investment in the S&P 500 index and that certainly is a time-tested and valid way to go. Illustrated below are the results of buying a portfolio comprised of the S&P 500 stocks that have the lowest risk (the steadiest cash flows) and the highest profit margins of any in that index. Selected by those simple rules, most of the market risk, at least for a holding period of ten years, is eliminated with 11% annually the worst (backtested) case. Again, these are model portfolio returns which don't include management fees or portfolio costs and come during a period of substantial economic growth. I do think the idea has merit and certainly, intuitively, owning the lowest risk stocks in the S&P index seems like a quite conservative way to proceed. If the goal is to eliminate noise and bias, these simple rules for managing portfolios ought to give better performance over time than my (or any professional's) best judgement. (I'm especially encouraged that all of the 156 four-year periods since 2009 have also been profitable). Again, this was a very favorable time for the economy, but also included 2005 to 2009, when the S&P would have still been underwater. If, like me, you are always worried about a market drop, then a strategy that works well even when you buy at the top of the market is pretty compelling.



Tom Lukic