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Investing in a World of Bubbles

One of the more fascinating aspects of the financial markets is the frequency and significance of price anomalies (*i.e.* bubbles where price is materially higher or lower than true value). Price is the place where buyers and sellers meet, and you would think that knowledgeable buyers would help to set prices (for all) at levels that are reasonably close to true value. However, if this worked as effectively and efficiently as it appears it should, we would not find ourselves in situations where masses of people with all levels of knowledge are on one side of the buying or selling equation - to such a degree that in some cases abnormally high or low demand causes prices to be off as much as 20% to 50%.

The movie *The Big Short* did a fantastic job of highlighting the structural flaws in the banking system that served as a major contributor to the real estate bubble in the mid-2000s. However, there were other significant factors that led to that outcome, including what we will call the "crowding" of people on one side of the transaction. This crowding effect was caused by people reacting to historically low interest rates, relaxed lending standards, and short-term increases in real estate values that stirred national excitement.

Crowding was also caused by the fact that nationally we either lost sight of or did not understand the relationship between price and value. While interest rates were relatively low, national employment and income could only support and sustain a certain amount of mortgage payment - and therefore a certain level for house prices. In other words, we were in trouble once home prices meaningfully exceeded sustainable levels, which are determined by a normal level of demand where Americans can reasonably make their mortgage payments.

The true underlying value of securities within a market should set price for the overall market, and on an ongoing basis, prices should not materially deviate from true underlying value. However, a key contributor to periods when prices differ significantly from values is the incredible challenge investors face when attempting to calculate true value. There are so many variables that can potentially impact the value of a security (*e.g.* Apple's stock), and the impact of any one of the variables is very difficult to predict (it could be negligible, or it could be material). For these reasons, there is no magic formula for calculating true value or the perfect price of securities or markets. If there were, significant price anomalies would not occur because investors would know with certainty where prices should be for an asset class.

The closest option we have for determining the reasonableness of price relative to value is historical norms. However, even with metrics like price-to-earnings ratios (P/E) for the stock market, significant changes in earnings can cause the ratio to vary more widely than expected, potentially sending misleading signals. For example, the long-term average (since 1926) for the Schiller P/E, which is a version of the ratio that takes into account S&P 500 earnings over the past 10 years, is 17.8. The current Schiller P/E is 26.4, but it is important to note that trailing 10-year earnings include the period of very low or non-existent earnings during the Financial Crisis, which is inflating the ratio since the divisor is

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Benchmark Performance	Sector	Quarter	YTD	1-Year Average	3-Year Average	5-Year Average	10-Year Average
Index: Russell 3000 TR	Total US Stock	4.40	8.18	14.96	10.44	16.36	7.37
Index: S&P 500 TR	Large Blend	3.85	7.84	15.43	11.16	16.37	7.24
Index: Russell 2000 TR	Small Cap Stock	9.05	11.46	15.47	6.71	15.82	7.07
Index: MSCI ACWI ex-US IMI NR USD	Total Foreign Stock	7.05	6.08	9.81	0.62	6.37	2.47
Index: Barcap Aggregate Bond TR	Bond	0.46	5.80	5.19	4.03	3.08	4.79
Index: US Treasury Bill 3-Month	Stable Value	0.08	0.22	0.26	0.11	0.09	0.83

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smaller. *If you divide by earnings and earnings are lower, you get a higher P/E.* The market may or may not be overvalued now, but the money managers we utilize do not believe current prices are as out of line as the current Schiller P/E would indicate.

The housing bubble in the mid-2000s and the technology bubble of the late 1990s stand out in our minds as historic events, but it is important to recognize that price anomalies happen quite often in the asset classes that impact us the most (*e.g.* real estate, commodities, bonds and stocks). Additional examples of recent bubbles where prices were too high or too low include oil at $145 a barrel in July of 2008 ($50 a barrel today), the S&P 500 Index at 676 in March of 2009 (2,125 today), gold at $1,895 per ounce in September of 2011 ($1,255 per ounce today), and oil at $26 a barrel in February of this year (again, $50 a barrel today). *Of course, the prices of these assets today could be off, but it is unlikely they are off enough to change the fact that these were points where price anomalies were present.*

It is also important to recognize that bubbles occur <u>within</u> asset classes more frequently than they do for the asset class as a whole. The Russell 3000 Index, which represents the total U.S. stock market, could be perfectly priced, but if one-half of the index (in terms of market value) is 10% overpriced and the other half is 10% underpriced, anomalies exist within. This actually creates opportunity for money managers who have the experience and knowledge to identify the anomalies and properly position their portfolios to take advantage of them.

> "Bubbles arise if the price far exceeds the asset's fundamental value, to the point that no plausible future income scenario can justify the price."
>
> *- Justin Fox*

Regarding current market conditions, one of the ways low interest rates have had an impact on stocks illustrates how anomalies within an asset class are formed and create opportunity. For a variety of reasons, including an aging American population, there is high demand for investment income. However, low rates have made it difficult to obtain this income with relative safety, since high quality bonds are yielding less today than they have historically. As a result, investors have looked for alternative sources of income, which has led them to high-yielding sectors of the stock market (*i.e.* sectors that contain high dividend paying companies). The strategy was a prudent one at the onset, but unfortunately, crowding has now occurred and the unusually high demand has caused price to exceed value for many of these sectors.

In our 1st quarter newsletter earlier this year, we spoke to the popularity of index funds and provided some context with which to measure the exceptionally strong run of performance they have had relative to the average active stock manager since the Financial Crisis. However, what we did not highlight in that newsletter is index funds buy everything within the index, whereas savvy money managers have the opportunity to avoid and take advantage of intra-market price bubbles. For example, a number of our value teams have been net sellers of sectors that pay higher dividends due to the fact they believe stock prices within these sectors are too high. Instead, they have invested in other areas of the stock market where the crowd has left opportunity.

To beat the market, you have to be different than the market. John Bogle, the founder of Vanguard, would argue that beating the market with any level of consistency over time is highly unlikely, and he is correct when the comparison is made with the average money manager. However, those who use active money managers should only do so if they are investing with the elite teams in the business that have the experience, expertise, and resources necessary to appropriately determine the reasonableness of prices relative to underlying value. With this said, to be truly successful with active managers, you must be patient when they position themselves away from the crowd, since corrections in prices can take time to occur. *The average investor is not equipped to identify the top active fund management teams and is unlikely to have the patience with teams while they wait for market anomalies to correct; therefore, low-cost index investing is a prudent approach. Of course, we assist our clients with identifying the top teams, being patient with them when necessary, and using indexes when it is prudent to do so.*

It is our hope that investors have learned lessons over the past 20 years that will help asset class prices more closely follow underlying values, but our hope is tempered by 1) the incredible challenge investors face in determining appropriate price and valuation levels, 2) high appetites for return in a lower return environment, and 3) the fact that meaningful price anomalies are still happening today. The lesson to be learned as investors is to use strategies that reduce the potential of being adversely affected by price anomalies. These include buying incrementally over time (to avoid buying a material amount at a high price), selling incrementally over time (to avoid selling a material amount at a low price), avoiding the temptation to make major changes in asset allocation based on short-term performance, using the top active managers in the business who are better equipped to evaluate price relative to value, and having the patience with managers when they believe market anomalies exist. Investing is not easy, but employing these strategies should increase your odds of success in a world that continues to crowd on the buy or sell side of transactions.

Market Commentary

Following a volatile end to the 2nd quarter with a surprise decision by the U.K. to exit the European Union, stocks rebounded around the globe and posted respectable gains during the 3rd quarter. In the U.S., positive signs related to labor, inflation, housing and consumer spending, indicated the U.S. economy is continuing to modestly advance. Within the U.S., higher-yielding sectors (*e.g.* Utilities, Real Estate) led the market through midyear, but this trend reversed course in the 3rd quarter and more economically-sensitive sectors (*e.g.* Technology, Financial Services) made up some ground. Internationally speaking, accommodative central bank policy and positive improvements on the manufacturing front overshadowed the otherwise lackluster to modest economic data and provided support for a positive advance in international equity markets. In fact, foreign stocks outperformed domestic stocks by a wide margin in the 3rd quarter, but they continue to trail for the YTD period.

Regarding fixed income, bond returns were modest in the 3rd quarter as interest rates incrementally rose. The rise in rates was driven entirely by anticipation of Federal Reserve ("Fed") action. Specifically, improvements in the U.S. economy led many to believe the Fed would raise rates in September (for the first time in 2016). However, in an uncharacteristic split decision, the majority of Fed officials decided to leave rates unchanged while setting the expectation they will likely raise rates one time later this year. Due to a relatively calm market environment and strong demand for yield, risk-on bond sectors such as High-Yield Corporate and Emerging Markets bonds performed well, while U.S. Treasuries posted modest losses.

Moving forward, it appears investors have been primarily focused on two main factors: the upcoming presidential election and the Fed's uncertain path to raising interest rates. Given the uncertainty of these factors and an overall balanced picture for the global economy, it is increasingly important to remain diversified and maintain the proper long-term perspective.

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