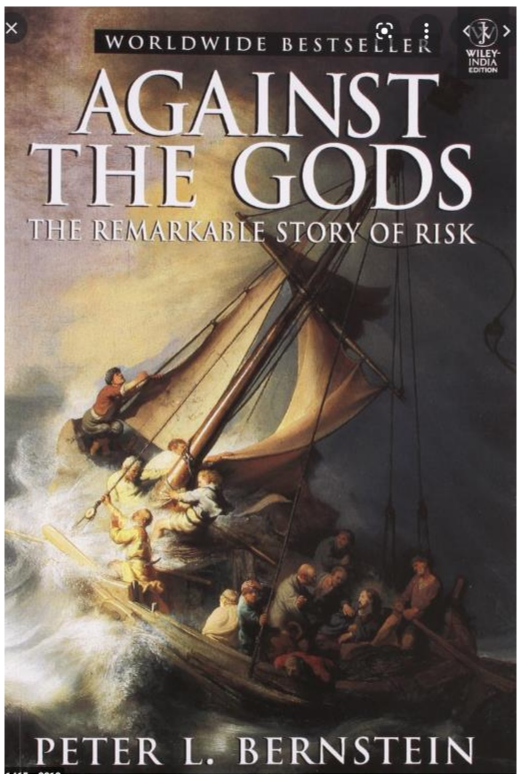
MEDALLION WEALTH MANAGEMENT

August 2021 Market Commentary

Against The Gods



"Our lives teem with numbers, but we sometimes forget that numbers are only tools. They have no soul; they may indeed become fetishes."
-Peter Bernstein

There's something about the slower pace of summer that makes me a bit more reflective and introspective than usual. And introspection is probably one of the most critical variables in becoming a successful investor, for if we don't understand our own mental and emotional processes how can we possibly hope to understand Mr. Market's psyche?

For me this introspective process begins with questioning my beliefs, knowing full well that I simply don't know how the future will unfold. Every year I'm amazed that certain events happened or didn't happen, despite what I thought should happen. In other words, the Gods were laughing at my certitude.

Which takes me to one of my favorite finance books of all time, *Against The Gods: The Remarkable Story of Risk*, from the equally remarkable Peter L. Bernstein. Even though this book was published in 1996; before the collapse of Long Term Capital, the internet bubble, the housing bubble, the Great Recession of 2008-2009, ZIRP, Quantitative Easing, the Pandemic and Modern Monetary Theory, it still has many useful history lessons that are relevant today, namely that we just don't know what the future holds.

For thousands of years humans viewed uncertainty and risk as something destined from on high. If a farmer needed rain, they would provide an offering to the rain God. If they were going to war, they would pray to a war deity, and so forth. It was only in the last few hundred years that humans decided to go "against" the Gods and learn probabilities.

As Bernstein writes, "The word 'risk' derives from the early Italian risicare, which means 'to dare'. In this sense, risk is a choice rather than a fate. The actions we dare to take, which depend on how free we are to make choices, are what the story of risk is all about. And that story helps define what it means to be a human being."

Mathematicians began to understand probabilities, calculating the odds of a seven being rolled in a game of dice, or the probability of crop failure depending on the amount of rain received. Knowing the amount of rainfall needed for a successful harvest led to the creation of dams and irrigation systems, and fewer human sacrifices.

Another way of looking at risk is presented by the Chinese word for Risk as shown below, Danger and Opportunity.

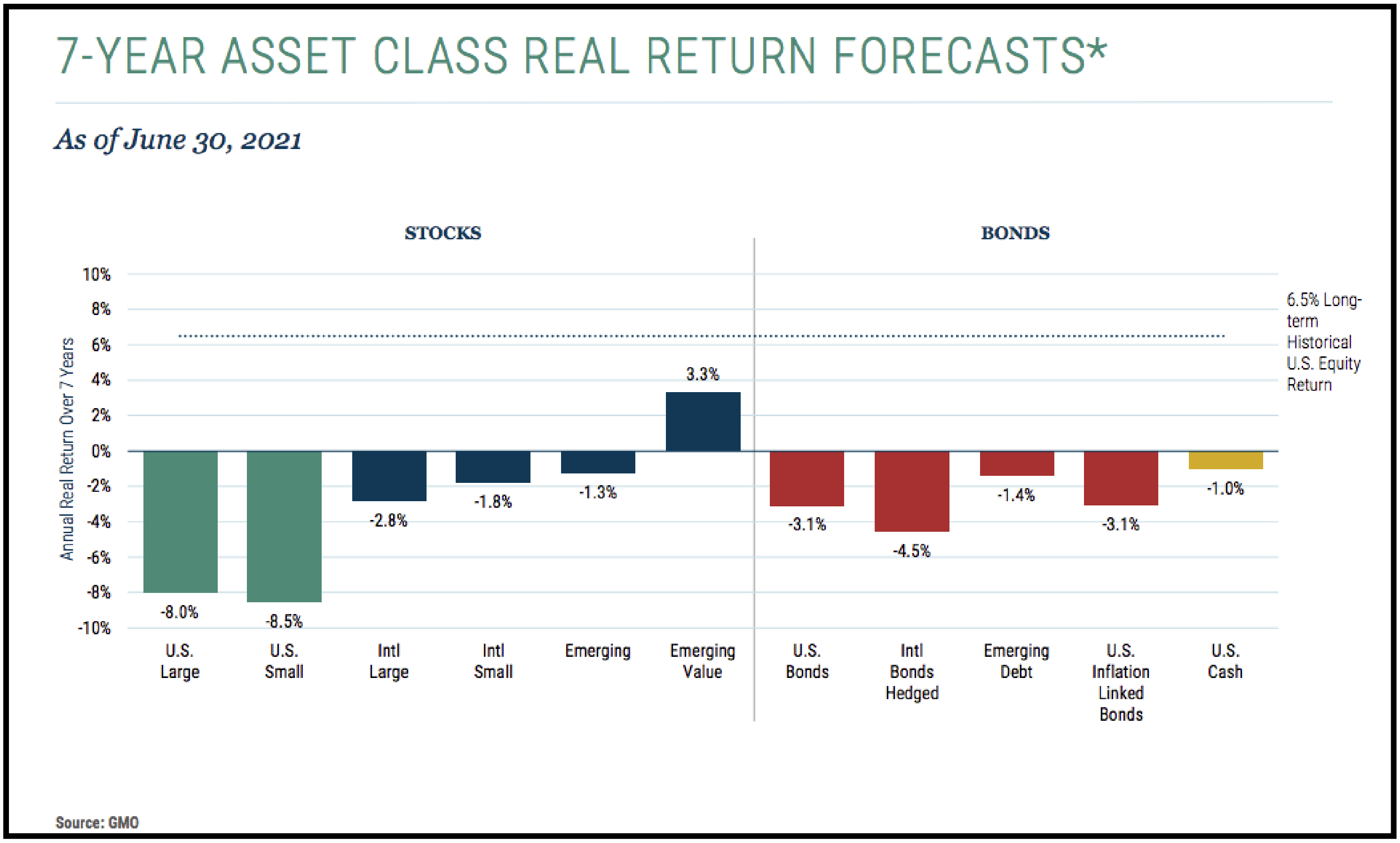
This is such a powerful observation because one of the key determinates of whether or not you should assume a risk is if you can handle the consequences. In our everyday lives we are faced with countless risks that we rarely even consider. Walking down the outside steps to get the mail presents many choices. What's the opportunity? Is there a check, a letter from a friend, or just bills and junk? What's the danger? Is the weather clear, and are the steps in good repair? Usually no thought is given to this task, but as we age and the weather turns icy and cold, we may view the danger greater than the opportunity. When analyzing whether or not to accept a risk we should not be solely focused on the opportunity, or the probability, but on whether or not we can **handle the consequences**. Can we recover if everything goes wrong?

Never has the power of risk analysis presented itself more forcefully than in our current pandemic. Our governments, and we as individuals have been (and continue to be) faced with a multitude of decisions on how best to manage covid risk. Everybody has different views on how this risk should be managed, from shutdowns to mask mandates, to vaccines, and stimulus payments, unemployment benefits, eviction moratoriums, etc. One of the biggest questions has been who decides what risks should be accepted or avoided, is it the state or the individual? I'm not about to wade into this minefield, but it is fun to watch.

Lets get back to the markets, and in particular investment risk. One of the key takeaways from Bernstein's book is that we simply don't know what the future holds and never will, therefore we need to focus on survival, **survival is the only road to riches**. Let me say that again: Survival is the only road to riches. You should try to maximize return only if losses would not threaten your survival and if you have a compelling future need for the extra gains you might earn.

The riskiest moment is when you're right. That's when you're in the most trouble, because you tend to overstay the good decisions. Once you've been right for long enough, you don't even *consider* reducing your winning positions. They feel so good, you can't even face that. Today in the midst of one of the greatest global health crises, we are sitting here in the U.S. with record levels of wealth, record high stock prices, record home prices, record car prices, and record low interest rates. How can you not feel good? This is exactly what Bernstein warned against, a level of hubris and arrogance that makes us believe that the risk of financial ruin is ever so slight. Today our focus should be on survival, not on increasing our levels of risk to maximize gain.

Lets just take a look at current valuations and future expected returns given today's valuations. The folks at GMO, Jeremy Grantham's firm, have been publishing their 7-year asset class real return forecasts for decades now and the results of their current forecast can be seen below. It's not a pretty picture. According to GMO, which largely bases their outlook on current valuations versus historic norms, an investor can expect to lose about 8% annually in U.S. stocks and 3% annually in bonds.



Now let's take this "outlook" with a grain of salt, GMO has been forecasting dismal returns for at least the last decade and they have been **VERY WRONG.** If we went back in time and looked at their 7-year forecast 7 years ago in 2014 we would have seen that they forecasted a 7-year return on large-cap U.S. stocks of -1.2%, and a return on U.S. bonds of 0.3%, the reality was U.S. stocks returned 17.6%, and bonds returned 4.3%. If you listened to GMO in 2014 you would have missed out on one of the strongest 7-year periods ever!

I'm not badmouthing GMO here at all, I've been equally too cautious over the last decade, sure I've had about 65% invested in stocks but I've carried way too much cash in hindsight. What I'm pointing out is what Peter Bernstein so eloquently articulated in his book, "So we pour in data from the past to fuel the decision-making mechanisms created by our models, be they linear or nonlinear. But therein lies the logician's trap: past data from real life constitute a sequence of events rather than a set of independent observations, which is what the laws of probability demand.[...]It is in those outliers and imperfections that the wildness lurks." **And what wildness we've had in the last 7-years!**

He continues, "The real trouble with this world of ours is not that it is an unreasonable world, nor even that it is a reasonable one. The commonest kind of trouble is that it is nearly reasonable, but not quite. Life is not an illogicality; yet it is a trap for logicians. It looks just a little more mathematical and regular than it is; its exactitude is obvious, but its inexactitude is hidden; its wildness lies in wait."

Yes, forecasting the future is a fools game, but don't we have to try and at least understand what our current risk levels are? Yes, of course we do.

As I've said recently forecasting returns in fixed income is pretty simple, if you buy a 10-year Treasury today you'll get about 1.15% annually for the next 10-years, and that's before inflation makes your real returns negative. Fixed-income is all the risk, no return.

Equities are another story, with massive amounts of liquidity flooding our markets, and record low interest rates, equities have been **the** place investors have flocked too. And as GMO shows, current valuations are at record highs meaning expected future returns are dismal. But as Bernstein shows, we just don't know. Rates in the U.S. may go negative, like so many other countries, which may drive even more money into stocks. Or inflation may get totally out of hand making only cash and gold look attractive. We simply don't know.

As I review my own portfolio, and prepare to spend a couple of weeks at the beach, I can't help but remember Bernstein's number one historic observation, **Survival is the only road to riches.** We must make sure we can survive the consequences of the risk we have taken. I feel pretty good about the cash I've raised by selling a large portion of my fixed income. I'm nervous about my equity holdings given the fact that they all trade at or near all-time highs, but am reassured that at least I know what I own and believe that these companies can survive in a harsh environment. If we have a sharp correction I'll have dry powder ready to deploy, if the equity market continues to rise I'll participate.

For now I'm focused on survival.

Be careful out there,

Chris Wiles, CFA

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