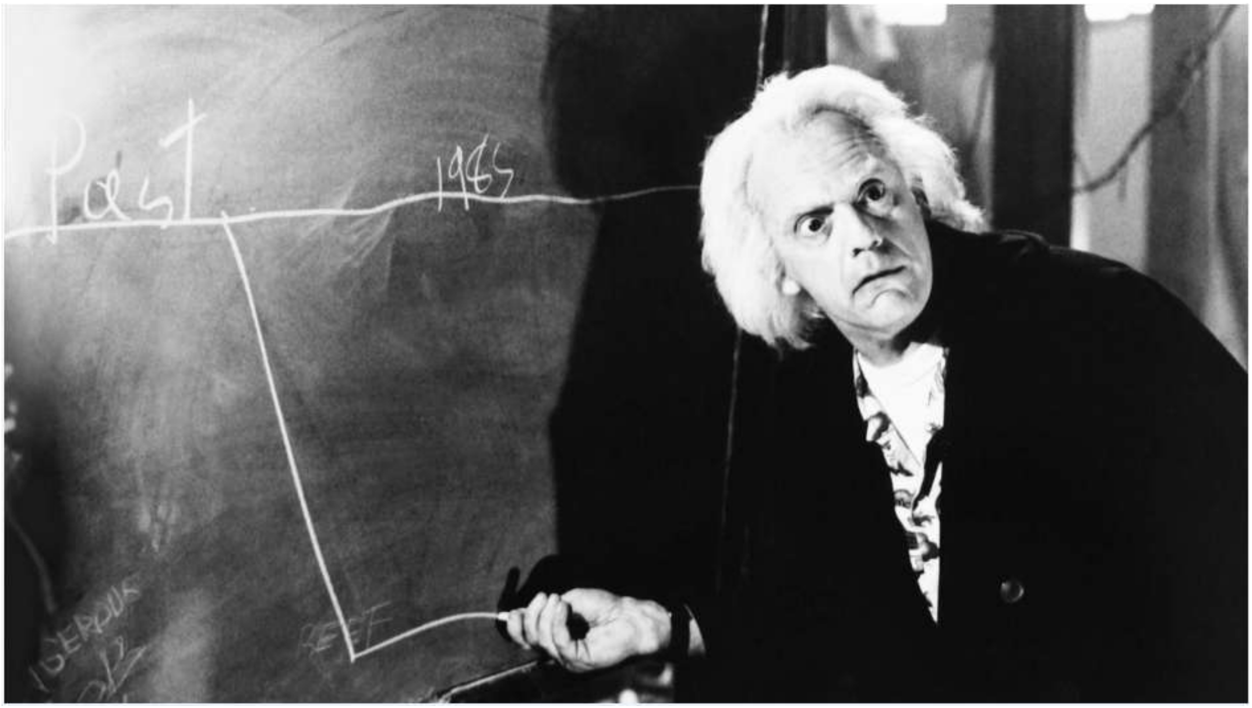
Lessons Learned

"It is difficult to make predictions, especially about the future." – A Danish Proverb, often attributed to Niels Bohr



With the market bottom likely behind us and less market uncertainty now than in the past two months, I wanted to directly provide my thoughts on where we are and the important takeaways from the crisis.

What looks obvious now with hindsight was largely unthinkable three months ago. For example, the Spanish Flu in 1918 was a public health catastrophe that killed 50,000,000 people worldwide and 675,000 in the US. While the current COVID-19 crisis is not over yet, it is relatively safe to say that the Spanish Flu was much worse. However, from peak to bottom the Dow Jones Industrial Average (DJI) fell just shy of 11% in reaction to the Spanish Flu pandemic. In contrast, the DJI fell 37% from the peak on February 12th to the bottom on March 23rd. Large swaths of the world and US almost completely shutting down for more than a month did not seem politically possible, yet looking back it appears inevitable.

I did not see the full scope of the crisis until it was too late. That being said, even if I had I would not have changed much. In order to successfully predict a market crash, you have to be able to first see the economic calamity coming before the rest of the market, and then predict precisely how the market will react to said calamity, as the economy and stock market are not perfectly correlated (in fact, they have very little correlation, if any at all). Being right once is hard enough. Being right twice, and getting the timing perfect is exceptionally challenging. While being a perma-bear and waiting a decade for each new panic to say "I told you so" looks prophetic when everybody is bailing, missing out on long stretches of market gains makes such a strategy suspect at best. In the long run, staying the course tends to work better.

In the midst of a panic, moving to the sidelines and missing the rebound is a greater risk than staying the course or being too early when buying. However, roughly timing the bottom is possible, but acting too late can be very detrimental. On March 20th I felt that the market would likely bottom the following week, and more precisely that it would bottom that Tuesday. It bottomed on Monday. While "close" in terms of time, the S&P 500 ended up 6% higher by the end of Tuesday. Despite being a day late, adding positions on Tuesday rather than wait for the Market to retest the low appears to have been the right call (though future Market movements could still refute this statement).

The economic news is not as bad for stocks as it appears on the surface. While breathless media coverage proclaims that we are seeing the worst unemployment numbers since the Great Depression, a large portion of this is due to the Government (rightly) changing the definition of unemployment to include people who are merely furloughed, or are independent contractors who aren't actively seeking another job. That's not to say that the situation for millions of people around the country isn't dire, because it is. However, the massive suffering at the individual level is unlikely to translate fully to further stock market losses. There is significant pent up demand for products and services that wasn't present during times such as the bottom of the Great Recession. Further, there likely won't be the political will to lockdown the country once more in the event of a COVID-19~~'s~~ second wave, meaning the impact on earnings will be significantly less pronounced than this Spring. Looking ahead, while we could still see a retest of the March lows, I don't see that as likely. In March the market was pricing in Armageddon, and while the news has been catastrophic from a public health perspective, uncertainty surrounding the bad news has decreased substantially, and it is uncertainty that most often results in sustained market downturns.

Reducing downside risk is hard while still trying to justify a management fee, and many of the instruments designed to do so don't. In my admittedly short investing career, QMNIX remains my biggest mistake, which we have covered ad nauseum in previous Worth Sharings. In short, QMNIX offered a Factor-based approach with 0 beta, which worked until it didn't. While potentially viable in the long run, managing maximum drawdown risk is very much an immediate term concern. Unfortunately, none of the alternatives we had invested in to fulfill the risk mitigation role functioned properly either in the midst of the panic. While most have recovered somewhat, the point of these funds was to mitigate the initial drawdown, which they didn't. Fortunately, many of our "risky" funds such as MTUM performed better than expected during the crash, which helped cushion the blow.

This isn't to say that products don't exist that reduce risk. For example, there is currently a Goldman Sachs Certificate of Deposit (CD) that yields 1.6% annually and, being FDIC insured, is functionally risk free. However, it is not possible for me to justify a 1% (for clients with individual positions) or even a 0.5% (for clients with funds only portfolios after the first year) management fee while investing a client in a product with such small potential upside. As such, in the future for clients with low risk tolerance, HCM will be recommending setting a portion of the portfolio outside of HCM's direct management that can be invested in such a product to reduce risk. HCM will then manage the "risky" portion of the overall portfolio. This will allow the client's risk tolerance to be met, while avoiding prohibitive management fees on low yielding products.

For somebody with a measurable risk tolerance, individual stocks do not appear advisable. It's too early to tell whether I will continue investing in individual stocks even for clients who are solely focused on capital appreciation, as the market needs to fully recover before determining whether individual IVA System picks (that rely on the Insider Buying and Value Factors, combined with analyst estimates) are worth the additional drawdown risk.

Expertise is paramount. On April 20th, I recall looking at plunging oil prices when they hit $10 a barrel and thinking that they didn't have much room to go lower and that the price was likely a bargain. I had no real avenue to act as I don't trade futures contracts (due to a lack of expertise in the field and prohibitively extensive state regulations). An hour or two later the price per barrel was -35.20. I didn't realize that the price for a barrel of oil COULD go negative, and this was indeed the first time in history that it had. My expertise is in equities and crafting a portfolio to meet a client's risk profile, and particularly in times of uncertainty and panic that expertise is crucial to not making rash decisions that are financially ruinous. Knowing the limits of that expertise (such as trading futures in the oil market) is also critical to avoid making bad decisions.

Finally, patience is a very valuable investing skill, yet in the short term can seem indistinguishable from stubbornness paired with confirmation bias. Factors can underperform the broader market for decades at a time (such as the Value Factor currently), yet over the very long-term still significantly outperform. The inherent problem with such a long time horizon is that it can take an entire career to find out at the end that a Factor was no longer functioning. This is why it is critical to diversify across Factors.

Thank you for your trust during these troubled times,
Devin