July 2024

From Bloomberg's Weekend Reading:

It’s been a long and arduous journey, but the current US monetary tightening cycle is by all accounts at its peak, with a September interest-rate cut by the Federal Reserve a forgone conclusion. But softer economic data caused some on Wall Street and elsewhere to panic Aug. 5, sending markets on a wild ride that less excitable observers noted was largely unnecessary. Disappointing labor data caused markets to plummet on Monday, but by Thursday positive labor data sent nervy investors back to their terminals. Now, all eyes turn to next week’s inflation print to handicap the central bank’s effort to achieve a soft landing that seems oh-so-close.

And while repeated, often fevered predictions of a downturn have fallen flat for over two years now, tightening conditions attendant to the Fed’s effort to cool the economy haven’t been painless. The real estate market is plagued by low-inventory and soaring borrowing costs while consumers have been dogged by a spike in prices (some would say gouging) for everything from cars to eggs. As a whole (though not among tech firms that have terminated tens of thousands), businesses scarred by pandemic-era worker shortages have so far largely avoided firings and instead pulled back on hiring, trimmed job openings and reduced hours. In some locations, a surge in migration—furious opposition to which is the central component of Donald Trump’s presidential campaign—has helped ease deep labor shortfalls and thus helped the Fed control inflation. How does all of this play out in an election year? Whether the next three months show Fed Chair Jerome Powell continuing to cool the economy without doing damage may be determinative.

From the WSJ:

How to Stay Sane When Markets Get Wild

Market strategists and online pundits always have explanations for stock-market volatility. That doesn’t mean you have to believe them.

By *Jason Zweig*
Aug. 9, 2024

Stop trying to make it make sense.

Just about every volatility storm in the markets quickly morphs into a baloney blizzard, as Wall Street’s market strategists and a swarm of online pundits pretend to explain what just happened and concoct predictions of what will happen next. ...

On Monday, Aug. 5, the Japanese stock market had its worst day since 1987, crumbling 12.4%, and U.S. stocks slumped 3%. Wall Street’s fear gauge, the VIX index of volatility, shot up more than 50% to its highest level since the dark pandemic days of 2020. The next day, Japan bounced up 10%, while the S&P 500 gained 1% and the VIX fell 28%. By week’s end stocks stood not far below where they did before the wild ride.

Were the future cash flows of Japanese corporations one-eighth less valuable on Monday than the day before—and then one-tenth more valuable on Tuesday?

Of course not. But the more implausible an event feels, the more the human mind seems to crave a plausible explanation for it.

What's the harm in that? A believable story might lead you to think you know exactly what's coming next and to trade on that belief, when it's probably nothing but a delusion. Or a compelling narrative might prompt you to believe the teller saw the whole thing coming, when that wasn't the case.

Nearly a century after the crash of 1929 and almost four decades after the crash of 1987, no one knows for sure what caused either one. But this week, Wall Street was already abuzz with confident theories of what had happened on Monday.

Big hedge funds had borrowed in cheap Japanese yen to buy U.S. stocks and other assets, then panicked when the yen suddenly rose against other currencies, making the borrowings more costly. Or investors had suddenly lost confidence that the Federal Reserve could prevent the economy from sagging into a recession. Or expectations for big technology stocks had gotten out of hand.

More likely, the extraordinary smoothness of markets over the past year-and-a-half had goaded hedge funds and other big traders into taking ever-escalating amounts of risk. From Feb. 22, 2023 to this July 23, the S&P 500 never dropped by more than 2% in a day, the longest such streak in more than 17 years.

But you can only stretch a rubber band so far until it snaps, and when it snaps it stings.

The simplest explanation of all: Markets went haywire early this week because markets consist of people, and crazy behavior is contagious. To paraphrase Mark Twain, truth is stranger than fiction because fiction has to make sense. Markets don't.

No less an authority than Paul Samuelson, the Nobel laureate in economics, who died in 2009, argued that markets are "micro-efficient" but "macro-inefficient."

By that he meant that investors are good at quickly integrating new information about individual securities—but bad at sizing up geopolitical and macroeconomic developments that can affect entire categories of assets like stock, bonds or commodities.

In a private letter later published by Robert Shiller, the Yale economist who eventually won a Nobel Prize himself, Samuelson defined macro-inefficiency as "long waves" of prices for broad baskets of securities "below and above…fundamental values."

Shiller tells me he believes markets are micro-efficient but macro-inefficient because an individual security is discrete and affected by a fairly limited number of factors. Broader bundles of assets like entire national stock markets can be swayed by countless forces, making their value "more subjective," he says.

And he thinks macro-inefficiency can unfold not just in the long waves that Samuelson assumed, but in short bursts as well.

"There's a narrative that big market moves are a leading indicator, and it's a very fast-acting leading indicator," Shiller says. "The human sympathetic nervous system evolved for us to jump to action in an emergency. Time is sped up. People drop what they're doing and think, 'I've got to handle this.'"

That urge is exactly what brokerage firms and trading apps play—and prey—on. And it's what long-term investors must be on guard against.

Financial marketers grab and hold your attention online by playing on your emotions, especially fear and anger.

... You don’t have to try to make sense of markets that make no sense. And you certainly shouldn’t listen to anyone trying to make you panic. ...

From Thursday's Global Investment Strategy:

One-Two Punch

Against the Ropes

Global equities have had a rough three weeks. After peaking on July 16, the MSCI ACWI index has fallen by 5.8%. In common-currency terms, the US has underperformed the rest of the world, dropping by 6.8%.

The initial decline in equity prices was concentrated in large-cap tech names. Outside of the tech sector, stocks held their ground. In fact, small caps even rallied.

The resilience of the broader market ended late last week when growth concerns began to dominate the market narrative.

Even the prospect of faster Fed rate cuts did not help. On the contrary, the narrowing of rate differentials between the US and Japan triggered a vicious unwinding of the yen carry trade. Investors who had borrowed yen in order to buy stocks and other risky assets were forced to cover their bets, leading to an unorderly selloff.

Other popular “low vol” hedge fund strategies quickly blew up, briefly sending the VIX to a four-year high. These included the so-called “dispersion trade.” This particular trade buys options at the individual stock level but sells options at the index level, on the hope that much of the variation of individual stock prices will cancel out (narrator: it didn’t).

As we go to press, equities have stabilized and begun to recoup some of their losses, thanks in part to a stronger services ISM reading on Monday and a lower-than-expected initial unemployment claims print this morning.

It is possible that the recovery will continue for another week or so, but ultimately, stocks will fall to fresh lows. This is because, as we discuss below, the storylines around both AI-linked tech stocks and the global economy are likely to get worse rather than better.

AI Scepticism on the Rise

Following some rather underwhelming commentary from Salesforce and other companies concerning the demand for AI applications, Wall Street analysts have begun to question the AI thesis.

Jim Covello, Goldman Sachs’ head of global equity research, has noted that past innovations allowed low-cost solutions to displace higher-priced options fairly quickly. For example, by the late 1990s, it was already clear that e-commerce offered unparalleled cost advantages over brick-and-mortar stores. With large language models, however, no “killer app” has yet emerged, and it is not clear if one ever will.

From our perspective, there are two questions that need to be answered: First, how large will productivity gains from AI be? And second, to what extent will firms be able to capture those gains in the form of higher profits?

On the first question, there is a wide range of estimates, including within Goldman Sachs itself (in contrast to Covello, their economics team is quite bullish on AI). As a base case, Goldman economics, McKinsey, and Brookings all expect AI to boost productivity growth by over 1% per year.

Other economists are more sceptical. Daron Acemoglu has estimated that AI will boost annual productivity growth by 0.06% over the next 10 years.

Are LLMs Even AI?

Personally, I am quite bullish on AI. However, I am not convinced that Large Language Models (LLMs) are a true stepping stone to artificial general intelligence – or even for that matter, that it is appropriate to refer to LLMs as AI.

The problem is that there is no evidence that LLMs can reason in the sense of being able to create new knowledge out of existing knowledge. ...

LLMs work by synthesising existing knowledge. At this point, many of the best sources of knowledge have already been incorporated into training datasets. The addition of lower-quality knowledge – data scraped off Reddit, for example – could generate "data pollution" that makes the models worse, not better.

The Cost Problem

Then there is the issue of cost. Most people are familiar with the immense computing costs associated with AI models, but there is one cost that is rarely mentioned because AI companies have largely managed to avoid it: The cost of acquiring the training data itself.

Several lawsuits have been filed against OpenAI and other tech companies alleging that they are running veritable IP chop shops – taking copyrighted data from the internet, sometimes from pirated book sites, and then using it to train their models without compensating the original owners. Tech companies have offered a variety of self-serving arguments for their behavior, but the odds are high that at some point, they will be forced to pay up.

Narrow Competitive Moats

The cost of creating and maintaining LLMs would not be so daunting if the models could generate enough revenue. But whether they will is unclear. Even if LLMs end up significantly boosting productivity, they could still end up functioning like airlines – very valuable in terms of facilitating global commerce, but barely profitable in the best of times.

Since they are trained on similar data sets and have similar neural net architectures, most LLMs generate similar output when they are posed the same question.

Moreover, unlike social media platforms that become more valuable if more people use them, LLMs do not benefit from network effects. In that regard, they are more comparable to internet browsers or low-end memory chips, two examples of tech that have become largely commodified.

Right now, Nvidia books a fat profit every time it sells one of its GPUs. However, the companies that buy these chips do not suffer a corresponding loss – no, they record those purchases as capex.

While it is true that today's tech giants have deep pockets and are not at any serious risk of going under, it is also true that investors are assuming that all this capex will pay off. Even after the recent selloff, Microsoft is trading at 40-times free cash flow. If the profit opportunities created by LLMs end up being smaller than currently believed, we could see large charge-offs on all these capital expenditures in the years ahead.

The Lowdown on the Economic Slowdown

Angst over AI is coming at an inopportune time. Global growth has started to slow. Concerns over the growth picture first surfaced in Europe and China and then spread to the US following last Friday's soft employment report.

Manufacturing seems to be weakening again. The global manufacturing PMI fell below 50 in July for the first time in seven months. The forward-looking new orders component also dipped.

Both the US and the global Citi economic surprise indices have hit multi-year lows. The Bloomberg US economic surprise index remains deep in negative territory (**Chart 3**).

The health of the US labor market is of particular concern. The labor market subcomponent of the Bloomberg surprise index is near levels not seen in 13 years.

Payrolls grew by less than expected in July. The deceleration was broad-based ....

Perhaps most alarming, the unemployment rate jumped to 4.3% in July. The unemployment rate is a highly mean-reverting series. Usually, when it starts rising, it keeps rising (**Chart 5**). ...

What matters is the broad trend in the labor market. On this front, there is some good news and some bad news.

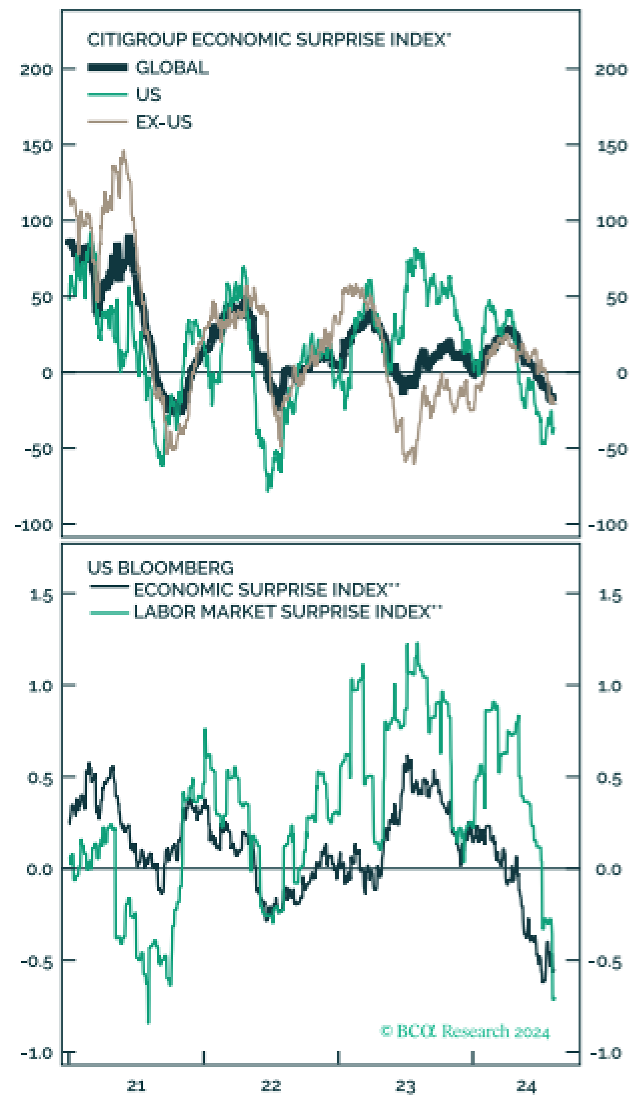
On the more optimistic side, a sizable portion of the increase in the unemployment rate this year has come from rising labor supply. Of the nearly 50 bps increase in the 3-month average of the unemployment rate from its 12-month low, 22 basis points have come from new entrants and re-entrants joining the labor market. ...

Similarly, payroll growth remains positive. The employment-population ratio for prime-age workers actually hit a 23-year high in July.

Blame the Weather?

Many commentators have argued that bad weather contributed to the rise in the unemployment rate in July. We

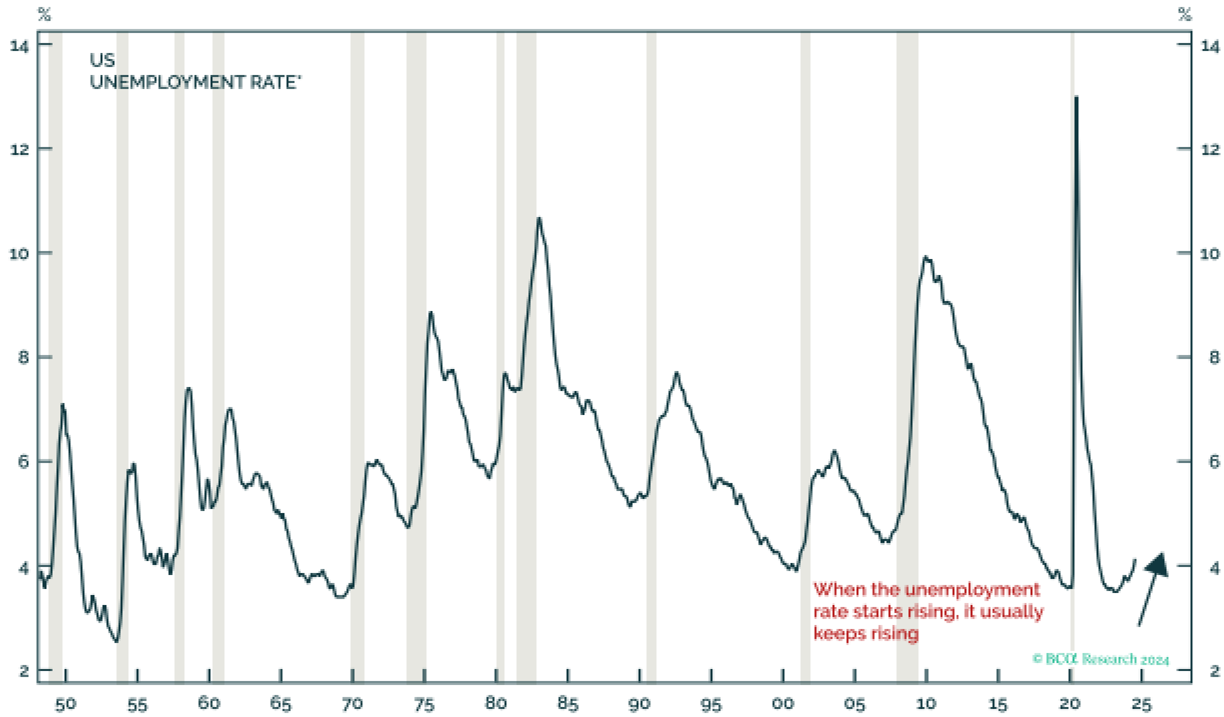
CHART 3
Economic Surprise Indices Have Fallen Deep Into Negative Territory



* ROLLING 3-MONTH STANDARD DEVIATION OF DATA SURPRISES.
SOURCE: CITIGROUP GLOBAL MARKETS INC.
** SOURCE: BLOOMBERG FINANCE L.P.

CHART 5

The Unemployment Rate Is A Highly Mean-Reverting Series



* SHOWN AS A 3-MONTH MOVING AVERAGE.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

are agnostic on this issue. It is true that 436,000 people were out of work in the nonfarm sector in July due to weather-related reasons, 10 times more than the average of past Julys since 1976. However, this should have only affected the payroll count, which is drawn from the establishment survey, rather than the unemployment rate, which is drawn from the household survey. In the household survey, absences from work due to weather-related reasons do not affect one's employment status.

Affirming this point, the BLS stated that "Hurricane Beryl had no discernible effect on the national employment and unemployment data for July."

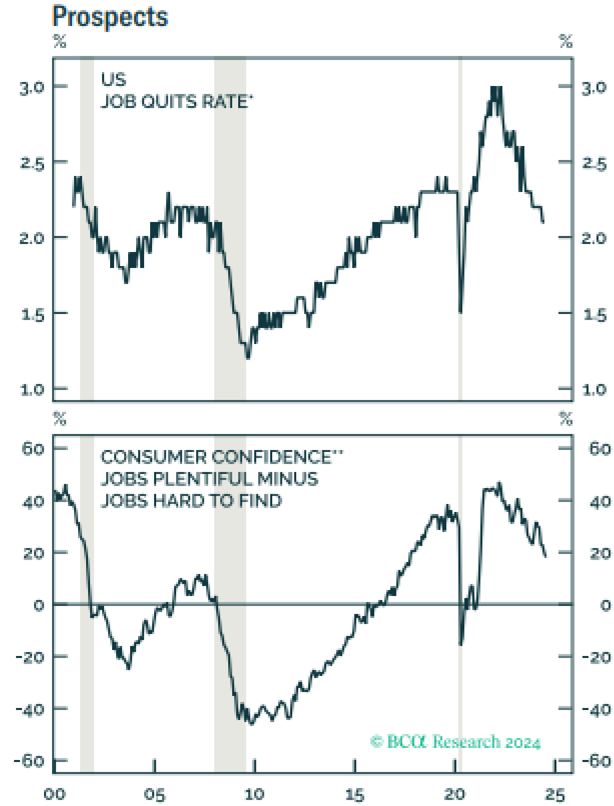
So why did the number of workers on temporary layoff jump by 249,000 in July, accounting for more than half of the increase in the unemployment rate? That is a bit of a mystery.

... In any case, it is worth keeping in mind that firms usually reduce the pace of hiring before they start firing. On that front, there is no confusion as to what is happening: Hiring has dropped off sharply. The JOLTS hiring rate is now well below pre-pandemic levels. Hires tabulated by Challenger, Gray, and Christmas were down 43% in the first seven months of the year relative to the same period a year ago.

The lack of hiring helps explain why continuing unemployment claims have been trending higher even though

CHART 12

Households Are Less Optimistic About Job Prospects



* SOURCE: JOB OPENINGS AND LABOR TURNOVER SURVEY (JOLTS), BLS.
** SOURCE: THE CONFERENCE BOARD.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

initial claims remain subdued. Simply put, those who are unlucky enough to lose their jobs are having more difficulty in finding new work.

On The Road to Recession

... Worryingly, as a share of the labor force, the number of people who are unemployed because they lost their job has already reached levels that usually presage recessions. Household perceptions of job availability have deteriorated, as evidenced by a falling quits rate and a decline in the proportion of people who think that jobs are "plentiful" versus "hard to get" in The Conference Board survey (**Chart 12**).

Despite a rising stock market, narrowing credit spreads, a massive apartment building boom, the spending down of pandemic savings, rising credit card debt, and fiscal support from the CHIPS Act and the IRA, job openings have still managed to fall by four million since early 2022. If job openings continue to decline, as is likely given that most of the tailwinds listed above have either stalled or reversed, ... rising unemployment will start to feed on itself, culminating in a recession. ...

How Deep Will The Recession Be?

While we do not expect the recession to be particularly deep, we do not buy the argument that structural imbalances are so slight that the US economy will avert a downturn altogether.

There is clearly excess supply in the office segment, and increasingly in the multifamily real estate segment as well. While there is no glut of single-family homes, home prices are 22% higher in real terms than they were at the start of the pandemic. If unemployment starts rising, home prices could decline meaningfully.

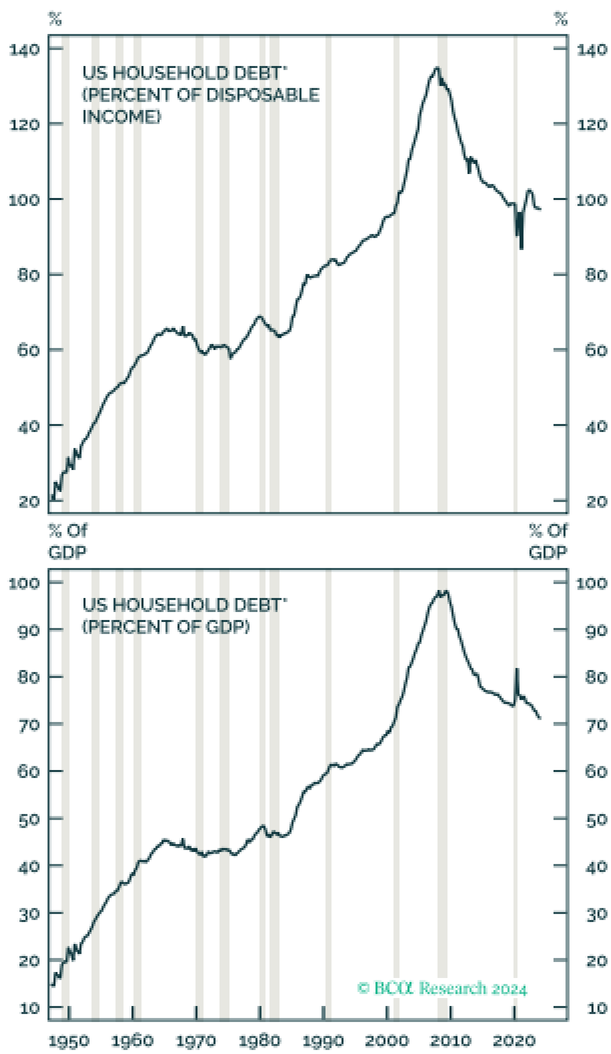
Household balance sheets are not in bad shape, but they are far from pristine. As a share of disposable income, household debt is higher now than at the outset of every recession save the 2008/09 downturn (**Chart 15**). Credit card and auto loan delinquencies have risen substantially.

Banks continued to tighten credit card lending standards in the second quarter, while keeping interest rates near record highs.

The personal savings rate currently stands at 3.4%, half of where it was in 2019 (**Chart 17**). Now that excess pandemic savings have been depleted, households will need to save more. The problem is that any effort by households to collectively raise savings will reduce aggregate demand, leading to lower employment and income growth. Income could even fall so much that aggregate savings decline, a

CHART 15

Household Debt Is Well Below GFC Levels, But Is Still Fairly Elevated By Historic Standards



* SOURCE: FEDERAL RESERVE, FINANCIAL ACCOUNTS OF THE UNITED STATES.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

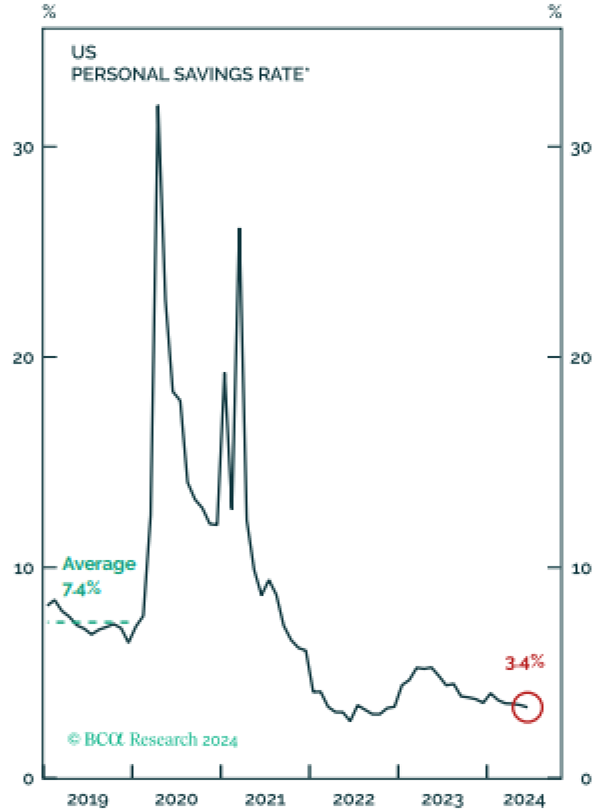
phenomenon John Maynard Keynes called the "paradox of thrift."

Fiscal policy is unlikely to help very much. If Kamala Harris wins in November, the Republicans in Congress will block any fiscal stimulus. For her part, Harris will let the Trump-era personal income tax cuts expire at the end of 2025. If Trump were to win, he will try to extend the personal tax cuts and perhaps even cut taxes on tips and social security payments. However, the benefit of those measures could be offset by higher tariffs. According to calculations made by the Peterson Institute, most households would see a decline in disposable income if Trump's proposed higher tariffs came into effect.

This just leaves monetary policy. Fed rate cuts will eventually help spur growth, but as was the case in the past, the benefits will come with too long of a lag. **Chart 19** shows that the economy fell into recession just months after the Fed started cutting rates in December 2000 and August 2007.

The market is already pricing in 225 bps of Fed rate cuts through to the end of 2025. An even faster pace of rate cuts would be required to bring down long-term yields further. Such an aggressive pace of rate cuts is unlikely to materialize outside of a recession.

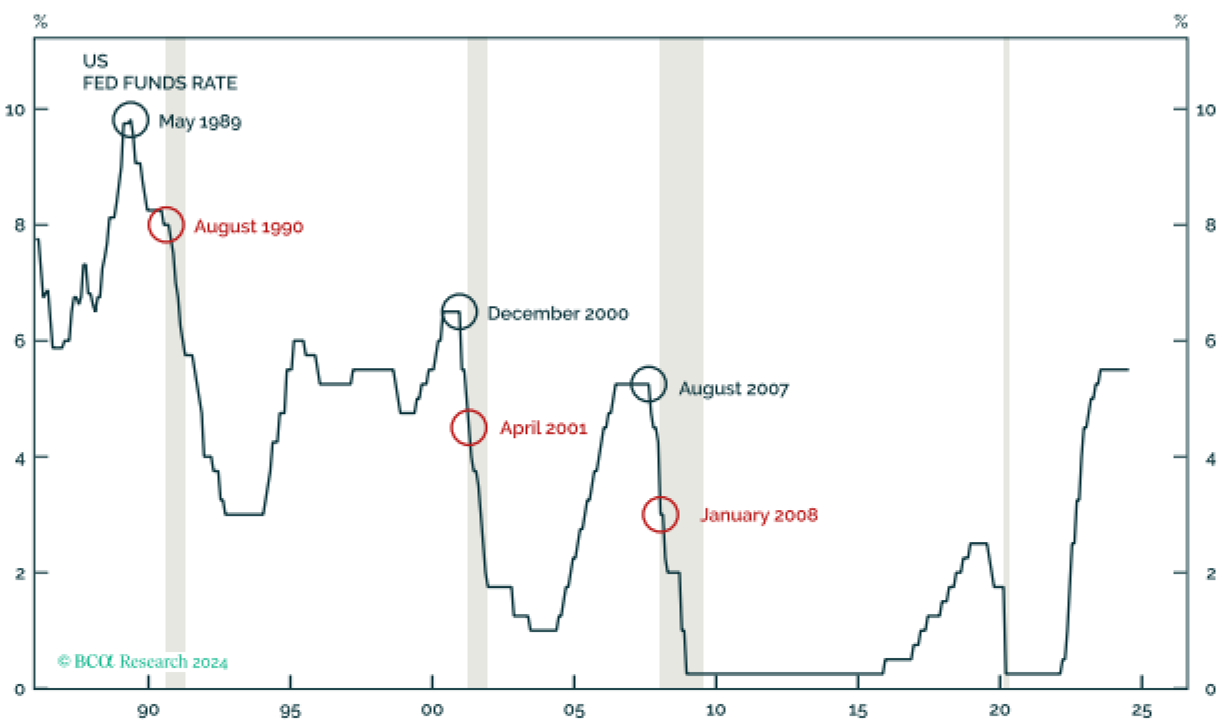
CHART 17
The Savings Rate Is Likely To Rise



* SHOWN AS A PERCENT OF DISPOSABLE INCOME.

... we expect the S&P 500 to drop to 3750 next year and for the 10-year Treasury yield to fall to 3%.

CHART 19
Recessions Often Start Not Long After The Fed Begins Cutting Rates



SOURCE: FEDERAL RESERVE.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

Follow-ups

Two from Morningstar:

Don’t Let Recency Bias Lead You Astray

If you’re considering a mega-cap highflyer, it’s probably too late.

Larry Swedroe Aug 8, 2024

Recency bias is the tendency for people to overweight new information or events, projecting them into the future while ignoring long-term evidence. This bias causes many investors to engage in performance-chasing—tending to buy stocks and funds after a period of good performance and tending to sell after a period of poor performance.

Buying after periods of strong performance (when valuations are higher and expected returns are now lower) and selling after periods of poor performance (when valuations are lower and expected returns are now higher) is not a prescription for successful investing. Yet, because of recency bias, it is the way many individuals invest. What disciplined investors do is the opposite—they rebalance to maintain their well-thought-out allocation to risky assets.

Performance of Largest Stocks

With their recent spectacular performance, I thought it a good idea to review the historical performance of the 10 largest stocks. Before doing so, let’s take a brief look at how the composition of the 10 largest stocks changes over time.

At the start of 2024, the 10 largest US stocks were Apple AAPL, Microsoft MSFT, Alphabet GOOGL, Amazon.com AMZN, Nvidia NVDA, Meta Platforms META, Tesla TSLA, Berkshire Hathaway BRK.B, Eli Lilly LLY, and Visa V. There was a lot of turnover (40%) from the start of 2023, with Nvidia, Meta, Tesla, and Eli Lilly joining the list, while UnitedHealth UNH, Johnson & Johnson JNJ, Exxon Mobil XOM, and JPMorgan Chase JPM left. Such turnover is quite common. For example, 10 years earlier, at the start of 2014, only Apple, Microsoft, and Berkshire Hathaway were in the top 10. If we go back 30 years to the start of 1994, not a single one of 2024′s top 10 managed to stay there for the full period. The 10 largest then were Exxon Mobil, Coca-Cola KO, Walmart WMT, Raytheon, Merck MRK, Procter & Gamble PG, GE GE, PepsiCo PEP, IBM IBM, and Johnson & Johnson.

With our focus on recency bias, our review of the performance of the largest stocks will examine returns over the three-, five-, and 10-year periods *before* and *after* the stocks joined the list of the 10 largest. The data covers the period 1926 through 2023 and includes stocks in the CRSP database.

Highflyers Return to Earth

In the 10 years before becoming one of the largest 10 US stocks, they returned 11.8% per year. In the five years before doing so, they returned 20% annually. And in the three years before doing so, they returned a spectacular 27.2% annually. The combination of recency bias and the fear of missing out, or FOMO, can lead investors to overweight these companies. What investors subject to these biases likely fail to understand is that spectacular performance is often fueled not just by earnings growth, but also—and often mostly—by multiple expansion.

Multiple expansion lowers the cost of capital for companies, which lowers the expected returns to investors. So, how did these highflyers perform in the periods *after* they became a top-10 stock?

In the three years after joining the list of the largest 10 companies by market cap, these stocks returned just 0.5% per year. In the five years after doing so, they did even worse—losing 0.9% per year. And in the 10 years after doing so, they performed worse still, losing 1.5% per year. In other words, after their spectacular performance allowed them to become one of the 10 largest stocks, over the next three-, five-, and 10-year periods, these once highflyers underperformed totally riskless one-month Treasury bills.

Investor Takeaways

Because investors can only buy tomorrow's returns, not yesterday's, one of the keys to successful investing is to avoid recency bias and FOMO, which can cause investors to abandon even well-thought-out plans.

Larry Swedroe is the author or co-author of 18 books on investing ...

While HCM highly recommends and practices international diversification, it is important to note that governance matters. Emerging markets in particular can prove extremely volatile due to political upheaval, and countries with authoritarian governments that can seize investor assets at a massive scale should be treated with extreme caution (such as China, and Russia). Additionally, populist governments (either on the left or right) pose a substantial risk to returns. Once these political considerations are accounted for, using a Factor-Based approach is still important in foreign markets.

Why International Investing Makes Sense for Long-Term Investors

Overseas markets aren't as risky as they once were.

John Rekenthaler Jul 9, 2024

Deep Risk

Usually, this headline's question is answered by statistics. The calculation typically compares the standard deviation of a domestic portfolio with that of a diversified investment, which includes securities of other countries.

All of that is fine; I have no quarrels with such exercises. However, short-term volatility is only one way to measure investment danger. Another is the potential long-term damage to a portfolio's purchasing power: "deep risk," as my friend Bill Bernstein writes. That is the topic for today's column.

While Bernstein customarily measures deep risk over several decades, I will do so over 10-year increments. This will provide more independent periods without changing the general findings. Otherwise, my approach matches his. Unlike traditional investment calculations, which measure nominal total returns, deep risk assesses *after-inflation performance*. After all, if prices have tripled, doubling one's money means financial failure rather than success.

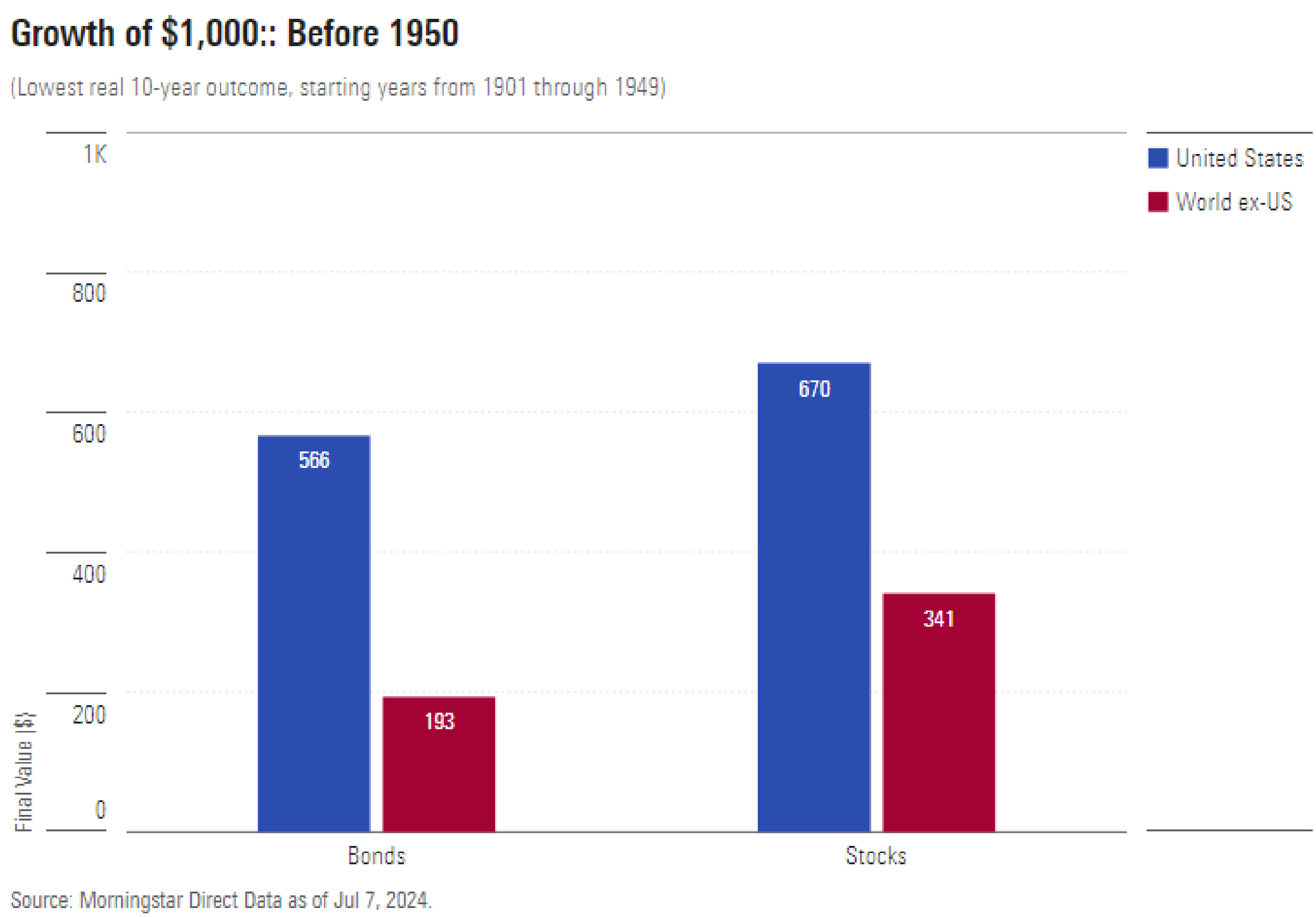
The Data Source

My numbers come from three academics: Elroy Dimson, Paul Marsh, and Mike Staunton. They consist of the annual after-inflation returns from 1901, computed in US dollar terms, for four assets: 1) US bonds, 2) US stocks, 3) the rest of the world's bonds, and 4) the rest of the world's stocks. The trio supply the results for many single countries, which are wonderfully interesting—who wouldn't want to know that from 1902 through 1913, New Zealand stocks provided 12 straight years of real gains?—but beside this article's point.

I split the study into two segments: 1) periods that began before 1950, and 2) periods after 1950. The cause for the division should be apparent. The first half of the past century featured two world wars and a global depression. More recently, there have been no world wars nor such a steep economic downturn. One would therefore expect the sharpest declines to have occurred during the first epoch, obscuring the results for the second era.

Back in the Day

Let's see the results for the earlier period. The chart below shows the lowest 10-year real outcomes for each asset class, through the starting date of 1949. The totals are cumulative.



The worst result for US bonds should not come as a shock. Wartime breeds inflation, and inflation destroys the value of fixed-income investments. Over the four years from 1916 through 1919, consumer prices rose by 83%. The interest payments from US bonds were backed by the faith and fidelity of the federal government. What those payments could buy, however, was not so much!

(Bondholders fared somewhat better through World War II but nevertheless ended 1951 with only 72 cents on their inflation-adjusted dollars.)

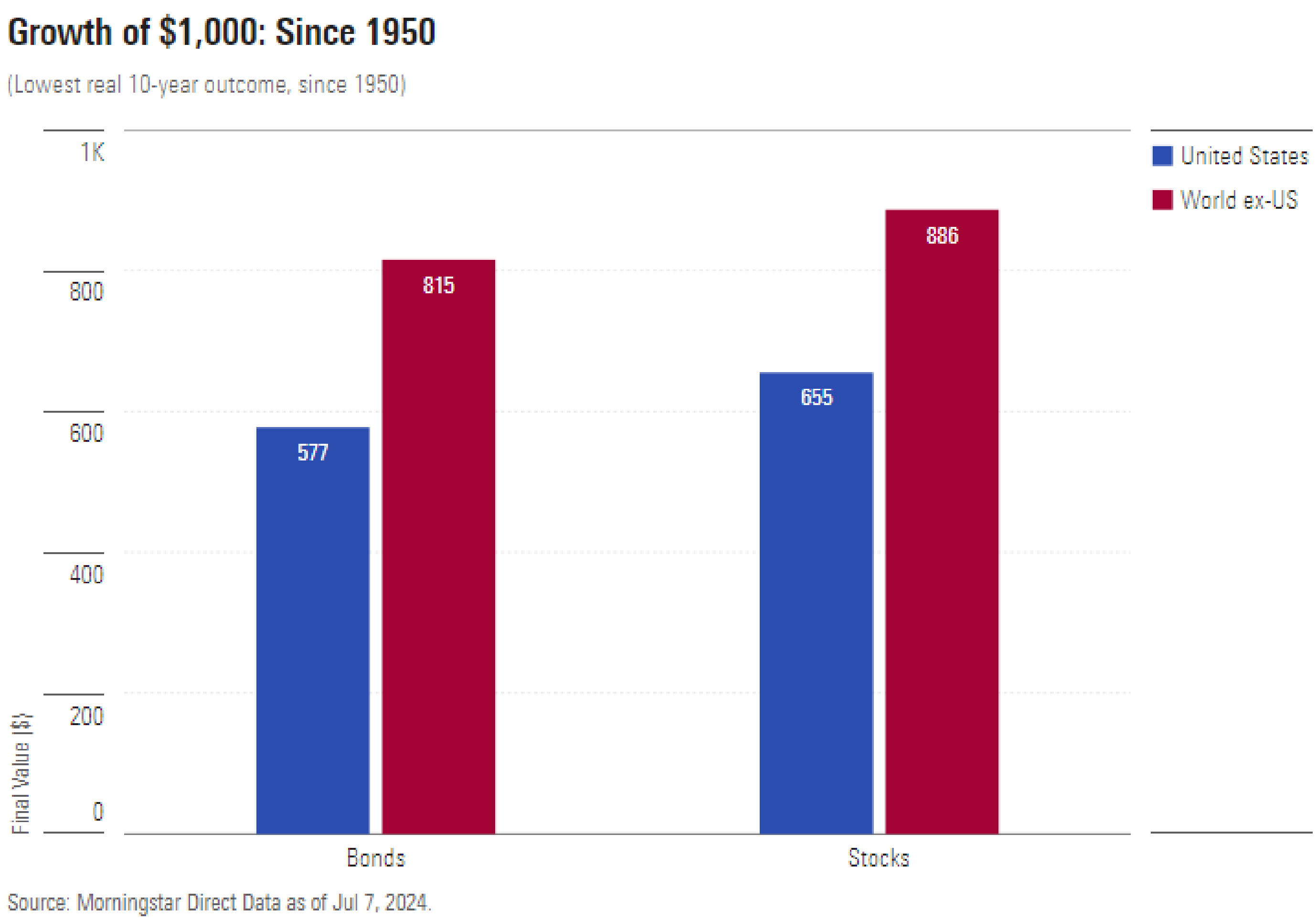
US equities, however, lost less value than is commonly advertised. We are accustomed to reading about the devastation of US stocks during the Great Depression when they fell almost 90%. Well, … yes and no. Stocks did nosedive from late 1929 through early 1933, but their 10-year returns were not so terrible, thanks to a strong subsequent rally. Also, consumer prices fell during the Great Depression, which helped equities maintain some of their buying power.

In contrast, international investments were an unmitigated disaster. Foreign bonds were particularly awful. Not only did they surrender more than 80% of their real value during their worst decade, but that date exactly overlapped with US bonds' lowest showing, which also ended in 1920. Invest only in domestic bonds, lose 43% for the decade. Protect against deep risk by stashing half the portfolio overseas, lose 62% instead. Just great.

Foreign equities were not much better. On the bright side, their steepest loss was not quite as severe as with bonds, and it did not occur during the Great Depression. That said, a 66% real decline is nonetheless awful, as was the timing, because that downturn also occurred during the 10 years that concluded in 1920! For the entire century, the worst decade for US bonds, world stocks, and world bonds coincided. So much for the good old days.

Modern Times

Here are the more recent results, applying the same methodology.

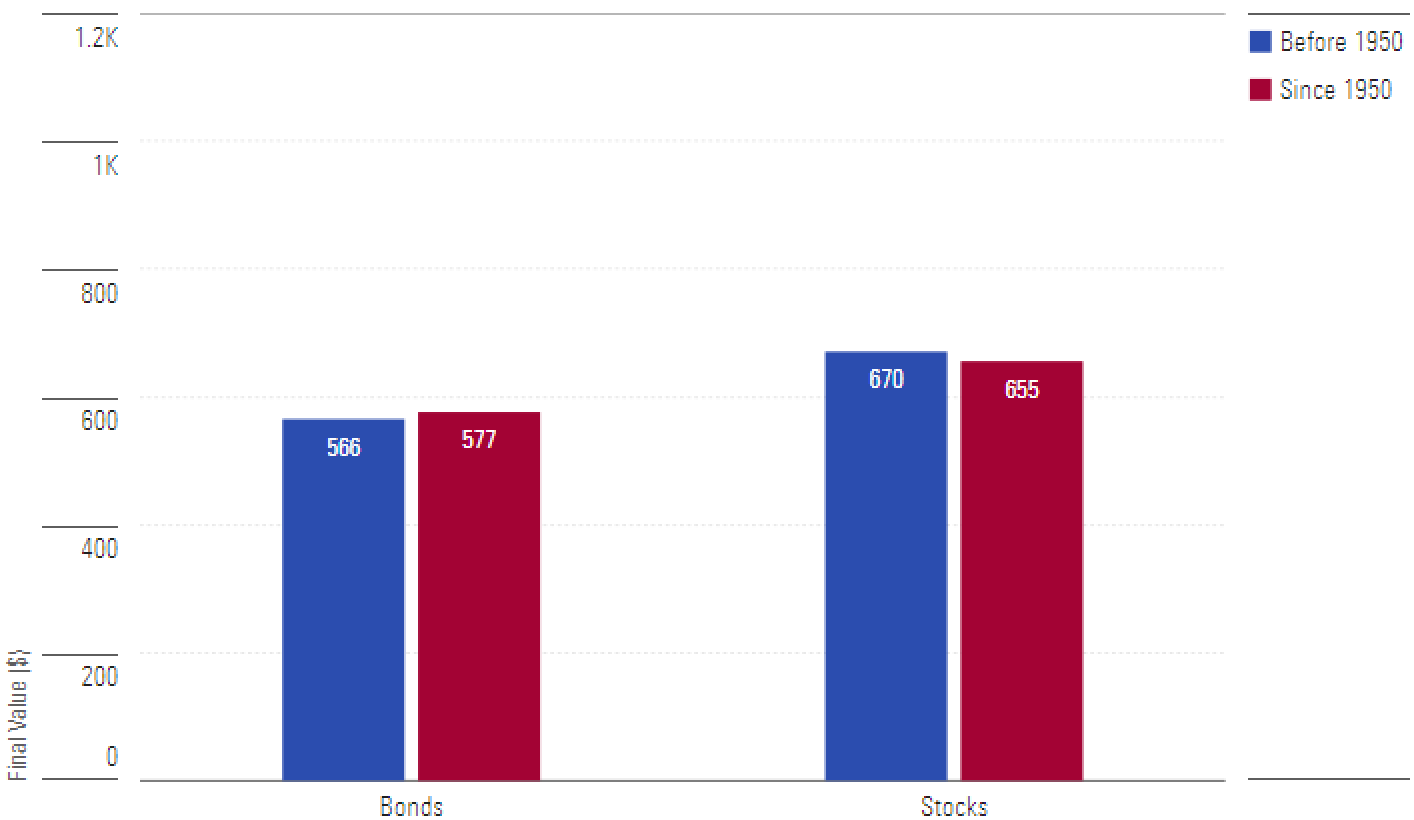


The US results may come as a surprise. Their absolute losses match conventional expectations, as even those who did not live through the 1970s recall the era's inflation, which sunk bond prices. And although one is not accustomed to seeing large cumulative 10-year losses for stocks, that result does make sense given how persistent inflation can erode purchasing power.

The remarkable aspect of the recent worst-case scenarios for US assets lies instead with their *relative* levels. The lowest post-1950 performances almost match those from the black-and-white generations.

Growth of $1,000: US Assets, Before 1950 and Afterwards

(Lowest real 10-year outcomes)

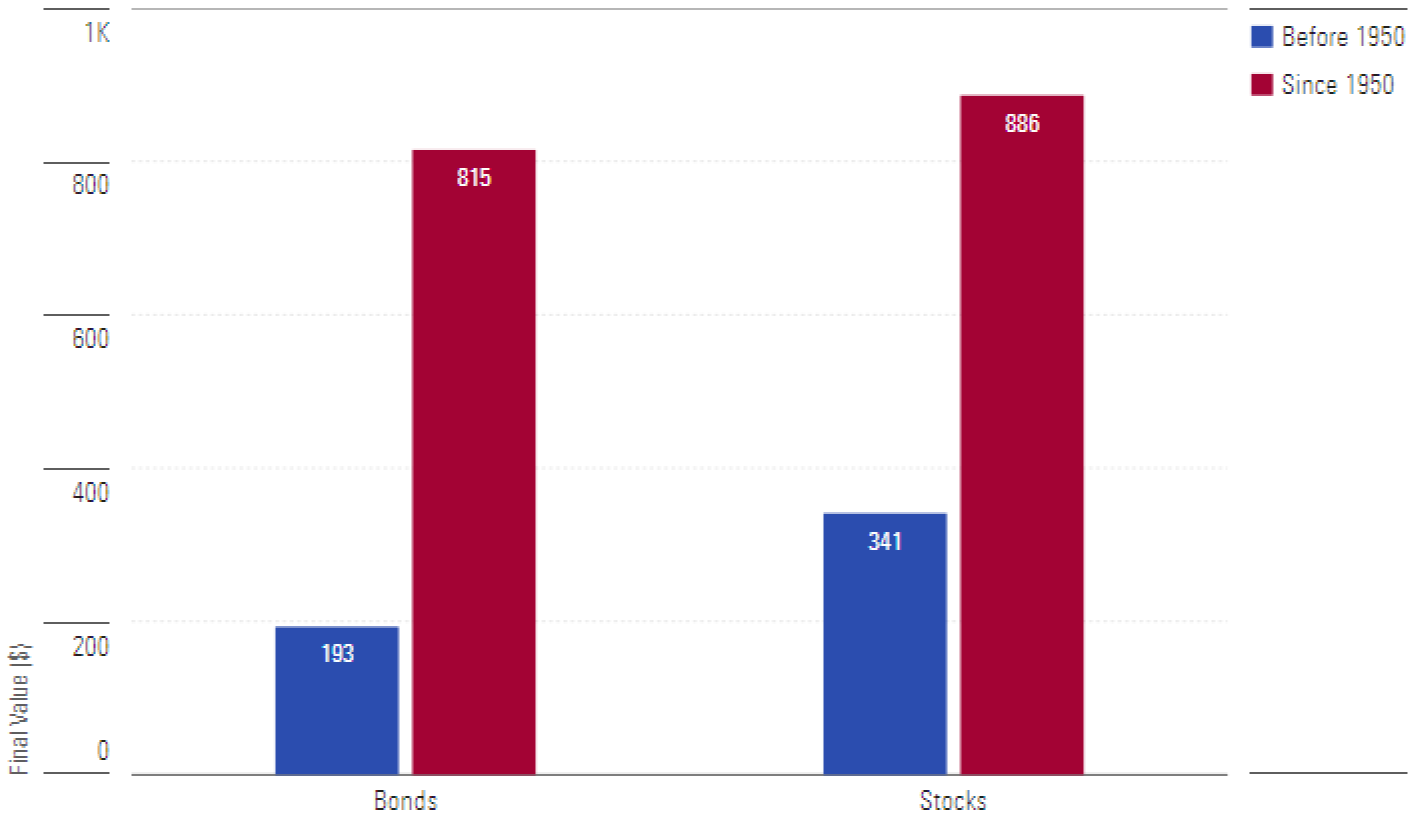


Source: Morningstar Direct Data as of Jul 7, 2024.

The overseas results stand in stark contrast to the domestic outcomes. Whereas leaving the US once meant courting danger, international diversification has powerfully earned its keep during recent decades, with both bonds and stocks posting mild worst-case performances. Since 1950, their deep risk has looked nothing like that of the distant past.

Growth of $1,000: World ex-US Assets, Before 1950 and Afterwards

(Lowest real 10-year outcomes)



Source: Morningstar Direct Data as of Jul 7, 2024.

The reason for their improvement is straightforward. Back in the day, Europe accounted for almost all foreign investment. When it became embroiled in continentwide wars, there was little escape, not for bondholders beset by inflation and sovereign defaults nor equity shareholders facing corporate ruin. Today, not only are there no such wars, but the geography is far more varied. Currently, for example, none of the world's four largest stock markets are in Europe, as they consist of the US, China, Japan, and India.

Summary

International portfolio diversification is a relatively new concept, spurred by technological advancements that both improved global communications and simplified the process of overseas investing. As it turns out, the delay was fortuitously timed, as early US investors profited by staying home.

Since then, though, overseas diversification has delivered on its promise. As the managers of target-date funds can ruefully attest, investing in foreign securities does not necessarily increase a portfolio's returns, but without question it reduces deep risk. That is very much a meaningful benefit.

Two from the WSJ:

The Insurance Industry Is Winning a Fight to Kill New Protections for Retirement Savers

Advisers are promoting annuities with big commissions that eat into returns

By Jean Eaglesham
Aug. 7, 2024

The insurance industry is waging a legal war against new protections for retirement savers. The courtroom offensive appears likely to kill a yearslong effort to curb advice steering people toward products packed with hidden fees**.**

The high-stakes battle centers on a new standard for financial advice affecting the nearly $1 trillion a year rolled over from employer-sponsored 401(k)s to individual retirement accounts. The Labor Department rule would require advisers on IRAs to recommend what is best for the saver and avoid misrepresentations and excessive charges.

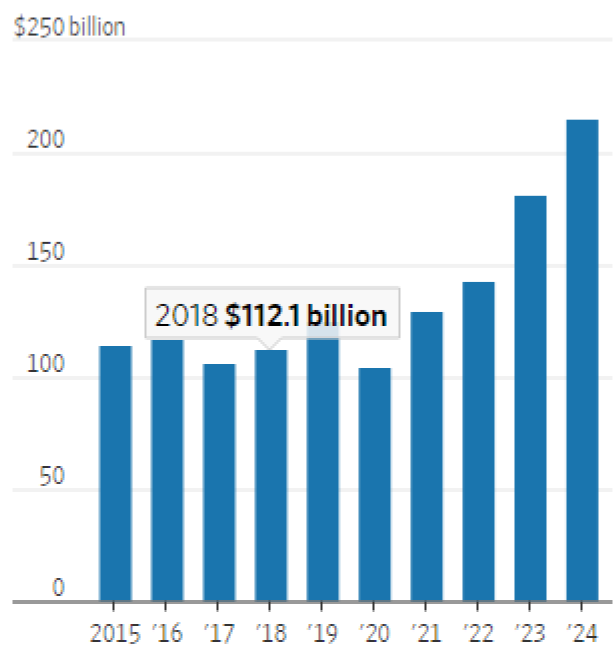
The rule is forecast to curb commissions on annuities sharply. These products are sold as a way to convert retirement savings including an IRA into an often-guaranteed income stream. While annuities have surged in popularity in recent years, they can carry hefty charges and lock in savers.

A dozen industry groups are suing the government, saying it lacks the legal authority to create the new protections.

“Insurers and agents are fighting for their right to keep ripping off clients, with biased advice and sky-high commissions,” said Joseph Peiffer, president of the Public Investors Advocate Bar Association of lawyers who represent investors. “And, right now, they’re winning.”

Insurers counter that the new rule would limit choice for consumers. “This rule would deprive millions of consumers access to much needed retirement financial guidance,” the American Council of Life Insurers said.

Annuity sales in the first six months of each year



Source: Limra

Scrapping the rule matters for the industry’s bottom line. Annuity sales are booming, in part because high interest rates in recent years have juiced returns. An aging population is swelling the ranks of retirement savers, many of whom want the protection against stock-market declines that some annuities offer.

For the first six months of this year, sales hit $215 billion—beating the “record-shattering” $181 billion logged over the same time last year, according to Bryan Hodgens, a senior vice president at Limra, an industry-funded research firm.

The flood of cash is fueling concerns about whether people are receiving the best advice. Financial advisers typically get upfront commissions for the sale of annuities, giving them an incentive to promote the products to clients. Products with the biggest commissions have accounted for much of the recent sales growth.

One type of annuity that has drawn particular fire: fixed indexed products, which tie their performance to a market index. These annuities generally put a floor on losses while also capping returns. The protection is attractive to many savers, but can come with a steep price tag.

Commissions on fixed indexed annuities are typically around 8%, but can range up to 14% or 15% on “really bad” products, according to David Lau, whose firm, DPL Financial Partners, develops no-commission annuities. High commissions are often baked into the product’s costs, hitting the performance of what can otherwise be a good product. Such costs are often built into the annuity in ways that can be hard to figure out.

“Products have gotten increasingly complicated, with added bells and whistles,” Lau said. “That complexity makes it easier to hide fees, and more difficult for savers to compare and contrast.”

Consider a Nationwide fixed indexed annuity that lets savers choose between six indexes. In a Q&A, the company explains, “There are no annual contract or administration fees.” But the fine print reveals many costs.

One of the indexes, for example, carries a 0.5% annual “deduction rate,” as well as unspecified “servicing and rebalancing costs,” according to a footnote. Then there are “strategy spreads,” such as the 1.95% a year deducted from the return for one option tied to the S&P 500. That option also caps gains to 55% of the index’s rise.

A Nationwide spokesman said the charges let providers offer “100% protection for the principal” and cover overhead costs.

High commissions go hand in hand with tougher withdrawal penalties, since providers want to earn back the money paid to advisers. Fixed indexed annuities can lock in savers for a decade or more, with surrender charges of more than 10% of the amount withdrawn.

More than half the money held in annuities last year carried a withdrawal penalty or ban, according to an analysis for The Wall Street Journal by the ratings firm AM Best.

The new Labor Department rule also says advisers can only get “reasonable” compensation. That could have a huge impact on costs for savers. Retirement investors would save around $3.25 billion a year in reduced commissions on rollovers into fixed indexed annuities alone, according to an estimate from the data firm Morningstar.

Advisers who sell annuities aren’t shy about their own concerns.

“The net effect of this will be that my income will decline,” said James Holloway, whose Texas insurance agency last year sold around $11 million of annuities.

In a court filing supporting an industry lawsuit, Holloway said the rule would “stifle competition amongst insurers” to pay advisers high commissions to sell their products.

Agents are also concerned that the new standard would leave them exposed to legal action. “We might be sued…just because the client believes that they were sold a product that is less financially advantageous to them than another,” said Brian Hudspeth of a Texas-based insurance firm in a court filing.

Late last month, Texas judges overseeing two industry-group lawsuits agreed to stay implementation of the new protections, which had been slated to take effect next month. In one ruling, a judge said the industry’s case was “virtually certain to succeed on the merits.”

The government is expected to appeal. But the industry appears confident it will prevail.

“We just wish they’d take the hint,” said Kim O’Brien, head of an insurance industry group, the Federation of Americans for Consumer Choice. “Back away from this never-ending attack on insurance agents.”

The Junk in Your Index Fund Is Costing You Big-Time

Small-cap stocks are on a roll, but the simplest and most popular way to buy them should carry a warning label

By Spencer Jakab
July 26, 2024

A little over two years ago, millions of investors found themselves owning a stake in Enochian Biosciences, a money-losing drug development company few had heard of.

Even fewer would have bought it on purpose. The man listed as its “scientific founder” and largest shareholder had just been arrested for murder. It turned out that he wasn’t a doctor as claimed, or even a college graduate, and that he was wanted for selling bogus cures in his native Turkey. Despite that much of that was public information already, a large number of the company’s shares were bought automatically by funds that

Arrested Development

Share price of Enochian (now Renovaro)

Note: "Scientific founder" arrested four weeks before index inclusion
Source: FactSet

track the Russell 2000 index, the most closely followed gauge of America's small companies.

Several weeks earlier, on what is called "Rank Day" in the small-cap stock-investing world, Enochian had gained entry by being worth at least $240.1 million—that year's cutoff. Its stock had doubled in the previous year to $7 a share. On the day that index funds were forced to buy it while simultaneously selling companies booted from the benchmark, they still paid as much as $3.70 a share. Over the ensuing 12 months, the stock lost another 85% and then saw another flurry—this time, of forced selling—locking in a loss.

Investors who embrace passive investing pay too little attention to how stock indexes are built. Companies gaming the system, or just being of low quality, create an imperceptible drag that has cost investors hundreds of percentage points of gains over the years.

Close to $11 trillion of investor money follows various Russell indexes, and its leading ones are based on market value alone, slicing the market into about 1,000 large-capitalization stocks, 2,000 small-capitalization ones and microcaps below that.

"The goal of the index is to be representative" says Catherine Yoshimoto, director of Product Management at FTSE Russell.

Other indexes have personalities, for better and worse. The granddaddy of them all, the Dow Jones Industrial Average, reflects the opinions of its gatekeepers, who include editors of The Wall Street Journal. While the 30-member gauge certainly wouldn't see a company mired in controversy added to its ranks, changes aren't always well timed.

When aluminum company Alcoa saw its long Dow tenure end in 2013 for no longer being representative of the U.S. economy, it delivered a return 10 times that of the index over the following year. And the index's overseers booted Exxon Mobil four years ago yet kept Chevron as a representative of the oil industry. Exxon has trounced its smaller rival with a total return more than twice as high.

Few funds follow the clunky Dow, but the S&P 500, managed by S&P Dow Jones Indices, is the most-tracked stock benchmark in the world. By focusing on factors such as profitability and how easy a company's shares are to buy, a company committee has in the past excluded stocks that would have been worth owning.

Warren Buffett's Berkshire Hathaway famously didn't get in until 2010 when it split its "B" shares. By then, it was the most valuable American company not in the index. Between 1965, when Buffett took over, and 2010, it increased its book value by 490,000% or about 78 times the performance of the S&P 500.

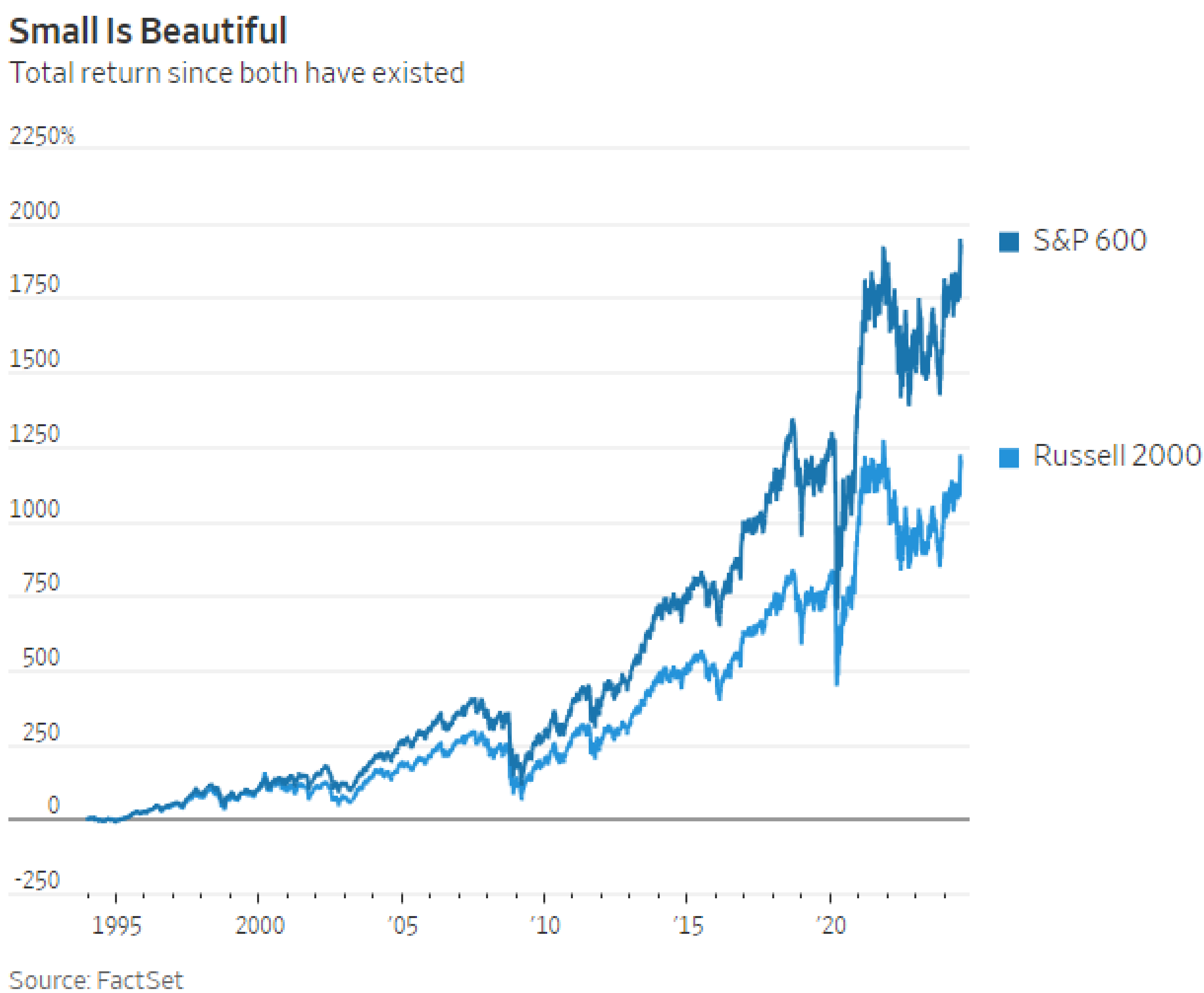
Tougher standards were costly both before and after previously unprofitable Tesla was finally added in December 2020 as the largest company to ever enter the index. Once it looks like the committee will relent, passive investors can wind up paying an inflated price. The EV maker's stock rallied by almost 800% in the year before it got included but has been stuck in neutral since, lagging behind the S&P 500 by 58 percentage points. Getting Tesla wrong has a lot more impact on fund investors than a tiny company at the margins such as Enochian.

Small duds add up, though, and, in the meme stock era, some questionable ones aren't so small. Consider Trump Media & Technology Group. It reported sharp losses in its most recent quarterly results on revenue that would be low for a single McDonald's restaurant, yet retail excitement among the former president's fans propelled it to a value of about $4.5 billion when it entered the large capitalization Russell 1000 a month ago. That is unlikely to last. Fortunately, its index weight is limited because of low float—the number of shares that actually can be traded.

The gyrations can be crazier internationally. Chinese company Ding Yi Feng Holdings, listed in Hong Kong, became one of the world's top-performing stocks, mysteriously soaring more than 8,000% to gain a spot in index provider MSCI's All-Country World Index in 2018 and 2019. Individual investors in Vanguard and BlackRock funds became some of its largest shareholders despite there not being much of a business behind it. MSCI reversed course and removed it after its shares were suspended, but too late to avoid a painful loss for fund investors.

During a recent surge of investor interest in neglected small U.S. companies, Russell's index got almost all of the ink. Since July 10, it has trounced the previously red-hot Nasdaq 100 by more than 17 percentage points. Pretty much anything with "small cap" on the label has worked for that tactical trade.

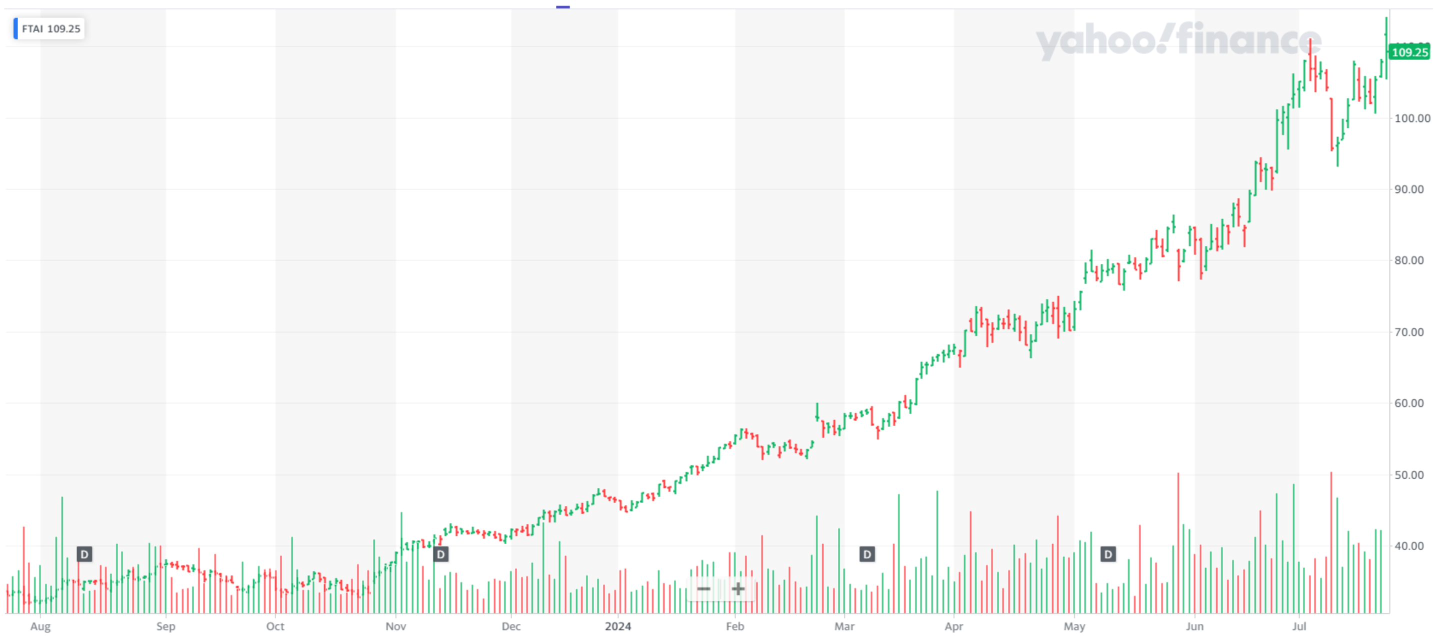
But investors in the category for the long haul should consider how companies get into their fund. The less-followed S&P 600 small-capitalization index—dating to 1994, making it seven years younger than the Russell 2000—has only about $137 billion tracking it. By screening for profitability (as we have noted numerous times), though, it has beaten its more popular competitor by more than 700 percentage points since then**.**



Index funds—and beaten-down small-caps specifically—might well be the cure for recently sagging portfolios. Just read the label carefully.

Positions

FTAI - As detailed on our website, when a stock becomes fully valued we look for an opportunity to sell, provided that it results in a long-term capital gain. On 7/24 we sold for 2 clients @t 108.63:



WLKP - Rated a Sell by 1 of the 2 energy services we follow, on 7/15 we sold for 5 clients @ 23.27: