From Asset Allocation "Nirvana" to Asset Allocation "Nightmare"

July 26, 2011

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Dear Fellow Investors:

Scarcity creates value and scarce behavior, in the investment markets, creates value. We have repeated John Maynard Keynes great quote many times, but as an introduction to our topic today, it must be said: "Investing is the one sphere of life and activity where victory, security and success is always to the minority and never to the majority".

What created the circumstances we have today where financial advisors, registered investment advisors, consulting firms, and institutional investors are pursuing the same basic asset allocation format? We believe it can be laid at the feet of the massive US equity bubble of 1999. Most of the risk capital in the world came to be concentrated in the 50 largest capitalization technology stocks and 90% of these companies were in the US. Massive money flows came into the S&P 500 Index through mutual funds. Most of those flows came into large-cap US equity funds. In an effort to diversify away from ridiculously over-priced tech stocks, veteran large-cap growth stock managers moved into large-cap growth staples and ran them up to 40-50 PE multiples. In the process, the S&P 500 Index became massively over-valued. The "nightmare" in the US stock market was created by over-concentration in an over-priced stock market.

While that sector flourished in a runaway bubble, all other asset classes were starved for capital. There was only money for tech and large growth. There were no small cap tech stocks in 1999 and small cap was dying for capital. Capital-intensive value portfolios didn't own tech and they were starved. The Federal Reserve was tightening credit in 1999 to try to slow the economic boom that went with the tech bubble. The credit tightening caused bonds to be deeply out of favor. They had no ability to compete with the stock market which had gained more than 20% per year on average over the prior 5 years. No other country in the world had a concentration of major tech companies, therefore, international and emerging markets were starved for capital. They had just been hit by the "Asian Contagion" and Long-Term Capital Management debacles of 1997-98. Oil was $11 per barrel at its low in 1999. Commodities had been in a bear market since 1981. Manufacturing companies were squeezed by higher interest rates and a lack of demand from commodity-oriented countries and companies. Every other asset class and stock market sector was having its oxygen (capital) sucked up by the tech stock tri-athletes who were running the most spectacular race the US stock market had ever seen!

When the tech bubble burst, a great deal of capital was destroyed. Some major part of what was pulled out in the US tech driven stock bubble began to be moved into other asset classes. First, it went into bonds. Ten-year Treasuries were at 6% in 1999-2000 and rates bottomed in late 2008 at 2%. Gold was close to $200 per ounce and major world governments dumped their long-time gold holdings. Emerging markets, which started out with tiny stock market capitalizations began to explode as a small part of what was in tech stocks was an enormous amount of new money. Commodities began to catch a bid in 2003 and by February 2011 had produced the best ten-year rolling return in US commodity trading history. Small-cap US portfolios clobbered their large-cap brethren over the last ten years.

Former Merrill Lynch Strategist Richard Bernstein has talked about, "investing like the Mafia". He argues that the Mafia invests in areas that nobody else wants to touch and demands extremely favorable results in return. The Mafia does that by going into areas where capital is scarce due to illegality. There is nothing stopping us from doing the same thing in legal stock sectors or asset classes.

What created "nirvana" was that early asset allocators, who widely diversified, ended up with above-average returns and they got it by taking below-average risk. The risk was below average because their behavior was scarce. I've explained this before using a horse racing analogy. Let's say there are 10 horses in a race. If I bet $2 to win on every horse in the race, I can only make money if a horse carrying 10-1 (or better) odds wins the race. From the year 2000 to today, an unusually large number of the asset classes with greater than 10-1 odds won the race. Almost every other asset class besides US large-cap began the race at 10-1 odds or better and most of them were more like 30-1 to 90-1 odds.

Once those who were early adopters of wide asset allocation began to have outsized success, they began to draw a great deal of attention. The folks running the endowments of Harvard and Yale were in a position to do this and were wise enough to execute the scarce behavior. Investment firms, consultants, RIA firms and financial advisors quickly fell into place behind them between 2005 and 2008. The flow of money came out of large-cap US stocks and stock funds and was spread across these asset classes which had been starved for capital. In many cases, these asset classes were incapable of handling that much money without running up in price so much that they became a bubble market on their own.

When the tech bubble was in its go-go years, Wall Street found a number of new companies and new ways to pursue the tech agenda. The same is now true for wide asset allocation. Bloomberg had an article on June 8th, 2011 which explained how advisory firms are using Exchange-Traded Funds (ETFs) to execute their wide asset allocation strategies at the expense of using equity mutual funds. These lower cost vehicles allow money managers to "move around" more easily, based on their macro-economic outlook among asset classes or stock/bond sectors. They seek to offset a part of the expense they charge investors for selecting which asset classes to over-weight or under-weight. The article explained this through a quote from Scott Burns, the head of ETF research at Morningstar, who said, "There's a shift going on from seeking outperformance on an individual-company basis to seeking it on a macro basis." I hate to be the person that tells this to Scott, but the shift has been going on since the end of 1999. My favorite quote on this subject comes from investing great, Peter Lynch, who said, "I spend about 15 minutes a year on economic analysis. The way you lose money in the stock market is to start off with an economic picture."

How does wide asset allocation become a "nightmare"? It is simple. Almost every horse in the race has so many bets placed on them that they trade much closer to 2-1 odds than 10-1. In other words, diversifying by asset class to reduce risk is impossible because there appears to be only one horse in the race which is starved of capital. We believe the Mafia would only consider large-cap US and they would only look at those large-cap funds who are avoiding oil, basic materials and heavy industrial companies. Those are the only S&P Index subsectors which succeeded during the last ten years and are trading at the highest price-to-book value ratios they have traded for in the last 25 years. Those subsectors are at no better than 2-1 odds, in our opinion.

We believe the next 10 years will be about money moving back into non-cyclical US large cap stocks and domestic companies which enjoy lower commodity prices and the repatriation of money from "highly" risky asset classes with poor odds. We have placed our bets and are excited about the race which is set to begin. Being widely asset allocated today prepares folks for an under-performance "nightmare". In our opinion, bonds are expensive, commodities are outlandish, small caps trade at a huge premium and as China's economic contraction occurs, the crowd will flee emerging markets. Scarce behavior today means buying and holding US large cap stocks which meet our eight criteria and avoiding any of the stock market sectors which are open to being part of that "nightmare".

Best Wishes,

William Smead

This Missive and others are available at www.smeadblog.com.