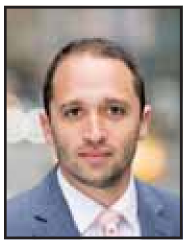
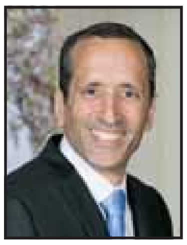
A Farewell to Easy Returns

By Joseph Caplan and Jonathan Caplan





The 11-year bull market from 2009-2020 that followed the financial crisis of 2008-2009 was one of the longest on record. The prolonged, positive performance of the market can be attributed to several factors. First, real U.S. gross domestic product (adjusted for inflation) expanded every year. Second, unemployment declined to multi-decade lows. Third, profit margins steadily increased due to the rapid growth of technological innovation, which in turn drove higher productivity. Finally, federal government and central bank policies, highlighted by tax cuts and highly accommodative interest rates, were predominantly favorable to corporations.

To many market observers and participants, financial markets appeared infallible. Therefore, investors became complacent and began to neglect time-tested investment principles. Many who embraced orthodox investment tenets such as portfolio diversification, focus on valuation and disciplined risk management were likely to generate below-average returns compared to many popular market indices such as the S&P 500 and Nasdaq 100.

In 2020, the federal government and Federal Reserve doubled down on accommodative policies to defend the country from an economic and financial collapse resulting from the COVID-19 pandemic. Consequently, financial markets quickly recovered from an early 2020 swoon and the market exuberance continued for another 18 months.

Due to the unique nature and unforeseen consequences of the global pandemic, the favorable macroeconomic backdrop has sharply reversed. Today, many investors are scrambling to restructure their investment portfolios in the wake of market declines and an increasingly uncertain economic future. In this article, we will highlight some investor misconceptions that should be considered as we enter a paradigm shift of the investment landscape.

Misconception 1: Inflation as a Risk Factor Is Alive and Well

Since the early 1980s, inflation did not play a major role in economic performance. Factors including globalization, demographic shifts and technology were the primary drivers that kept inflation in check for decades. Additionally, the Federal Reserve used their monetary policy tools to proactively head off potential inflationary threats whenever they surfaced. Therefore, there was little concern that inflation would spiral out of control.

In 2020, as the pandemic spread globally, both the federal government and central bank reacted to the economic shutdown through unparalleled stimulative actions. The federal government kept businesses and consumers afloat through direct checks to households, Paycheck Protection Program loans and child tax credits. The Federal Reserve lowered interest rates to near 0% while buying back trillions of bonds, which enabled the federal government to spend aggressively.

As the economy recovered, the consequences of monetary and fiscal stimulus have resulted in rising inflation. In a blog we wrote titled "The Inflation Outbreak" in May 2021, we warned that "the creeping force of inflation is gaining momentum, which could adversely impact our economic future." Throughout 2021, Fed Chairman Jay Powell continued to insist that inflation was "transitory" due to temporary "supply chain bottlenecks" and continued managing monetary policy with that narrative in mind.

Milton Friedman once said that inflation "is always and everywhere a monetary phenomenon." If the Federal Reserve had treated the inflationary pressures with more caution and apprehension, they would have tightened policy sooner and possibly prevented the extent of the problem. The Fed has recently capitulated and finally acknowledged that they are behind the curve. Inflation has become widespread, impacting consumers, corporations and the financial markets. Rising borrowing costs, profit margin compression and slowing economic activity (GDP declined 1.4% in the first quarter) are all manifestations of the impact of inflationary pressures.

While the Fed is adjusting policy, the fallout from an uncertain path to lower inflation is a major question mark. That said, investors have learned once again that inflation is never "dead" and that the risk can never be ignored.

Misconception 2: Investors Must Pay a Premium For Growth and Innovation

Investors generally prefer investing in the future of technological advancement. In recent years there has been growing enthusiasm about innovations including robotics, artificial intelligence, electric vehicles and gene editing. The question becomes how to invest in growth companies without taking on excessive risks.

Monumental mistakes were made as investors bet on innovation through companies with unproven business models in the hope of achieving outsized gains. This frenzy created a platform for fund manager Cathie Wood, the outspoken manager of the ARK Innovation ETF (Symbol: ARKK). Her fund purports to invest in "disruptive innovation" to deliver "spectacular returns." Indeed, from early 2020 to early 2021, the price of her flagship ETF more than tripled to over $150. On May 11, 2022, the fund closed at $36.63, a punishing performance for those who came late to the party.

Some may be surprised that many of the most established companies in the world are at the forefront of global innovation. For example, some of the largest oil and gas companies are a force behind energy transition projects (e.g., carbon capture and alternative energies). Established technology companies are at the forefront of technology breakthroughs (e.g., artificial intelligence, automation and robotics).

As investors seek out investment in innovation, they must carefully consider the viability of the company operationally and financially. Through intense research, one can find select companies that have significantly better risk profiles than those with more speculative characteristics.

Misconception 3: Valuation Doesn't Matter

It has become increasingly clear that the fundamental value of a company cannot be ignored. Like Warren Buffett is known to say: "Price is what you pay, Value is what you get." One who cannot distinguish between the two is likely not to achieve consistent performance.

What is value? To use homeownership as an analog, potential homebuyers need to determine whether the asking price represents fair value. Some considerations include the current condition of the house, expansion potential, schools and proximity to frequented venues and transportation services, to name a few. These are some of the "values" or benefits one can receive from purchasing a home. But valuation requires more quantifiable considerations including the cost of replacing the house, the supply/demand characteristics for homes in that neighborhood and demographic trends, to name a few. This enables the prospective buyer to decide the attractiveness of the asking price.

As it relates to investable assets, "value" can be measured by the estimated magnitude and certainty of future cash flows, the financial condition of the company or borrower, business risks and the utility of the asset within one's broader portfolio. (Note that the value of an asset can vary for each investor.) Given those considerations, one can determine a price that reflects one's estimation of fair value of an asset. Ideally, a successful long-term investor will invest in assets that trade at a discount to estimated value.

In recent years, investors have become accustomed to an economic environment characterized by ultra-low interest rates, excess liquidity and rising asset prices. This may have persuaded investors to ignore traditional valuation methods in favor of chasing momentum stocks and embracing questionable growth narratives. However, as economic conditions have become more volatile, investors have been forced to shift back to value-based approaches. As we have seen in past market cycles, valuation plays a meaningful role in long-term, risk-adjusted returns.

The Road Ahead

We are rapidly shifting away from the benign investment environment of the past 13 years. Given the fraught economic landscape, one must plan for a wide range of economic and market outcomes. Successful portfolio management will likely require a steadfast adherence to core investment principles that have historically helped investors weather the inevitable vagaries of market cycles.

CONTINUED ON P. 117