Damage Control

By Jonathan Caplan

The first half of 2022 has been nothing short of a miserable period for investors. The stock market has registered sharp declines while the bond market has offered no respite. I penned an article in The Jewish Link exactly one year ago entitled, "60/40 Hindsight: Is It Time to Reconsider One of the Key Tenets of Portfolio Management?" In this piece I suggested that because interest rates were being artificially repressed, investors were likely to encounter a new paradigm in which bonds would no longer be capable of mitigating downside risk of the equity portion of their portfolios. I concluded that article with the following warning:

"From a risk perspective, we are experiencing a period of strong monetary and fiscal stimulus, leaving investors with uncertainties as to how well the markets will perform as policies normalize. Both monetary and fiscal stimulus will undoubtedly need to be unwound, perhaps sooner than many expect. The magnitude and rapidity of that normalization process could lead to a variety of outcomes that need to be contemplated by investors as they weigh the risks in a post-pandemic world. While the 60/40 investment model may still prove to be effective in reducing portfolio volatility, the likelihood of unanticipated outcomes should give investors pause. The need to factor in the many risks ahead should motivate investors to consider asset allocation solutions that can provide the ballast to minimize portfolio risk while generating healthy returns."

In fact, the stock market has entered a bear market with the S&P 500 index falling over 20% as of this writing. Technology stocks, the market leaders for many years, have performed even worse. Former stalwarts like Meta Platforms (i.e., Facebook) and Netflix have declined in excess of 50% from their respective all-time highs. To be sure, many of these stocks were priced to perfection, such that they were vulnerable to negative news.

The vulnerability of the stock market was beginning to surface in early 2022 as it became clear that inflation was emerging as an increasingly persistent problem. In response, the Federal Reserve began to signal that monetary policy would enter a period of normalization and that higher interest rates were in the offing. The inflation problem was greatly exacerbated when Russia invaded Ukraine, which added considerably more fuel to rising commodity prices.

The Scouts' Motto: Be Prepared

It has been many decades since I was a cub scout. One of the things I learned then was to always "be prepared." Now I am not suggesting that simple platitudes are the secret to successful investing. But I would suggest that it is critical for investors to learn how to identify vulnerabilities in their portfolio allocation in light of evolving macroeconomic risks.

Our rigorous risk management process and portfolio management style has helped us navigate the market turmoil in a significant way this year. Having anticipated the continued rise in commodity prices and the potential for accelerating inflationary pressures, our primary portfolio models were positioned with a healthy allocation to the energy sector and a relatively low allocation to the technology sector. Energy has been a standout performing sector with strong positive returns so far this year. As a result, investors who have overweighted energy stocks and underweighted technology stocks have seen more modest losses than the popular stock market averages.

Being Prepared for What Is Next

No portfolio manager nor individual investor can necessarily assess with any certainty which parts of his portfolio are the most vulnerable. Nor can he predict what macroeconomic events could wreak havoc on his equity holdings. That said, successful investors should endeavor to identify potential risks and identify strategies to reduce those risks. In that respect, our firm continues to be concerned about the magnitude and rapidity of future interest rate increases in light of continuing inflationary impulses in the global economy.

The Golden Rule

Several decades ago, precious metals were one of the most favored asset classes for investors looking for a safe haven in a world of elevated inflation rates. During the 1970s until about 1980, the price of gold surged from about $35 per ounce to north of $800. Meanwhile, stocks and bonds languished as financial assets were pressured by the ill effects of "stagflation" (low economic growth in combination with rising inflation).

To be sure, I am neither suggesting that high inflation is here to stay nor am I predicting that the price of gold is about to surge once again. At Caplan Capital Management we have been finding anecdotally that gold and gold stocks have proven to be resilient, particularly on days of extreme stock market declines. Part of our thesis for maintaining investment in gold and gold stocks is that elevated macroeconomic and geopolitical risks are likely to persist for an extended period of time. We do not see a quick resolution to the war in Ukraine. We do see continued supply chain pressures throughout the global economy. And we believe that the Federal Reserve may end up tolerating a higher level of inflation for years to come rather than risk driving the economy into recession. This underscores the utility of gold as a risk mitigator in the uncertain times ahead.

Still Bullish on America

Perhaps I am painting a picture that "the sky is falling." Nothing could be further from the truth. I remain bullish on America over the longer term. And I am not about to position our clients' assets for a "nuclear winter" for stocks. But I believe that investors need to ensure that risk mitigation is at the forefront of the investment process.

Like Warren Buffett, our firm embraces volatility since it can help us uncover new opportunities for driving healthy long-term returns. But at the same time, we never take our eyes off the risks. Moreover, we believe that risk mitigation can be one of the most effective tools in limiting losses during highly uncertain times.

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