This Time It's (Not) Different

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It is often said that four of the most dangerous words in the English language are "this time it's different". Having been in the investment business for over 44 years, I find it interesting that, in the early stages of almost every major stock market decline, in spite of much evidence to the contrary, the great majority of investment "experts" pronounce it to be a "healthy correction" and a "buying opportunity". That may turn out to have been the case with the recent selloff, but my guess is that it is probably not.

Since the 1920s, there have been 14 major stock market declines (see Table 1) with losses averaging 34.65% and lasting 15.6 months.

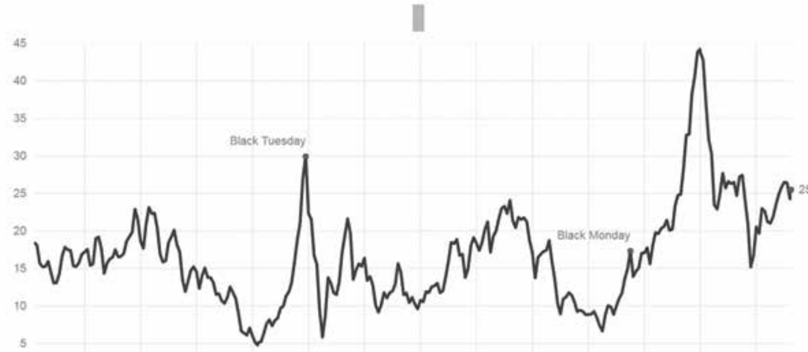
Looking at the bull run that started in March of 2009 and ended on May 21, 2015 from an historical perspective, one can see that the 2009–2015 run up from the bear market lows of March 9, 2009 was much greater in length and well above average in size compared to the other 13. The latest bull market's percentage increase in the S&P 500 was greater than that of 9 of the 13 previous major market advances since 1932 and it was as long as or longer than 11 of them. If the next cyclical market decline is equal to the average of the last 14 in both size and length, the S&P 500 should sink another 31% and bottom in early September of this year at around 1,392. Trees don't grow to the sky and this one, in my view, is unlikely to, either.

Table 1 **Major Market Declines & Advances (1929 – 3/15/16) – S&P 500 Index**

High Date	Low Date	Bear Months	Closing High	Closing Low	Bear Market % Change	Subs Bull	Bull Years
09/16/29	06/01/32	32.1	31.86	4.40	-86.2%	324.3%	4.8
03/10/37	03/31/38	12.5	18.67	8.50	-54.5%	62.2%	0.6
11/09/38	04/28/42	41.1	13.79	7.47	-45.8%	157.7%	4.1
05/29/46	05/19/47	11.5	19.25	13.77	-28.5%	23.9%	1.1
06/15/48	06/13/49	11.8	17.06	13.55	-20.6%	267.1%	7.0
08/02/56	10/22/57	14.5	49.74	38.98	-21.6%	86.4%	4.2
12/12/61	06/26/62	6.4	72.64	52.32	-28.0%	79.7%	3.6
02/09/66	10/07/66	7.8	94.06	73.20	-22.2%	48.1%	2.1
11/29/68	05/26/70	17.7	108.37	69.29	-36.1%	73.5%	2.6
01/11/73	10/03/74	20.4	120.24	62.28	-48.2%	125.6%	6.2
11/28/80	08/12/82	20.2	140.52	102.42	-27.1%	228.8%	5.0
08/25/87	10/19/87	1.8	336.77	224.84	-33.2%	579.4%	12.4
03/24/00	10/09/02	30.1	1,527.46	776.76	-49.2%	101.2%	5.0
10/09/07	03/09/09	16.8	1,565.15	676.53	-56.78%	215.0%	6.2
Median		**15.6**			**-34.65%**	**113.40%**	**4.5**

Source: O'Higgins Asset Management

Figure 1 **Shiller PE Ratio**



Source: www.multpl.com

How about valuation? Most prominent market observers, looking at forecasts for 2016 corporate earnings and applying them to current stock price levels, feel that U.S. stocks are, in general, either fairly valued or undervalued compared to historical price/earnings (P/E) ratios and, especially, versus interest rates currently available on 10-year U.S. Treasuries. On the other hand, if one looks at Robert Shiller's Cyclically Adjusted P/E (CAPE) history, which is based on a 10-year average of inflation-adjusted earnings, our stock market looks quite overvalued at its current level of 25.5 (see Figure 1). From CAPE's point of view, over the last 87 years, the only other times when it was more overvalued than now were in 1929 just before the 86% stock market decline of 1929–32, in 1968 before 1969–70's drop of 36.1%, in 2000 immediately preceding the S&P's 49.2% collapse in 2000–03, and in 2007 prior to 2008–09's 56.8% loss.

The future course of interest rates, the U.S. economy, the global economy, corporate earnings, and inflation is unknowable; but, even if one could accurately predict those critical influences on U.S. equity prices, how would one know how to play it? As I pointed out, using a number of very surprising examples, in my "Why Diversify" *Gloom, Boom and Doom Report* article of September of 2011, even when one manages to correctly predict the occurrence of a future event, it is very easy to pick the wrong investment vehicle or vehicles to play it profitably. In that and five other articles that I have written for this report over the past five years, I have outlined an asset allocation system, the Michael O'Higgins Absolute Return (MOAR) Strategy, that has, historically, solved that problem.

MOAR is a simple asset allocation method which has, historically, produced relatively high returns with very low volatility by spreading assets over four different asset classes: undervalued global stocks ("Dogs of the World"), physical gold or platinum, Intermediate Treasury Notes and Long Term Treasury Bonds, and rebalancing annually.

Normally, each sector is allocated 25% of the MOAR portfolio, except in years following a losing year for the equity portion of the strategy when an additional 15 percentage points, 5 percentage points taken from each of the other three portfolio sectors, are allocated to the equity portion giving it 40% of the total portfolio. For example, in 2009, 2012 and 2015, following the equity portion's losses of 47.59% in 2008, 18.07% in 2011 and 15.2% in 2014, its weighting was bumped up to 40% of the portfolio for the coming year. This overweighting of equities boosted MOAR's total return by 70% in 2009 and almost 24% in 2012. Last year, however, it hurt MOAR's performance when our Dogs of the World lost another 16.2%.

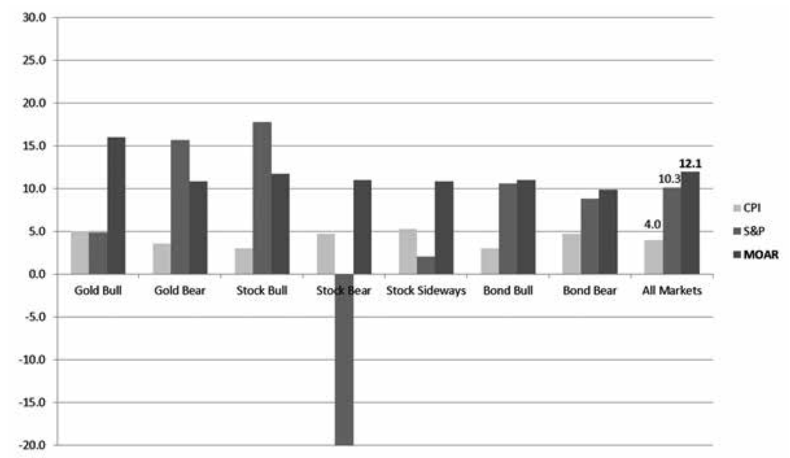
The rationale for this tilting toward equities is that stocks, especially our "Dogs", tend not to decline for more than one year in a row. Increasing our equity exposure after such a loss allows us to capture a larger piece of the ensuing rebound. Should consecutive down years in equities occur, however, the weighting is further increased by 15 percentage point increments each year. Interestingly, that has only happened five times since 1928 (versus 13 one-year declines) and only once since 1971.

Since 1971, the year when Nixon took us off the Gold Standard, the MOAR Strategy would have produced compound average annual returns of 12.1%, after a 1% management fee, versus 10.3% for the S&P 500, with only 6 losing years ranging from –12.85% in 2015 to –0.52% in 1994 compared to the S&P's 9 losing years, some of which, such as 2008, were as large as –37.00%. Moreover, MOAR would have beaten stocks and inflation in the overwhelming majority of bull, bear and sideways markets for gold, equities and bonds that occurred during those 42 years. In fact, the only two market environments in which MOAR has underperformed the S&P 500 have been during a gold bear market and a stock bull market and it has beaten inflation under every type of market (see Figure 2). The fact that gold was falling and stocks were rising strongly for most of the last four years largely explains why MOAR has had disappointing performance since 2011 (see Figure 3).

One of the key reasons for MOAR's long-term success is that, aside from the benefits accruing from annual re-balancing and tilting toward equities after losing years, is that it is also largely value-based and value investing is a proven way to maximize returns over long periods of time.

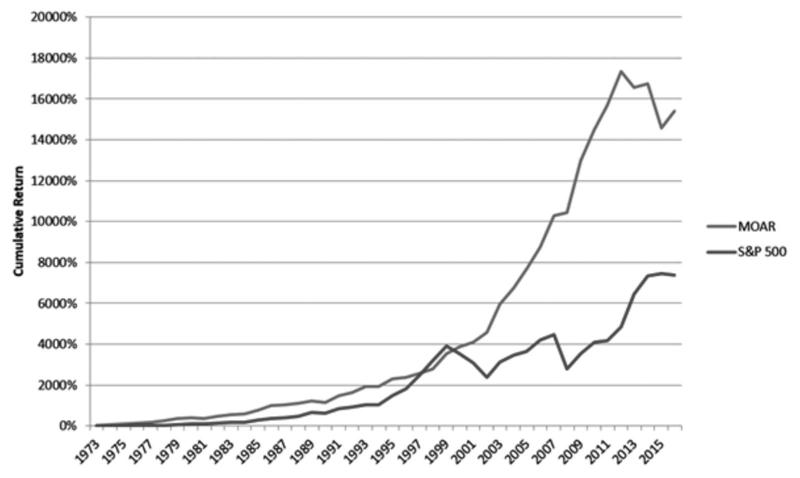
Using U.S. stocks as an example, going back to the beginning of 1928, according to Ibbotson Associates, large cap value stocks have beaten large cap growth stocks in 57 of the last 88 years, compounding at a rate of 11.05% per year versus 8.81% per

Figure 2 **MOAR Hypothetical Returns in Bull & Bear Cycles (1929 – 3/15/16)**



Source: O'Higgins Asset Management, Inc. and Bloomberg

Figure 3 **MOAR vs. S&P 500, Hypothetical Returns Net of 1% Fee (1972 – 3/15/2016)**



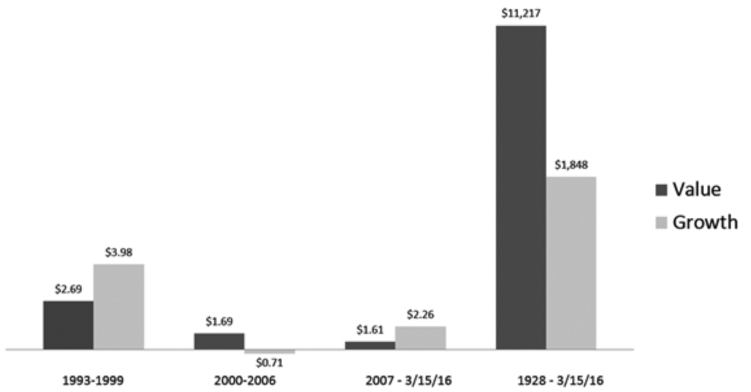
Source: O'Higgins Asset Management, Inc. and Bloomberg year for their "growthier" competitors. While this 2.24 percentage point annual advantage may seem small, over time the difference is substantial. A dollar invested in value stocks at the beginning of 1928 would have grown to $11,217 by March 15, 2016, or over 6 times the $1,848 that would have resulted had that same dollar been invested in a growth stock portfolio over the same period (see Figure 4).

So, right now, how do we at O'Higgins Asset Management manage to find value among the four broad sectors to which we limit ourselves: the "Dogs of the World", long-term U.S. Treasury Bonds, intermediate-term U.S. Treasury Notes and physical platinum? In the following paragraphs, we will explain how.

The Dogs of the World (DOTW) are what we consider to be the five cheapest investable equity markets in the world. Going back to the beginning of 1996, they have compounded at over 12.9% annually during a period when the S&P 500 returned roughly 1/2 of that and the Morgan Stanley World Index did less than 1/4 as well. **This year's DOTW are Brazil, Korea, Poland, Russia and Singapore.** So far in 2016 they are +5.82%, on average, not including their substantial dividends. At their current prices, using a variety of fundamental metrics, they are selling at roughly 1/2 the price of the S&P 500 without even considering the depressed currencies in which they are denominated.

Long-term U.S. Treasury Bonds would not appear on many investment observers' lists of undervalued assets but consider the following. According to Sydney Homer, the author of *The History of Interest Rates*, since Babylonian times, high-quality long-term debt has paid 2% points over the long-term rate of inflation. Ibbotson Associates tells us that, in the postwar period since 1945, long-term U.S Treasuries have yielded 5.9% annually while inflation, as measured by the Consumer Price Index (CPI), averaged 3.8%. For the 12 months through January of 2016, CPI was +1.0%. So, if inflation is 1.00%, then 2.73% on 30-year T-Bonds isn't so bad, especially if we are going to follow a number of our fellow G-7 members into negative short-term rates, as seems increasingly likely.

Figure 4 **A Dollar Invested Over Time, Value vs. Growth (1928 – 3/15/16)**



Source: Ibbotson Associates, Bloomberg and O'Higgins Asset Management

Figure 5 **Platinum (Spot Price), 2006–2016**

Source: www.stockcharts.com

Intermediate Treasury Notes at 1.99% are throwing off a slightly lower 0.99% "real" yield but look shockingly cheap when compared to yields available on other high-quality sovereign debt. Maybe the Swiss deserve to sell 10-year debt at negative 0.32% and the Germans and Dutch at 0.31% and 0.41%, respectively. But how about Italy at 1.36% or Spain at 1.51%? Does anyone really think that they are more likely to make their interest and principal payments than we, the USA, are? And let's not even consider that most of them are denominated in a depreciating currency.

Our last undervalued investment is one that you won't find on very many Wall Street recommended lists, either: physical platinum. While our precious metal position is usually invested in gold, we are currently in platinum because, while it has historically been priced 25% higher in price than gold, on average, it is currently almost 22% below gold. As far as gold's relative undervaluation, its price has historically averaged 1/10 the price of the Dow Jones Industrial Average and, as I write, it is only 1/14th ($1,234/17,252) the price of the Dow. Therefore, in our view, fair value for platinum right now would be $2,155/oz. or 124% above its current price of $962/oz., if historical relationships were to return to normal.

For 2016, the MOAR Strategy calls for investing as follows: 15% in Long Term U.S. Treasury Bonds (TLT), 15% in Intermediate Term Treasury Notes (IEF), 15% in platinum (PPLT) [Figure 5 depicts spot platinum price — *ed. note*] **and 55% in the "Dogs of the World" (DOTW). This year's DOTW are: Brazil (EWZ), Korea (EWY), Poland (EPOL), Russia (RSX) and Singapore (EWS).**

So far this year, our MOAR strategy has produced a gain of 5.52%, after fees, versus losses of –0.86% for the S&P 500 and –0.31% for the DJIA. Time will tell if the above allocation will prove profitable for the remainder of the year but, after almost seven consecutive years of stock market gains, it is highly likely that this time it will, indeed, be "different" but not in the way most market participants expect [emphasis added].