

First Quarter 2014

# Economic and Market Commentary

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The scene is set, we the viewers are in the midst of a 1940s cocktail party held in lavish digs. Conversation is loud, cigarette smoke fills the room, and there's tension in the air. We're on the set of Joseph L. Mankiewicz's 1950 film classic, *All About Eve*. In the movie, Bette Davis plays a fading stage star named Margo Channing, and tonight she's out for blood.

Throwing back "see-throughs" with wild abandon, Margo exchanges terse one-liners with her fellow guests until she makes her way to center stage, turns to her audience and delivers one of Hollywood's great lines: "Fasten your seatbelts, it's going to be a bumpy night."

## **You Could Say The Same About Today's Equity Markets**

With first-quarter results now in the bag, it's quite clear that 2014 is shaping up to be a much more volatile year than last. Case in point: Already the Dow, S&P 500 and the NASDAQ have had twice the number of "big market swing" days, with markets closing 1% or more higher or lower than last year. Think back. January was a ghastly month in the equity markets. In February, however, the markets came roaring back. The first trading day in March, the Dow was down over 300 points within hours of the market's opening, but by Thursday's close, the S&P 500 had moved to another record high, it's 50<sup>th</sup> in the previous 12 months. Historically speaking, traders like market volatility since they often own stocks not measured in years or months or days or even hours, but in seconds. Investors do not like a lot of volatility. Volatility does not bode well for bull markets.

## **So What Do the Tea Leaves Say?**

We're now entering into the second and third quarters in the second year of a presidential cycle. Historically speaking, this is the weakest six-month period in the entire 16 quarter election cycle. Think back to the end of last year and you'll remember analysts were saying perhaps employment growth might be gaining a little traction, but by and large, the economy was in a slow growth mode, plodding along at an anemic 2+ % GDP. Housing was cooling off in many parts of the country, and how much could be chalked up to the bad weather was anybody's guess. The market had gained significantly in the past year, and riskier things went up most.

Against the backdrop of 2013, investors recognized that some segments of the market had gotten very expensive. In fact, most sectors of the markets in general were either fairly priced or expensive.

So after fueling the fire for five years with accommodating Fed policy and easy money, the markets now have entered into a period where investors are rotating out of various asset classes— small cap to large cap, growth to value, emerging to developed markets. Even last year’s pariah of asset classes, utilities, have come to shine, all resulting in heightened volatility and big market swings with more on the horizon.

## **Okay, Smart Guy, What Are You Going To Do About It?**

The truth is, you can’t take the volatility out of the market, but you can take it out of your portfolio. Successful navigation of volatile market conditions requires a strategy— a plan of action designed to achieve a particular goal. In our case, the goal is simple. We want to avoid buying particularly overpriced asset classes, including much of the bond market and produce positive returns with well managed risk. To accomplish this, we’re going to use an algorithm. That’s the ninth century invention of Muhammad ibn Musa al-Khwarizmi, astronomer, geographer and mathematician. Just to be clear, Muhammad was no one trick pony. In addition to inventing the algorithm, he founded algebra and the decimal system, as well as producing the first map of the known world in 830 CE.

So just what is an algorithm? Basically it’s a well-defined set of instructions for calculating a function. When the instructions have been followed, an outcome produces the desired ending state.

Where it gets tricky is in the fact that there are a lot of alternative protocols available in each case, and you need to pick the one that delivers the desired result for the task at hand. Here’s an example: You have a friend who just arrived at the airport, and he’ll be staying at your home as your guest. The particular goal here is to get him to your house. Here are some sample algorithms to accomplish your goal:

### **Algorithm I The Taxi Algorithm**

Tell him ....

1. Go to the taxi stand
2. Get in the taxi
3. Give the driver my address

Or

## Algorithm II The Bus Algorithm

Tell him ....

1. Outside the baggage claim, catch bus number 70
2. Transfer to bus number 14 on Main Street
3. Get off at Elm Street
4. Walk two blocks north to my house

Each algorithm accomplishes the same goal but does it in a completely different way. If you were cost-conscious, algorithm II would be the preferred choice. On the other hand, if you were time conscious, you would go with algorithm I. You choose the algorithm based on the circumstances.

Our circumstances require a plan that results in the dependable avoidance of overpriced assets and the expectation of timely acquisitions of underpriced assets. What we need is an algorithm that works like a thermostat.

## The Underappreciated Thermostat

Just about anyone could tell you that Galileo is credited with inventing the earliest gauge that allowed temperature variations to be measured for the very first time. It consisted of a container filled with bulbs of varying mass, each with a temperature marking the buoyancy of water changes with temperature. Some of the bulbs sank while others floated. The lowest bulb indicated what temperature it was. Yeah, I know that was an easy one, but you'll need your A-game to tell me the name of the father of the thermostat. Okay, here it is, his name was Andrew Ure. Andrew was a Scottish chemist who, in the 1830s, invented a bimetallic thermostat for the textile industry.

In the early 19<sup>th</sup> century, textile mills needed a constant and steady temperature to operate optimally. With this in mind, Ure fashioned the bimetallic thermostat that would bend as one of the metals expanded in response to the increased temperature and cut off the energy supply.

Remember, a thermostat is part of a control system that regulates temperature in order to keep things at or near a “set point,” a Goldilocks temperature— not too hot, not too cold, just right. So what if we applied the same thermostat principle to our investments, not to control temperature, but to manage risk and run an efficient and opportunistic portfolio.

## So How Does That Work?

Glad you asked. Allow me to explain.

Think of Honeywell's iconic "The Round" model T 87 thermostat from the 70s, one of which lies in the Smithsonian Museum. It has a round dial with temperature readings from 40°F on the left of the dial to 105°F on the right of the dial. Now you set the top of your range, the temperature you do not want to exceed, and the bottom of the range, i.e., the temperature you don't want it to fall below. If the top of the range is met, the air conditioner comes on to cool things off. And if the bottom of the range is met, the furnace kicks in to warm things up. With me so far?

Our thermostat works exactly the same way, but instead of the dial indicating temperatures, our dial is going to indicate ranges in the stock market as illustrated by the S&P 500. Let's say the middle of the dial is 1800, roughly where we are today. (Don't misread this, I'm not suggesting we're in the middle of our trading range right now, I'm illustrating.) At the top of the gauge, on the far right-hand side, is an S&P 500 of 2400. An S&P 500 valuation at that level would reflect a double sigma event in terms of probability at current earning rates. (In other words, a very long shot that it would get that high based on current corporate profit margins). At the far left-hand side of the dial is an S&P 500 of 900, representing a 50% markdown from current levels, or roughly approximating the 50% decline during the Great Recession of 2007-2009.

Now in a perfect world, we would want to set our thermostat so that at the very top of the market, we would have sold all our stocks. Think of it as an air conditioner, turning on when the house gets too hot. In our case, we're selling all our stocks because the market has gotten too hot. Read that as "overpriced" or "overbought."

Now at the other end of the dial, we'd want to be moving into more stocks if the market got to the far left of the dial with the market oversold and the S&P 500 down around 900. In other words, we'd want to be fully invested, with all of our assets securing stocks at the bottom of the market. How fundamental. Buy low, sell high. A real aha moment.

## No Argument From Me

Yes, I know it's sure not as easy as it seems, but that's where our algorithm comes into play. It is designed to provide a clear and well-defined set of instructions by which we reallocate the portfolio to attain our goal. Avoiding overpriced asset classes, and acquiring underpriced asset classes while staying true to our risk preferences, namely avoiding the oversized hit in a down market.

Let me give you an example of just how it would work. Let's say our portfolio model called for the following allocation based on an S&P of 1800: Stocks 60%, preferreds and convertibles 20%, currency and managed futures 8%, with cash, metals and other income alternatives 12%. As the stock market rose to an S&P of 2000, our model might call for

35% stocks, 35% preferreds, 10% cash and metals, with the remaining 20% in income alternatives, e.g., absolute return funds, triple net leases, unit investment trusts.

So what are we effectively doing? We're avoiding overpriced asset classes by selling into strength and harvesting profits. Those profits get banked into more stable, lower volatility asset classes pending future deployment, keeping our powder dry. When do we deploy these banked assets? As the market moves down the left-hand side of the gauge toward an S&P 900, we're buying more stocks at good valuations. Where are we getting the funds to make the buys from? By selling our more stable value, preferreds, convertibles, and managed futures.

## **Conclusion**

So there you have it. Volatile markets require clear and disciplined thinking to navigate successfully. Like Andrew Ure discovered almost 200 years ago, if you pay attention to your thermostat's settings, keep your equipment running smoothly and well-maintained, it is possible to stay in the comfort zone.

As always, I look forward to seeing you at our upcoming review.

Best Regards,

Ray Lent  
RLL/dot  
Enclosures