LYELL WEALTH MANAGEMENT

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Unforced Errors

We are in an unusual economic and market environment. Sub-par economic activity, unprecedented aggressive monetary policy, historically low interest rates and high financial asset prices are vexing most market participants. Technology, communications, globalization and demographics are among several factors which are presenting unique challenges and opportunities.

As Lyell navigates this investment landscape, we tend to agree with Mark Twain in that while history doesn't repeat, it does rhyme. Successful investing is difficult. The best researched and thoughtfully executed investments sometimes do not meet expectations. Although a poor investment is occasionally unavoidable, an experienced investor can learn from history and prior market cycles. Investment portfolios can benefit by avoiding what would appear to be predictable mistakes, which tend to be popular investments whose fundamental underpinnings are in doubt. Eliminating these unforced errors is like a tennis player with a large lead not hitting double faults.

So what unforced errors might investors make in today's markets?

Thinking You Know the Future

It is important to have a plan and investment strategy, but one should be prepared that events and new information may dramatically alter the trajectory. Lyell's base view is that the slow growth U.S. economy has years of expansion yet ahead. Interest rates may rise somewhat from current low levels, but any increase will be modest. The cocktail of economic expansion and low interest rates will support price/earnings multiples and allow further appreciation in this current bull market in stocks. However, major shocks such as a serious U.S. trade policy error or messy disruptions from Europe or China would alter this trajectory. The future unknown should be respected, and having investments that will behave differently in these scenarios is advisable. It is also important to remain open minded and consistently question your thesis. To paraphrase, John Maynard Keynes, when the information changes, be prepared to change your opinion.

Reaching for Yield

It is commonplace to seek income during challenging markets as it can create the appearance of predictable cash flow. Retirees and those on fixed incomes are particularly focused on investments that provide regular income, such as bonds or dividend-paying stocks. Today's very low to non-existent interest rate environment has made this search for yield an acute global phenomenon. However, reaching for yield can often lead to future pain. The yield is often high for a reason; it is the market's message that the likelihood of receiving that income in the future is low, and the high yield is meant to compensate you for that risk. For example, as energy prices collapsed over the past two years, many Master Limited Partnerships (MLPs) dropped in value

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so that their annual distributions exceeded 10%, and in some instances much higher. These high yields signaled a significant likelihood of the distribution rates being cut or eliminated. And they eventually were.

A much more widespread reach for yield has been underway in the spike in valuations for slow or no growth Utilities & Telecom stocks. Low interest rates have made the high dividends paid by such companies more desirable. The S&P Utilities sector trades for 18.8x 2017 earnings versus a five year median of 15.7x according to Thomson Baseline; however, earnings are only projected to grow at 2% annually. Such a wide dispersion between P/E multiples and growth rates is a big warning. Most of these companies already have a high payout ratio (dividends paid out as a percentage of earnings) which limits future dividend growth. The Utilities and Telecom companies in the S&P 500 pay out 75% and 67% of their earnings despite their anemic earnings growth; the average S&P 500 company pays less than 40% of its earnings in dividends according to Strategas Research Partners. These high dividend stocks are likely to be penalized swiftly if interest rates rise as we saw in the 2013 taper tantrum, when interest rates temporarily spiked. There is nothing conservative or defensive about owning a "widows and orphan" stock if you buy it at a very high valuation.

Lyell views dividends as an important component of overall portfolio return. It is our preference, however, to invest in companies whose earnings can continue to fund future dividend increases, rather than purchasing yield simply because it is in short supply.

An emerging trend in the reach for yield is large pension funds, such as in Hawaii and South Carolina, that are using a derivatives strategy that is successful if stock prices rise or stay flat. The Wall Street Journal reported in August that these funds are selling options on stocks and stock indexes that provide premium income (enhanced yield) today, but risks major losses if the stock market goes down. These funds apparently don't own the underlying stocks, so they are "naked" which differentiates them from the popular covered call strategy. While this new trend is visible in the institutional market, one worries that brokers may be pushing similar products to retail investors. It offers very limited cash flow gain now with the risk of large loss. This reminds us of Warren Buffett's comment about AIG's mortgage insurance business prior to the Financial Crisis as "picking up nickels in front of a steamroller." Lyell seeks to avoid such strategies.

Being a Patsy

One should be wary when offered an unusual investment opportunity, if there isn't a good reason why you have access to it. A private Oil & Gas company from Texas raising money from individual investors in California, for example, should be viewed skeptically; there are a lot of smart energy investors in the Gulf region who likely declined to invest. In a related point, it is best to avoid investments in certain asset classes unless you truly have special access. Venture capital and private equity funds can be great investment vehicles. However, less than 10% of the funds deliver superior returns and the rest aren't worth investing in. Brokers and banks package funds-of-funds which aggregate many funds together. However, they don't have access to the top funds. This is the definition of "adverse selection." The double layer of fees in these funds (to the fund manager as well as the sponsoring financial institution) makes good returns for the investor even more unlikely.

The explosion of crowdfunding and retail angel investing will likely prove to be a passing fad once the widespread losses are tallied. Cool ideas and start-ups are highly risky and the vetting which occurs when fundraising through sophisticated VC and angel investors is Darwinian in a good way. Although the democratization of venture capital inevitably has its success stories, your average individual doesn't have the knowledge and industry insights to assess whether a startup is viable or not. Per the first paragraph, unless there is a reason why you have special access and you know the sector well, you are better off staying out of it.

In recent years there has been an emergence of the sale of private company stock by founders, employees and early investors to new investors. Venture-backed companies have stayed private much longer over the past decade, in some part due to the regulations and short-term expectations associated with public companies. As such, it is reasonable that executives and employees who have deferred lifestyle choices for many years be able to sell a moderate amount of stock. Lyell's professionals have in fact advised numerous private company executives on the timing, quantity and tax impact of their sales. However, this practice of selling secondary shares has become too commonplace in our opinion. When someone very close to a situation with presumably big upside wants to sell you their stock, be skeptical. An extreme example of this was Zynga's CEO Mark Pincus who sold about $220 million in Zynga's stock before its IPO. Caveat emptor.

The twin stock market crashes in 2000-01 and 2008-09 have understandably rattled most investors. Seeing one's stock portfolio drop as much as 50% twice within a decade is memorable. As such, a major industry has developed by organizations selling against these fears of large losses. They come in various products and structures, but they are essentially insurance instruments. One common product is the "structured note" which promises to allow the investor to participate in stock market gains up to a capped return, but then makes them whole if the portfolio drops – but only to a point, such as down 10%. If the stock market index drops 50%, then the investor's portfolio drops 40%. So the entire benefit of the product is to insure against the first 10% drop which is rarely the magnitude that inspires such fears. Needless to say, there are large embedded fees in these derivative products. To our knowledge, they are rarely promoted by fiduciaries who have the legal standard to seek the client's best interest.

Chasing Returns

The financial media is constantly covering what asset classes are hot. For example, over the last few months, US dollar weakening coupled with stronger economic growth resulted in a rebound in emerging markets stocks and bonds. Strong returns over a prior period can be used to justify investing new money into the same theme. By the time the media is covering these topics, it is frequently too late and the fast money is already moving on. Market timing and active trading are best left to a small number of professionals.

As discussed earlier, this economic cycle has confounded many investors. Many likely now find themselves trailing relevant benchmarks. While some may feel the temptation to take on more risk in an effort to "win it back," this is highly inadvisable. Investors should stay disciplined, focusing on their personal goals and the opportunities at hand rather than the success or failure of previous decisions.

Betting Against History

It is generally a good idea to distrust forecasts that conflict with human history. Today we are experiencing negative interest rates for the first time in over 5,000 years of human civilization. However, those rates have been created by central banks around the world. The market didn't take rates to negative levels, the policy makers did. As pointed out by the The Wall Street Journal the markets are now pricing the long-term yield on inflation-linked government bonds (stripping out the next decade to avoid short-term fluctuations) at below inflation for the next 30 years. Lyell doesn't share that view. Although bonds have provided capital gains as yields have fallen over the past 30 years, the risk/reward is clearly skewed towards the risk. It is worth remembering the history of fiat currencies and that representative governments are inherently inflationary.