Lessons From the Road

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February, 2015—Forget the war on drugs, forget the war on terror, forget the war on whatever. Here in Atlanta, we need a War on Traffic! Of course I jest, but if you've recently driven on one of spaghetti junction's eighteen lanes during a foggy, rainy, wintery rush tri-hour, then you know what I mean—it's brutal!

And, of course, the lane I'm in has a big rig in front of the lawn service truck I'm behind. And, oh no, I can make out a school bus in front of the big rig. And surely that can't be Nathan's Driving School nestled between them. The perfect storm. Gotta get out of this lane.

The lane to my left seems to be moving pretty well, the one left of that even better. A sweet maneuver I learned in college gets me over there; but what's that? Blue lights and red lights begin to pierce the wintery mix. At first I thought I was seeing tail lights, but now it's a veritable swirl of lights, a smoky menagerie of emergency vehicles. Dead stop.

Jack-knifed chicken rig. Seriously? All of a sudden I'm in a "Haitian voodoo homecoming" meets "Terminator 2" (I will spare you the details, but let's just say some of the drivers involved will probably never eat chicken again).

I look two lanes to my right and what do I see? With reminiscence and fond regards, my former lane, before so nonresponsive and unyielding, now takes the solemn lead. There goes the lawn truck—out of site now, but not out of mind.

And so it goes with investing, particularly with the cyclical nature of various asset classes. Some lanes (asset classes) look good for a while, but as soon as you make a change you come to regret it. Think about all the people who bought into the dot.com boom in 1998 or the real estate boom in 2007.

Right now, as we look around, the fast lane on our investment highway is Large Cap U.S. Stocks, as represented by the S&P 500. If you have recently compared the performance of your portfolio to the S&P 500 and noted that you aren't seeing the same kind of returns, you may be tempted to switch lanes—shouldn't we jump into that lane and drive as fast as we can, while we can?

Forgive the continuing analogy, but when you're in the fast lane, you're far removed from the exit ramps. In fact, you may not notice any warning signs, so focused are you on your lane. Often times, to their regret, investors who are too heavily invested in stocks, going fast and hoping to reap their profits don't notice that they've missed the exit until it's too late.

As responsible financial advisors, we would never encourage you to go 'all in' to the fast lane, no matter how tempting; and we are, in fact, *prohibited* from allowing you to put all the money you have entrusted to our care into any single lane.

When Large Cap stocks stop being the 'fast lane' (and they inevitably will) who can know which lane will start moving next? Obviously, our answer to this conundrum is diversification. We create a fleet of cars to potentially reap the benefits of *all* of the lanes.

We do, indeed, have a car in the fast lane, but should that car blow a tire, we have several others plugging along in their respective lanes, in hopes of offsetting any losses that may result from the blow-out. Our ultimate goal is to get you to your destination.

I may have beaten my analogy into the ground, but if you're still with me and are ready to delve into geo-political factors and technical analysis, please continue reading.

We can look back at 2014 and recognize some things that we expected, like continued stock growth and nominal interest rates here at home, and some things we did not expect, like the renewed cold war with Russia and the sudden collapse in oil prices.

The following chart shows how various countries have performed relative to one another over the last ten years. You can see how the S&P 500 (light orange) outperformed in the last two years, but underperformed in several other years.

You can see that Emerging Markets (EME, medium gray) and the Pacific Rim (Pac ex-Japan, darkest gray) was in first or second place in six out of twelve years.

World Market Returns by Region — USD

Emerging market equity (EME) has often been a top performer but lagged in 2011-2013. The S&P 500 has been the runaway market leader this year, while the UK and Japan are the laggards.

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
EME 56.3%	Pac Ex-Japan 29.6%	EME 34.5%	Europe Ex-UK 36.4%	EME 39.8%	Japan -29.1%	EME 79.0%	EME 19.2%	S&P 500 2.1%	Pac Ex-Japan 21.7%	S&P 500 32.4%	S&P 500 14.0%
Pac Ex-Japan 47.0%	EME 26.0%	Japan 25.6%	Pac Ex-Japan 33.2%	Pac Ex-Japan 31.7%	S&P 500 -37.0%	Pac Ex-Japan 73.0%	Pac Ex-Japan 17.1%	UK -2.5%	Europe Ex-UK 18.7%	Europe Ex-UK 28.7%	EME 2.9%
Europe Ex-UK 43.6%	Europe Ex-UK 22.4%	Pac Ex-Japan 14.8%	EME 32.6%	Europe Ex-UK 17.5%	Europe Ex-UK -45.0%	UK 43.4%	Japan 15.6%	Pac Ex-Japan -12.7%	S&P 500 15.0%	Japan 27.3%	Pac Ex-Japan 2.2%
Japan 36.2%	UK 19.6%	Europe Ex-UK 11.3%	UK 30.7%	UK 8.4%	UK -48.3%	Europe Ex-UK 33.9%	S&P 500 15.1%	Japan -14.2%	EME 13.1%	UK 20.7%	Europe Ex-UK -0.9%
UK 32.1%	Japan 16.0%	UK 7.4%	S&P 500 15.8%	S&P 500 5.5%	EME -47.1%	S&P 500 26.5%	UK 8.8%	Europe Ex-UK -14.5%	UK 13.0%	Pac Ex-Japan 5.6%	Japan -2.3%
S&P 500 28.7%	S&P 500 10.9%	S&P 500 4.9%	Japan 6.3%	Japan -4.1%	Pac Ex-Japan -50.0%	Japan 6.4%	Europe Ex-UK 2.4%	EME -18.2%	Japan 2.9%	EME -2.3%	UK -2.7%

Note: All data are based on equity indexes for each regional or country index and are total returns including dividends for each calendar year or partial year.
Source: MSCI, Standard & Poor's, FactSet

As we know, prudent investing requires that we diversify our portfolios. Not just across different types and sizes of companies, but across international borders as well. In fact, from a strictly fundamental perspective, international stocks and emerging markets at times have better numbers than the S&P 500.

How can this be? Well, they usually have less debt. Whereas our debt to GDP is greater than 100%, Emerging Markets and developing economies have less than 35%.[1] They have a lower price/earnings ratio. Whereas the S&P 500 has a P/E of 17.5, Emerging Markets have a P/E of only 12.4.[2]

Today, Emerging Markets make up a bigger piece of the global pie, accounting for 39% of the world economy, as compared to only 20% just eleven years ago.[3] Consumption in those countries has increased by 100% in the last decade as compared to 50% in the U.S.[4]

And, of course, one cannot fail to mention the sharp drop in oil prices. Paradoxically, U.S. stocks sold off when oil prices dropped. Surely this means profits won’t be as generous for some oil producers, but for nearly every other producer, manufacturer, shipper, or consumer, it’s a great thing. And guess which asset class generally does well with lower oil prices? You got it: Emerging Markets.

Now that certainly doesn’t mean that we want to go “all in” in Emerging Markets. Absolutely not. We don’t want to go “all in” in anything. But it may mean that we don’t want to change out of the Emerging Markets lane simply because the last couple of years have seen the U.S. big stock lane rolling along.

In fact, since predicting the top performing asset class with any consistency is just about impossible, it’s no surprise that diversification, in light of one’s current risk tolerance, remains the cornerstone principle of any sound portfolio. However, it comes with a catch: It means that in any period, there will be portions of your plan that just aren’t working. And if you own a portfolio where all of the parts are working at once? That’s a pretty good sign that the portfolio may not actually be diversified, and may be a harbinger of a rough road ahead.

Take gold, silver, oil and commodities, for instance. Clearly they have all seen higher prices, and could be said to be in a slump. For most investors, these holdings are wise inflation hedges. Meaning, of course, that they do well when inflation is high. This is a sound policy with over a hundred years of statistical data. And yet, even though the Fed has quadrupled the money supply since 2009, these hard assets remain at an inviting price level.

Believe it or not, the sharp drop in gold, silver, oil and commodities could be seen as something very good to us. “Hey, there's no inflation, so we don't need to raise interest rates.” This is especially important because we are floating $18 trillion of debt—and counting.

[1] IMF World Economic outlook database
[2] FactSet
[3] International Monetary Fund as of 2014.
[4] World Bank, OICA

If we were to raise rates—and assuming at some time we will have to—then all the short term debt we have issued will adjust up, followed later by longer term maturities. This will greatly increase our debt service (interest payments) and cut into our already out-of-control budget. If we pay nothing else, we've got to pay the interest or the whole house of cards comes tumbling down.

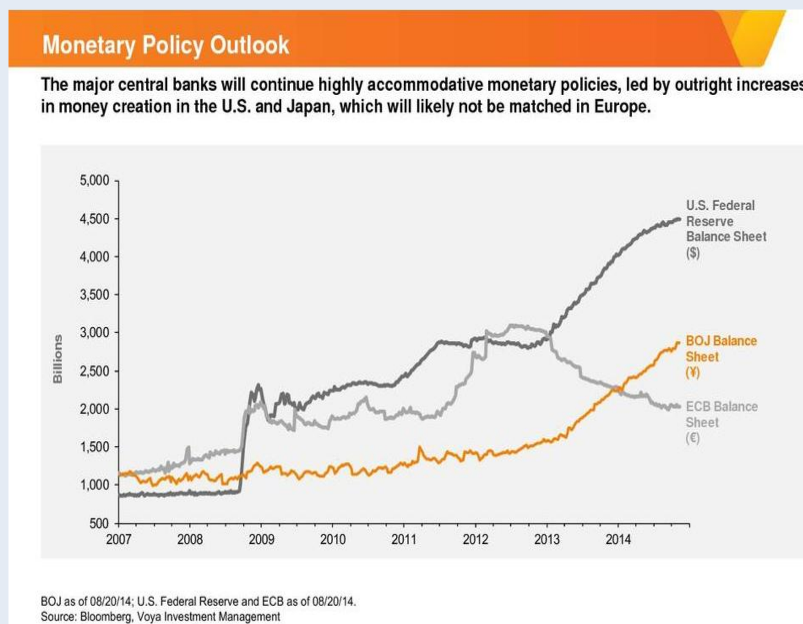
Imagine that you are making $2,000 per month, but spending $4,000. You put the $2,000 that you're not earning on your credit card. The sweetest credit card in the world. Now also imagine that you get to set your own interest rate. What would you chose? Something very near zero would be my answer. Sound familiar?

Now imagine that you get to increase your credit line every time you "max out." Would you ever decline yourself an increase, knowing that you have no other way to pay your bills, or even make interest payments?

I wouldn't. I'd have fun, fun, fun till daddy takes the T-bird away. I guess for us, daddy's name is Beijing.

And so it goes. Everyone “in the know” also knows that the so-called rally in U.S. stocks is directly attributable to increased money supply. Further investigation reveals that the European Central Bank has not likewise increased its money supply, largely due to Germany's cultural memory of the dangers of inflation from the days of the Weimar Republic. Again, a chart helps to compare the relative movements.

You can see how the U.S. (dark gray) and Japan (orange) have been busy little bees at the printing press, while the European Central Bank (light gray) has been relatively restrained. So it makes perfect sense that U.S. stocks would outperform international stocks, specifically Europe, notwithstanding the turmoil with Russia over Ukraine, which has certainly served to exacerbate Europe's underperformance.



And as the saying goes, if you can’t beat 'em, might as well join 'em. We can see how the Fed's monetary policy has “boosted” the U.S. economy. Now it’s Europe's turn for some of that same medicine: a tighter labor supply in Germany and relative perceived "deflation" gives the European Central Bank the green light to crank up the presses. Let 'er roll.

We are now so far removed from an honest, well-regulated, transparent and free market economy that traditional and fundamental factors like actual supply and actual demand become tertiary, at best. Primary is central bank action (monetary policy), and secondary is government spending (fiscal policy).

So as we finish up the first month of the New Year, the world doesn’t seem as though it has changed a lick. ISIL/ISIS is still on the loose, the problems with Greece have resurfaced, and terrorist attacks rock France. On the home front, Boehner and Obama face off for another two years, and the rest of us prepare for another Bush/Clinton show down.

And then there's Putin—the wild card. What if he relents? Or concedes? Or compromises? Big boom for Europe. And what if he takes a hard line? Could it be a boost for oil and other commodities? Perhaps a devastated ruble brings about a new gold standard in Russia? If they're having tea with their Chinese comrades down south they would know of that country's hoarding of the yellow metal. (A shrewd move at today's prices)

In any event, the moral of today’s story is that no asset class is the winner year after year, and there’s no way to predict the next winner with any regularity. The proven method is to allocate across multiple asset classes and countries: the risk is potentially lower, and the returns may be more consistent.

If you have concerns or questions about how you are allocated and whether you are properly diversified with all your assets, please call the office to schedule a get together to review.

We wish you and yours a very safe and happy New Year!

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Kevin Meaders graduated from Oglethorpe University in Atlanta with a double B.A. in Philosophy and Political Science, and then obtained a law degree from Georgia State University College of Law, focusing on estate planning and trust law. He has earned the designations of Certified Financial Planner (CFP®), Chartered Financial Consultant (ChFC) and Chartered Life Underwriter (CLU). He holds a General Securities Principal and Registered Representative registration and Investment Advisor Representative registration through Voya Financial Advisors (member SIPC).

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