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OBSERVATIONS ON THE MARKET

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There is never a free lunch! Ever. In the world of finance, this is especially true. The latest free lunch from Wall Street was supposed to be the minimum volatility fund. One of the larger funds is the iShares Edge minimum volatility USA fund (USMV). The pitch is pretty simple; only invest in high dividend paying stocks that historically have been less volatile than the market. Of course it always works until it doesn't.

USMV began life in October of 2011, and for a while, there was a free lunch. From inception through July of this year, USMV was beating the S&P 500 by 9%, and with the promised lower volatility. When a free lunch is offered, everyone shows up for their share. The fund currently (as of Sept. 30th) has about $13 billion invested in it, however, $6.3 billion has come in the last year - doubling the size of the fund. You can see the story unfold. When the S&P 500 declined by 10% through February of 2016, USMV was only down 5%. To make the story even more convincing, as the market recovered from February to July, USMV climbed to a positive 12%, while the market was only able to achieve a positive 6%. So there it is, half the down side and twice the up side. How much do you want?

In the world of money, when everybody starts doing it, it's probably not what you should be doing. Since July, the S&P 500 has declined by 1%, however, USMV is down 6%. You could see it coming. The fund is heavily invested in utilities and high dividend paying stocks, companies that tend to have slower growth. We have been in a 35-year cycle of declining interest rates, but when you get to 0, there probably isn't much left. AT&T is the largest position of USMV. AT&T has been adding to debt and has less room to grow their dividend, so the stock acts somewhat like a bond. A threat of higher interest rates effects these companies as much or more than the rest of the market. Higher growth in the economy is usually a good thing for the market, but it hurts interest sensitive investments. The ironic thing is that since its inception, USMV is up almost exactly what the S&P 500 is: 75%. Nothing to complain about. The problem is that half the shareholders of the fund have purchased it in the last year, and they have seen everything except low volatility.

It is always easy to pick apart something after the fact. These are not bad companies. AT&T has struggled to show attractive returns on their capital, but pays a 5% dividend. AT&T was at $29 in October of 2011, now, it is $37. Would you rather have a 27% gain and an extra 3% dividend for five years, or a 75% gain which is what the market has done? There is not necessarily a right answer, but low volatility is not a free lunch.

Since the election is only a few weeks away, and it is on everybody's mind, a few comments regarding the stock market. It is pretty much a certainty that half the population will want to crawl into a hole and hide for four years after the results are known. One of the best interpretations that I have heard is that this election is between a crook and a madman. It leaves everybody feeling uneasy, hence the high negative ratings. It also probably means volatility for the stock market. What is also certain is that on Wednesday, November 9th, we all will wake up and do pretty much the same thing we did the Wednesday before. The market has faced two World Wars, communism, a depression, presidents impeached, presidents shot, the list could go on and on. I plan to do nothing, except if there is a large enough correction, to buy companies that continue to generate more cash flow and ideally, pay some of it to you.