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OBSERVATIONS ON THE MARKET

By Greg Denewiler, CFA

"Because of these two factors (1 - relevant information you may lack and 2 - luck or randomness), well-thought out decisions may fail, and poor decisions may succeed. While it might seem counterintuitive, the best decision-maker isn't necessarily the person with the most successes, but rather the one with the best process and judgement. The two can be far from the same, and especially over a small number of trials, it can be impossible to know who's who." This is a quote from the latest Howard Mark's memo. Since the market seems to sometimes defy gravity, it may be a good time to review luck and process.

Profits for the stock market were up 4% in 2019, while prices increased 29%. Making that prediction at the beginning of 2019 would appear to have a whole lot of luck involved. However, if you step back and start applying a little more process, the story changes. In 2018, stocks declined by 6% even though earnings advanced by 21%. By the end of 2018, investors were fearing an economy that appeared to be slowing down, or at least saw factors in place they thought would lead to a slow down. If you look at earnings growth over two years ending in 2019, they are up 27%. Market prices for the same period are up 21%. This looks totally rational, probably what the market should have done. Was that luck or a longer-term process? Other parts of the financial markets appear to have a lot more luck priced into them currently.

The desperate search for yield has led investors to rely more on luck than process in the corporate bond market. According to S&P Global the average annual default rate for B rated corporate bonds is 3.4%. The current yield for the B rated bond market is 5.1%. That is a difference of 1.7%. This begs the question; why not just buy a two-year CD and earn 1.8%? In 2008, the default rate reached 4.1% for these same bonds, which doesn't leave you much room to make any money. Maybe there is some value somewhere in this market for the discriminating investor, but it seems dangerous. What happens when we go down just one notch and look at the CCC market (near the bottom of the bond market)?

S&P Global says the average annual default rate for CCC corporate bonds is 26%. The current yield for these bonds: 11%. Is there something wrong with this picture? Not if you have been an investor in the iShare High Yield bond fund in the last several years, which has 37% of its money invested in B rated bonds and 11% in CCC. You made 14% last year, and you continue to earn 5% in interest. This is not to imply that these bonds should never be invested in, just the opposite. In the heat of the last recession, December 2008, the CCC corporate bond market reached a yield of 41%. If the average default rate is 26%, this is investing heaven. Your process should say: I am about to make 15% per year, and probably a lot more as the market eventually returns to 'normal'. It is never easy. In 2008 the world appeared to be falling apart so it was not easy to step into that market, but that is why Howard Marks suggests a process is so important. It would be a fair question to ask: How did we get here?

The simple answer is negative interest rates. Over half the world's interest rates are negative which means you must pay to own them. No retirement income here, it is more about luck. You are totally betting you will be able to sell your bonds to someone else for a profit. There is a point when even the best process appears to be not working. The interest rate market has been in a state of disarray for several years now. To earn more, investors start to 'reach' for yield. They get lucky for a few years and make money, and then their process is better than yours. You even start to wonder if maybe the world has changed? It hasn't; people still speed down I25, run red lights, and cut in front of you whenever possible.

Luck seems to eventually lead to permanent loss in the investment world. CCC bonds that default don't recover. Companies that have sustainable cash flow survive downturns. Your process doesn't avoid a temporary loss, it just helps you eventually recover.