When to Sell? How Should You Protect Yourself from the Risk of Falling Values?

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These are two of the most important questions in my conversations with investors as I write this article in September 2018. The U.S. equity markets have posted positive returns in each of the past nine calendar years. This is only the second time over the past century that equities have posted gains for nine consecutive years. I am going to lay out important considerations that should be factored in when investors consider and evaluate strategies to protect their investments from downside risks. An investment is only successful if you buy low and sell high. Being able to do that takes discipline and active management.

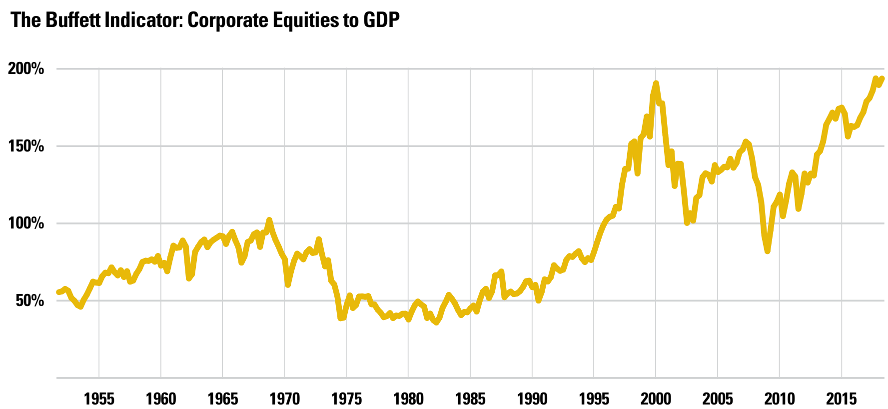
Why Is Risk Management Important?

Risk management seeks to mitigate downside risk. It is easy to forget that the risk of a downturn quietly accumulates as asset prices rise over time. One of the most dramatic risks of late is valuation of the U.S. stock market. Printed money from Central Banks has fallen like snow since the financial crisis. For 10 years, printed money has been quickly absorbed by financial markets and has led to rising valuations. Warren Buffett likes to compare the value of the U.S. equity market to U.S. GDP. As Figure 1 indicates, the stock market's valuation considerably exceeds the valuation of U.S. Gross Domestic Product. The printed money effect has been amplified by record low interest rates. The only period with a higher valuation was the 2001 Internet bubble, which means the need for risk management should be a significant consideration.

How to Solve Valuation Risk?

Reducing valuation risk does not mean you need to place cash under your mattress. There are other, more effective active management techniques. The U.S. economic recovery — now the longest in history — is a mature cycle that is closer to the end than the beginning. We are already seeing breakdowns in the valuation of automotive companies and home builders. Ask yourself if the companies in your portfolio have the ability to grow at or above the level of economic growth. If a company has become more of your portfolio than anticipated, then it is time to think about harvesting the gains. Selling a portion of the holding allows you to take profits and reduce concentration risk within your portfolio. Perhaps one of the best byproducts of harvesting profitable and unprofitable positions is that it creates cash — dry powder — that can be used when a correction occurs and valuations become more attractive.

Figure 1: The Rising Stock Market Valuation to Percentage of GDP



Source FactSet

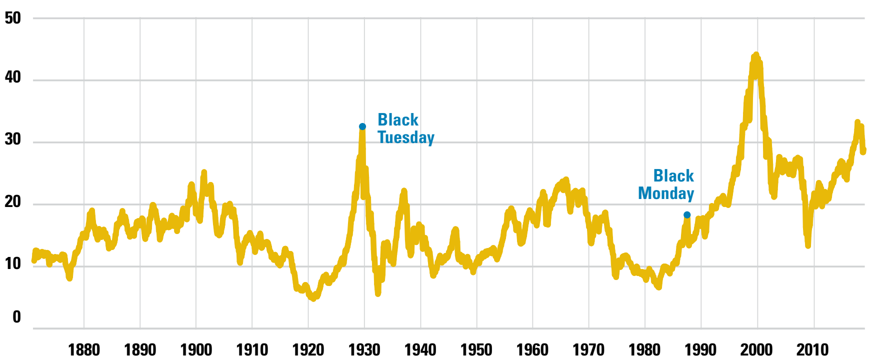
When evaluating a company's valuation, another important consideration is its potential market share growth. Ask if the company can continue to gain market share at the same rate, or has the company's valuation exceeded the total market opportunity? Valuation issues are particularly challenging in the technology sector where today's winner can become tomorrow's loser.

Cash is an Underappreciated Asset Class

The cash generated from the sale of securities sits ready for deployment in your investment account, waiting for attractive opportunities. Stock markets cannot continue going up unabated, which creates a downside to holding cash in your portfolio. Like any other form of insurance, the cash in your portfolio has an opportunity cost, but there is also the potential of a benefit. Currently, by two important valuation risk measures, Buffett Indicator (Corporate Equity Valuation to GDP) and the Shiller P/E Ratio (Cyclically adjusted P/E Ratio – see Figure 2), there is reason to take pause.

We live in a world of instant gratification that encourages us to want more, but sometimes more is exactly the opposite of what we need. Since the future is unknown, having a practiced approach to harvesting returns – using cash as an asset class – will reduce downside risk, while giving you the dry powder to take advantage of investment opportunities in the future. Harvesting returns also avoids portfolio concentration and maintains portfolio diversification, which further reduces downside risk.

Figure 2: The Cyclically Adjusted P/E Ratio Indicates Valuation is Rising



Price earnings ratio is based on average inflation-adjusted earnings from the previous 10 years, known as the Cyclically Adjusted P/E Ratio (CAPE Ratio), Shiller P/E Ratio.

Source data http://www.multpl.com/shiller-pe/table

Valuation and Portfolio Concentration are Key Considerations

Some useful valuation measures include the Price to Earnings (P/E) and the P/E-to-growth (PEG) ratios. What is the current P/E multiple versus the forward P/E multiple (using next year's estimated earnings)? Is the company growing into a lower valuation? A humbling way to use a P/E multiple is to remember the valuation measure indicates the number of years you would have to hold the stock to earn back the price being currently paid for the stock. This exercise will push you to re-examine a 180x P/E multiple paid for some technology stocks. Earnings growth will have to be 10-fold to bring the P/E multiple down to the S&P 500's forward (using next year's estimated earnings) 18x P/E ratio. Another way to look at the P/E multiple – assuming earnings do not grow – is that the technology stock would have to be held for 180 years to earn back the share price paid. Technology companies are an important part of any portfolio, but rich valuation levels may not be sustainable and warrant profit taking.

Another measure of valuation is the PEG Ratio, where the P/E ratio divided by the company's estimated five-year projected earnings growth rate. A PEG ratio below 1 is often considered a value stock. Emerging companies with high P/E multiples and high growth rates can boast PEG ratios above 3.

Table 1: Price/Earnings Growth (PEG Ratio)

Technology Stock ABC
Current P/E: 180 times earnings
Five year projected growth rate: 69%
PEG 180/69, or 2.61
Automotive Company XYZ
Current P/E: 6 times earnings
Five year projected growth rate: 15%
PEG 6/15, or 0.40

Interest Rates – The Changing Cost Of Money

In 2008, the Federal Reserve's emergency intervention cut the Fed Funds rate from 5.25% to 0%. In the 10 years since the financial crisis, governments, corporations and consumers have been over-served cheap debt. Developed and emerging market governments have dramatically increased the use of debt to stimulate demand. Corporations have also taken advantage of the low-rate environment to improve their perceived performance by issuing debt to buy back trillions of dollars of shares. So, following the financial crisis of 2008, the world is much more indebted than it was before. Now, the Federal Reserve is engaged in quantitative tightening instead of quantitative easing. In 2014, the Federal Reserve stopped buying bonds, and now bonds held by the Federal Reserve are maturing and are not being replaced, thus reducing the money supply as the quantity of money is reduced. The European Central Bank (ECB) is on track to end its 2.5 trillion quantitative easing program by the end of 2018, which will further reduce liquidity. The Federal Reserve is also normalizing interest rates which means Fed Funds are projected to be over 3% by 2020. Higher Fed Funds rates increase the interest cost for indebted borrowers. The steady increase in interest rates will cause a dramatic increase in interest expense as rates rise above the emergency accommodation provided by the Federal Reserve.

Are Fixed Income Securities at Risk In A Rising Interest Rate Environment?

To understand the impact of higher interest rates on fixed income securities it is important to understand the "fixed" part of fixed income, which means the value of the fixed income securities falls as interest rates increase. For example, the typical 10-year bond provides regular interest payments and a principal payment when the security matures. The periodic interest payments return cash to the investor and shorten the duration of the typical 10-year bond to 7 years. Duration measures the price sensitivity of the bond to a 1% change in interest rate. A 1% change in interest rate for a bond with a 7-year duration is 7% (1% x 7 = 7%). Duration is a multiplier that dramatically increases the price impact of interest rate changes. If interest rates increase 2% the negative price impact is 14%. The price impact increases as the term of the fixed income bond increases. Many investors in a low interest rate environment buy longer-term bonds not realizing the impact higher interest rates can have on their investment. There are a wide range of floating rate or indexed securities that lower price impact associated with higher interest rates.

Do Equities Offer A Hedge Against Higher Inflation?

Equity securities from companies whose products are in demand have a hedge against inflation since these companies can raise prices. Companies with pricing power can insulate themselves from rising rates by passing on additional costs; however, studies have shown the ability to pass on cost increases breaks down once inflation exceeds 5%. In the fixed income space there are also securities that limit the securities exposure to inflation. For example, Treasury Inflation Protected Securities (TIPS) offer inflation protection as measured by the Consumer Price Index (CPI) but TIPS do not offer protection from higher interest rates. All of this is to say that there are investment options in the capital markets when interest rates are on the rise, but it is key to understand how these securities are impacted by rates.

Maryland's Equity and Bond Markets

Baltimore has had a long history as a regional financial center. Between 1881 and 1949, the Baltimore Stock Exchange created a regional market for stocks and bonds. In 1949, scale and technology favored consolidation and the Baltimore Stock Exchange on 210 East Redwood Street merged with the Philadelphia Stock Exchange. In 1954, the Washington Stock Exchange merged with the Philadelphia Stock Exchange. In 2008, the Philadelphia Stock Exchange (PHLX) was purchased by the NASDAQ. Today, Marylanders have easy access to the New York Stock Exchange (NYSE), NASDAQ, and debt markets. The equity markets offered by the NYSE and NASDAQ offer best price execution, while debt markets help finance Maryland's state and local Government. It is these same debt markets that provide financing and investment opportunities for Baltimore and Maryland based companies.

Summary: What is a Successful Investment?

Successful investing can easily be described as buying low and selling high, but to reach that outcome requires research and a strong stomach. The initial investment in a company is challenging since it requires a great deal of research to address the unknowns. Often it is hard to let a successful or failed investment go due to its success or failure. Objectivity is required to sell an investment when demand for the investment is greater, and the outlook is positive but potentially not sustainable. It is important to remember that we live in a changing world. What works today may not work tomorrow. Active management of investments requires thoughtful attention to valuation, market share growth and the interest rate environment. Further, risk management requires diversification and cash can also be a useful asset class. In combination these tactics help make growth more sustainable, while lowering your portfolio's downside risk.

Further readings:

https://www.investopedia.com/articles/analyst/043002.asp

http://www.wsj.com/mdc/public/page/2_3021-peyield.html?mod=topnav_2_3002

https://www.washingtonpost.com/business/stocks-can-be-your-best-hedge-against-inflation/2011/05/17/AFj9tc8G_story.html?utm_term=.89093506185fhttps://www.bloomberg.com/news/articles/2018-07-09/after-years-of-easing-meet-quantitative-tightening-quicktake

https://www.msci.com/documents/10199/76960d74-0f2c-4f74-9e3c-66f2087b709e.

https://www.institutionalinvestor.com/article/b14zbcxn7mhn0w/how-to-pick-the-best-inflation-hedging-stocks

https://www.kiplinger.com/article/investing/T052-C019-S001-stocks-the-best-inflation-hedge.html