

3-Pitfalls To Avoid *While Navigating* A Late-Stage Bull Market



Don't believe this bull cycle is going to end, or at least pause? Ready to believe this is closer to the fourth and not the ninth inning? You're not alone. Best to check yourself. Stay grounded. The professional chatter is building. This is the big one. The stock market cycle that rivals 1982-2000 is upon us. **Well, perhaps it's different this time. Hey, it could be, I hope it is, but I doubt it.** If you're compelled to believe a narrative that the world has gone flat that of course is a personal decision. For those who invest in risk assets, it's best to stick to reality. As stocks are currently inured to bad news and prices accelerate on good vibes or soft data primarily, especially from the auspices of the Fed, cycles such as these are indicative of positive herd behavior or momentum, which I'll explain as I go further. However, the "fundies" with clout or financial professionals who focus on fundamental analysis, are throwing up red flags everywhere. It's a relentless and intelligent group. Their analysis is worth a read; although there's still road and tread left to traverse this bull market cycle (my humble opinion), a realistic perspective of how the terrain underneath your portfolio is as more a layer of spirit and hope than it is real economic conditions is crucial at this juncture. Today's market behavior is generally anathema to fundamentalists and downright frustrating. Let's face it ? people aren't wired for value investing. In a world of immediate gratification, nobody wants to plant a seed and wait for the tree to grow. We want to see the tree

right up front right now. We then feel rewarded as the tree (hopefully) continues to prosper. Those who focus on fundamental analysis are first about the integrity of the soil, not so much the tree. The logic is If the soil is dark with nutrients, then the tree will have a greater opportunity to thrive. A tree can grow in bad soil (take it from me I'm from Brooklyn. I've seen trees grow in the crevasses of muddy curb lines), but ostensibly will topple over and wreak all kinds of damage. So, let's not beat up on the soil people too much. Valuation measures are a downright lousy indicator of market performance but that doesn't minimize their importance. Think of these indicators as the warning signs, yellow lights along your investment path. In a recent missive, Howard Marks the legendary investor and co-founder of Oaktree Capital, outlines the following concerns regarding [today's investment environment](#). To wit:

- ***The uncertainties are unusual in terms of number, scale and insolubility in areas including secular economic growth; the impact of central banks; interest rates and inflation; political dysfunction; geopolitical trouble spots; and the long-term impact of technology.***
- ***In the vast majority of asset classes, prospective returns are just about the lowest they've ever been.***
- ***Asset prices are high across the board. Almost nothing can be bought below its intrinsic value, and there are few bargains. In general, the best we can do is look for things that are less over-priced than others.***
- ***Pro-risk behavior is commonplace, as the majority of investors embrace increased risk as the route to the returns they want or need***

Michael Lebowitz for Real Investment Advice succinctly outlines 22 realities in [22 Inconvenient Truths On Investing, Economy & The Fed](#). To make a case for positive stock performance, one can look no further than the work of a unique individual who understood how bat-sh*t crazy market participants can get. In the spirit of mathematician, father of [fractal trend analysis](#) Benoit Mandelbrot, who believed market price changes are not as random as preached in financial orthodoxy, stock prices indeed possess memory that drives positive or negative momentum. Modern systems of finance are built on cleanly-calculated outcomes that don't match actual market behavior or in many cases, a retail investor's experience. Life and markets are much more complex and fraught with risk. If well-read and invest on your own or work with a financial partner, odds are your wealth has succumbed to one or several of rotted chestnuts of suspect calculations. A popular conjuring is the Efficient Market Hypothesis which states that stock prices reflect all relevant information and that a random walk is the best metaphor to describe such markets.

Mandelbrot's focus was more on observation, not abstract theories stretched to mollify fear and act as a false "Snuggie" so ostensibly, most people spend their investment experiences breaking even. The widely-accepted modern portfolio theory which advocates a blind buy & hold philosophy, provides the financial industry (and subsequently you), a misguided sense of comfort or smoothness of risk that mostly falls within explainable, bell-curve shaped boundaries. The problem is buy and hold (not many can time markets), has been bastardized by Wall Street driven group-think; the theory has morphed into willing complacency which allows big box financial retailers to monetize assets to boost profit margins and brainwash brokers who are too lazy to seek information beyond their firms' biased research departments, to sell product and close shop at night with clean consciences. It's one big cognitive-biased mind meld. It's confirmation bias from a group who advises you to avoid confirmation bias?

Let me ask you: *If Wall Street, robo-advisors with bloated valuations and big-time financial book sellers are such passionate advocates for buy and hold, and alternate theories, even those coming from academic thought leaders like Andrew Lo at MIT (an advocate for a sell discipline as markets deteriorate), are merely squelched whispers, do you truly believe it's in your best interest as a retail investor?*

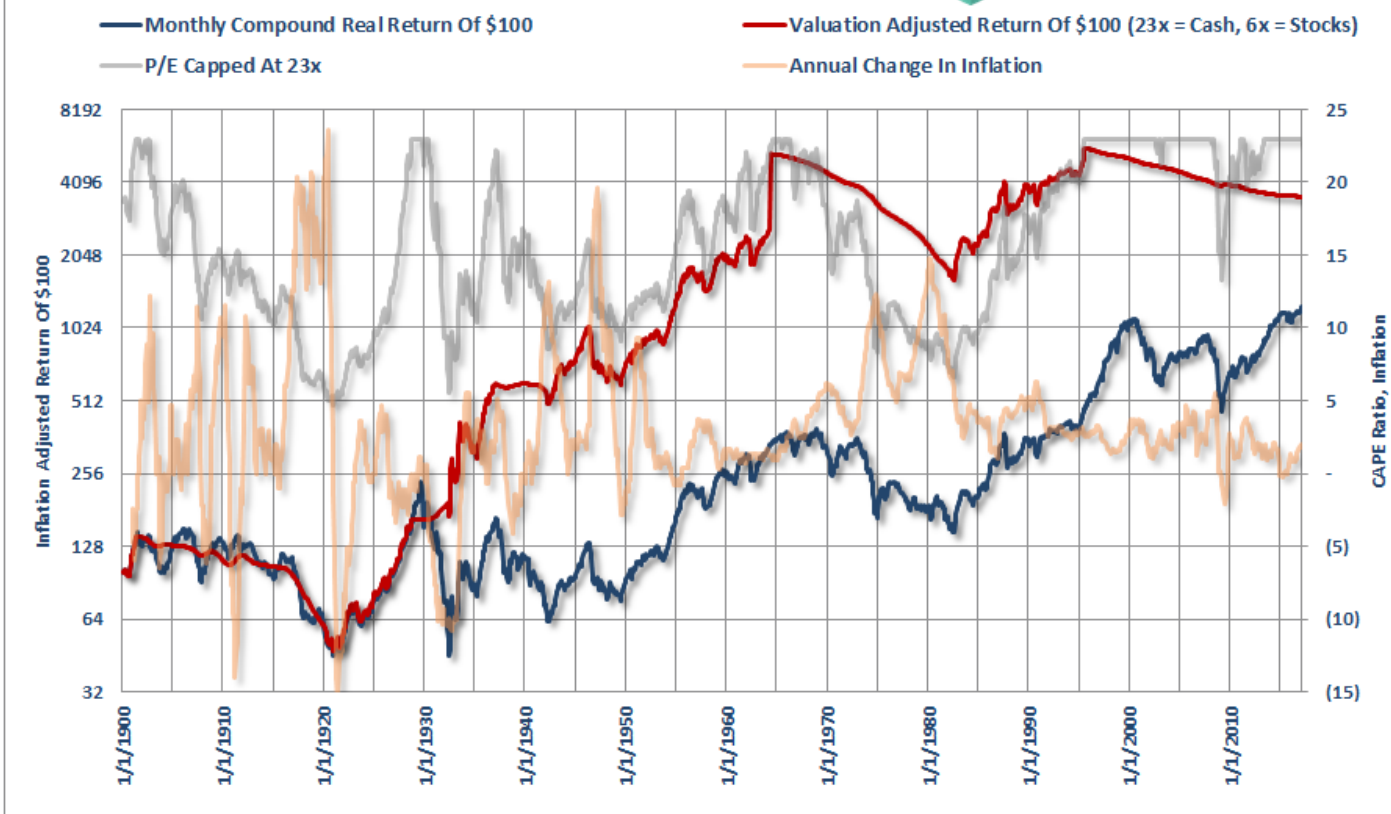
I know. I should be an agent for the *X-Files*. Certainly, from day to day, prices are headline driven

and random in nature. Over long periods, as Mandelbrot discovered, discernable trends emerge. There are bursts as I call them, or periods when "winds in the sails" indeed exist. Positive or negative, momentum effects are real. Prices indeed have memory. In his comprehensive analysis, **Mandelbrot created multi-fractal asset models, evidence that proved markets were far from efficient. Mainstream portfolio theories oversimplified how markets realistically behave.** Most likely the intent of these shaky theories was (is) to securitize Main Street cash, push people into perpetual fee generators. Mainstream portfolio theories are designed to easily explain how to contain risk and how that risk can fit neatly into bell curves that rarely represent how markets truly behave. Because as we know, markets are comprised of people and people are Spock-like rational when it comes to investment decisions. Readers will get the sarcasm. You don't require extensive study of Mandelbrot to feel in your gut that the nature of risk assets easily contained within explainable, quantifiable boundaries doesn't add up. Mandelbrot was a passionate believer in markets. However, he was in staunch opposition of how modern portfolio theory attempts to mold risk into neatly accountable statistical analysis. The beauty of markets, every market, is willingness of buyers and sellers to transact upon a mutually beneficial or perceived beneficial, price based on current views of overall supply and demand. There's no doubt, excluding fundamentals, that the demand for stocks remains at a fever pitch. Mandelbrot would advise to participate, however prepare for change - take the following three common misperceptions to heart.

Cash is never trash, especially at this juncture.

Daily, I meet with investors who lament about holding "too much cash." They share this information framed by such shame or regret. What is too much cash, anyway? Cash is indeed a part of an overall investment allocation; you may hold at all times 3-10% as a hedge against portfolio volatility. It's the simplest stabilizer sleeve in a long-term investment program, the best hedge. Cash is also best suited for emergency funds. Three months, six months. If your income is variable, erratic, perhaps a year or two of living expenses in cash optimum. Again, it's a personal decision I don't want you to stress over. Are you attempting to reach a short-term financial life benchmark like a down payment on a house that needs to be met in two years or less? You said it: Cash. No need to over-think this decision. The industry has permitted and communicated an enduring guilt message to fester over the maintenance of cash for extended periods. Why? Because brokerage firms lose fee revenue when you sit in cash and it irritates the heck out of their shareholders. Take it from me. These companies lose more money than you do in the long run when it comes to your cash. It burns a hole in their profit pockets. Not yours. **There's some percentage between 0% cash and 100% that feels right to you. Stick with it.** A number that doesn't cause you to make emotional mistakes with your invested dollars is worth whatever opportunity cost you're going to endure. Capital to invest at attractive valuations produces substantial outperformance over waiting for decimated capital to recover from losses. That's just inarguable fact.

The Real Value Of Cash



Lance Roberts:

The chart above shows the inflation-adjusted return of \$100 invested in the S&P 500 (capital appreciation only using data provided by Dr. Robert Shiller). The chart also shows Dr. Shiller's CAPE ratio. However, I have capped the CAPE ratio at 23x earnings which has historically been the peak of secular bull markets in the past. Lastly, I calculated a simple cash/stock switching model which buys stocks at a CAPE ratio of 6x or less and moves back to cash at a ratio of 23x. I have adjusted the value of holding cash for the annual inflation rate which is why during the sharp rise in inflation in the 1970's there is a downward slope in the value of cash.

However, while the value of cash is adjusted for purchasing power in terms of acquiring goods or services in the future, the impact of inflation on cash as an asset with respect to reinvestment may be different since asset prices are negatively impacted by spiking inflation. **In such an event, cash gains purchasing power parity in the future if assets prices fall more than inflation rises.**

Dollar-cost averaging is usually sub-optimal, depending on how you use and perceive the process.

Let's be clear: Dollar-cost averaging isn't an investment strategy or a very good one, regardless of what you've been told. Don't perceive it as such. It's a method devised by Wall Street and touted by brokers to foster complacency. Listen, a little complacency, a bit of auto-pilot can be positive to your bottom line; I agree that dollar-cost averaging is at the least a healthy financial habit. Dollar-cost averaging is nothing special. It won't do anything for your overall returns. If one seeks mollification to avoid regret bias or other emotional salve, then it's fine. Continue. However, at least consider the ultimate placement of the dollars. It doesn't necessarily need to be the stock market. DCA seems to get linked exclusively to stock investing. Go ahead and unlink your mind from the false narratives. It would be impossible and unrealistic for the financial industry to comprehend that dollar cost averaging into the S&P 500 may be less effective than tucked underneath the Posturepedic. Naturally, nobody is suggesting to literally use your mattress as a

deposit box. However, the point is that dollar-cost averaging was designed to be a sales tool to sucker you into investing and forgetting. **Not cool.**

?The truth is that many advisers are smart, and they are aware that dollar cost averaging is not a good idea. But rather than trusting people to learn, they are happy to get a second-best solution. After all, dollar cost averaging has such a good image, why not capitalize on it?? - Presh Talwalker, Author of The Joy of Game Theory ? An Introduction to Strategic Thinking.

A disciplined investor's approach would be to adhere to the process (because it is a good one), and establish a periodic investment plan where a specific amount of money is auto-deposited into a portfolio mix allocated based not on the time frame required to reach a financial benchmark, but on the current risk exposure required to achieve return at this stage of the current market cycle. Plainly speaking, fund a conservative allocation *temporarily* - then initiate larger, **lump sum** investments into riskier asset classes as valuations improve. How do you know when valuations improve? Well, that's what a financial adviser is there for, isn't it? Recently, an individual I counsel who has been out of the market for five years decided on dollar-cost averaging 20 percent into stocks (split between U.S. and international), 30% in short-duration bonds, 20% in intermediate-term fixed income and the rest in cash. She's willing to give up some possible continued short-term upside and consider risk first, based on the valuation risk in stocks. Smart move. It's a cake and eat it type of decision. If markets go higher, she participates. If they falter, her portfolio downside is muted.

Don't eschew valuation warnings and become overconfident in the path of future returns.

Several market big-leaguers are warning of extended market valuations ? Bob Shiller, Lacy Hunt, Robert Arnott the father of fundamental indexing, bond king Jeffrey Gundlach. Even [Goldman Sachs Asset Management](#) is chiming in on overvalued markets. Naturally, there are a slew of other pros molding the narrative to support the current stock valuations. Hey, this is what markets are all about, folks. Nobody has a clue as to when markets will finally correct or enter a bear. However, wise investors strip out the noise and understand not to become blinded by Recency Bias. Reversion to the mean, whether it's through a correction in price or time (*read: [Is Another Lost Decade Ahead?](#)*), the facts are the facts. It's never different. Eventually, your portfolio returns are going to suffer and place financial goals in jeopardy, especially if the decision is to just ?ride out? the next bear cycle. History shows that valuations above 25x earnings have dictated bull market peaks. I for one believe that this bull has further to go as structural conditions such as over indebtedness, low intermediate, long-term interest rates and dovish Fed action, continue to feed the TINA (there is no alternative) monster. **Never disregard valuations. Reversion is an inevitable event. It's best to replace the word ?investing? with the word ?trading? for new money you commit to markets here as the aspiration should be to purchase high and sell or trim profits at higher prices.** It's acceptable to take this road. The main thing is to objectively understand the terrain you're traveling at this juncture and maintain keen awareness of changing conditions that would compel you to exit, protect capital, as time is a precious resource and the majority of investors spend it financially breaking even, not getting ahead. Consider the writers at [Real Investment Advice](#) your navigators.