

What Does It Mean To Invest?



Submitted by David Robertson, CFA [Via Arete Asset Management](#) The late stages of any economic cycle provide fertile ground for divergent opinions. Some recent positive numbers, for example, can be viewed as reflective of underlying strength but they can also be viewed as an indication of overheating and ultimately higher inflation. What is unique to this cycle is that it is also accompanied by massively divergent beliefs regarding what the end game looks like. While some investors harbor doubts about whether markets can keep going up, others harbor doubts about whether many existing financial, economic, and political institutions serve a useful purpose. As a result, one must answer a seemingly stupid question in order to evaluate investment strategy: What does it even mean to invest? To be sure, markets delivered good news in the quarter. Major indexes recovered their mojo under the power of good economic strength, strong sentiment and low unemployment. Sentiment, especially for small caps, hit record highs which served as an expression of joy and relief about trends in taxes and regulation, among other things. Such good news was tempered, however, by Fed tightening and geopolitical concerns. Warning signals were

especially flashing in emerging markets. Indeed, there are plenty of signs that market activity is getting stretched. For example, the Financial Times quoted distressed debt investor Jason Mudrick [here] arguing that "the roaring economy" is "just not sustainable" He went on to say, "My job is not to predict exactly when [the turn in the cycle] happens but to have the platform ready when it does." As a result, he is planning ahead by marketing a second distressed debt fund to take advantage of the fallout when the market turns. Respected strategist David Rosenberg provided a very blunt assessment:

?Cycles die, and you know how they die? ... Because the Fed puts a bullet in its forehead.?

He went on to quantify the risk:

"We are seeing a significant shift in the markets. The Fed was responsible for 1,000 rally points this cycle so we have to pay attention to what happens when the movie runs backwards."

While the prospect of a meaningful decline in the market is unpleasant, there is something more going on. Perhaps nowhere is this captured better than with the trajectory of corporate debt. As the FT reports [here], "Debt is the legacy of the global financial crisis. Over the past decade of ultra low and negative interest rates, companies have more than doubled their outstanding amount of bonds and loans." Further, that massive increase in debt was not only accepted by credit markets, but applauded. As reported [here], "What is startling is that investors are not running scared. Instead, demand for risky debt is so high that the spread between safe and hazardous corporate debt ... is a wafer-thin 50 basis points. In 2012 it was 200 bp.?" As market commentator John Mauldin notes, the explosion in debt is hardly confined to corporations. He reports,

"As of 2014, total global debt had risen to \$199 trillion, growing some \$57 trillion in just the previous seven years, about \$8 trillion a year." Further, "Since that 2014 report was published, global debt rose by \$17 trillion through 3Q 2016." As a result of debt growth outpacing economic growth, "Global debt-to-GDP is now 325%." He concludes, "All that debt cannot be repaid under current arrangements, nor can those promises ultimately be kept ... At some point, we're going to have to deal with these issues and restructure everything."

On top of these issues, a self-sustaining feedback loop is making things even worse. As Chris Cole described [here] "Well, post 2009 something really unique happened, and that volatility as a yield instrument selling it out of the money put options on the S&P and collateralize it, began to outstrip on a yield basis what you were getting in corporates. And all of a sudden, everyone jumped into vol." In other words, artificially suppressed yields in credit markets prompted a desperate search for yield which was found in the (ultimately dangerous) strategy of shorting volatility.

As noted, "the volume of short positions in the Vix volatility index has climbed to the highest since late January". Chris Cole captured the feeling well [here] when he said, "And to me, it's giving rise to things like ramping up exposure. Like, there's just-- you feel it. There's a desperation and a resignation that says, you can never sell anything. You know, I can't explain it. I don't know, but -- It's career risk."

The same career risk has bled over into advisory and fund management businesses too. As the FT reports,

"The Bank of America Merrill Lynch monthly fund manager survey, which polls investors managing \$541bn of assets, showed in June that equity investors had returned to being overweight US equities for the first time in 15 months.?" As the FT goes on to say, "Now it appears many are throwing in the towel just when the real warning signs of overexuberance in parts of the market are becoming more apparent."

Career risk is a phenomenon that is very hard for many investors to see or appreciate. The lesson that many market participants have learned over the last several years is that regardless of signals to the contrary, you can't afford to be out of the market for any period of time. Needless to say this is a bad lesson to learn and creates systemic risk for the market. It is also deceptive, however, because it creates the appearance that market participants are enthusiastic about prospects. In addition to cracks developing in the economic cycle and the debt super-cycle, there are also signs that fundamental financial and economic institutions are getting stretched. For example, Michael Gove, secretary of state for the environment in the UK, recently gave a speech on the state of capitalism in which he captured much of the zeitgeist of the times. In it, he acknowledged

"...the failure of our current model of capitalism to deliver the progress we all aspire to."

Many developed economies have been struggling with productivity wage growth for years, but it has only been fairly recently that these failures have received much attention. Indeed, the economy is rife with examples of cronyism, rent-seeking, and market dominance that undermine the benefits of capitalism. Adam Smith himself worried "that markets were prone to being hijacked by rent-seekers and that companies could become tools of oppression. Perhaps no group has experienced the negative consequences as much as the millennials. As noted,

"Older millennials entered the workforce in the mid-2000s, and many lost jobs after the 2008 crisis. They were also caught by rapid inflation in house prices as interest rates fell and remained low. The milestones of leaving home, getting a job, marrying and having children have been delayed ? 45 per cent of 18 to 34-year-old Americans had done all four in 1975, but only 24 per cent had in 2015."

Not surprisingly, such experiences have caused millennials to become *"disenchanted with their lot."* As one indication of this, *"A UK Resolution Foundation study found that pessimists outweighed optimists by two to one when they were asked about their chances of improving on their parents' fortunes."* Further, *"A Pew study in 2014 found that only 19 per cent of millennials believed that others could be trusted, compared with 40 per cent of boomers and 31 per cent of the generation Xers."* As Keith Niedermeier, professor at the Wharton business school, summarizes, *"This generation is incredibly sceptical of governments and big corporations."* So what does all of this say about the market environment? It says that there is a much bigger game in play than fluctuations in the economy or twists and turns in the market. In order to fully appreciate this, however, it helps to establish some context by going back to first principles. We need to think about what it means to invest. One reasonable definition of investing, in a general sense, is *"to devote (one's time, effort, or energy) to a particular undertaking with the expectation of a worthwhile result."* A recent report, *"Future state of the investment professions?"*, from the CFA Institute e], makes a similar point that investing should serve a valuable role in society. The report notes, "the core purposes of the investment industry lie in two overlapping areas." One is wealth creation which involves "Mobilizing capital for jobs and growth," and another is savings and investments which involves "Deploying investment services for wealth and risk management." So far so good. The problem is that many of the trends and practices endemic to today's business environment fail on one or both counts. Loose monetary policy, excessive debt growth, and economic rent-seeking do little to *"mobilize capital for jobs and growth"*. Further, what little might be accomplished from such policies only benefits the short term at the expense of the long term and as such, is antithetical to the practice of investing. The investment industry itself has also largely failed this test. The CFA Institute report reveals that only *"11% of investment leaders describe the impact of the investment industry as very positive for society today."* A key reason for this weak result is that the industry has been much more focused on creating profitable "products" than in "deploying investment services for wealth and risk management". The result is a rising and widespread degree of financial insecurity. Retiring investors are affected, as Chris Cole noted, *"But what we've done is we've taken the tail risk from the present, and we've shifted it to the future on the retiring generation. They're going to bear the*

brunt of this.? Millennials and Xers are affected by being rightly skeptical of government promises. As a result, the exercise of wealth and risk management has become very far removed from the original purpose of investing and will have to adapt in order to become more socially useful. In a world vulnerable to major shocks and fraught with insecurity, what absolutely won't work is assuming that you just need to accumulate enough money. For one, the expected returns on financial assets are unlikely to be sufficient to provide an adequate nest egg for many investors. As Mauldin comments,

"I believe that diversifying among asset classes will simply diversify your losses during the next global recession."

For another, all of the evidence suggests that the assumption of having a fairly stable environment as a basis for planning retirement is wrong. High and growing levels of debt substantially increase the prospects of both inflation and deflation down the road, but well within investment planning horizons. Further, high and growing skepticism of government and big business increases the prospects of extreme and unexpected political outcomes. Some proactive investors are trying to find forms of investment that are more sustainable. For example, InvestmentNews identifies impact investing as *"the act of purposefully making investments that help achieve certain social and environmental benefits while generating financial returns"*. The story also reports that *"A large majority of affluent millennials (77%) and Generation X investors (72%) have made an impact investment,"* which contrasts with *"just 30% of affluent donors from the baby boomers and older generations."* Similar ideas are reported by Michael Shuman in his book, *Local dollars, local sense: How to shift your money from Wall Street to Main Street and achieve real prosperity*. Shuman calls out the fact that *"Americans are systematically overinvesting in Wall Street and underinvesting in Main Street"* and calls that gap a *"huge market failure"*. He then reports: *"A growing body of evidence suggests that local businesses are the key to economic prosperity, especially job creation."* Shuman does an especially nice job of illustrating the human aspects of economic exchanges: *"But what truly has become ridiculous is continuing to pour our hard-earned dollars, month after month, into global businesses and stock market casinos that increasingly bear no relationship to our own prosperity. Real prosperity must begin at home."* He summarizes by saying, *"I'm just sick and tired of my hard-earned dollars going to buy the equities of companies that I do not know [and] do not agree with ..."* By contrast, he describes the situation with cooperatives: *"There's real business value in being able to look your customers in the eye and say, You can trust us, because you own us, and we're in business to do nothing other than act in your best interest."* These ideas may sound too *"touchy-feely"* for died-in-the-wool free markets economists and finance purists, but they are well supported. For instance, the FT reports that institutional investors are increasingly *"grappling with the ethics of how ... returns are delivered"*. Specifically, the Washington and Wisconsin state pensions have *"questioned their allocation to KKR, the private equity titan"* in response to *"the ugly liquidation"* of Toys R Us that *"may see 30,000 ordinary workers lose their jobs without severance pay."* In addition, Adam Smith himself noted, *"Markets constitute a socially constructed and evolving order that exists and must exist not by divine right but because it serves the public good."* Smith also described how to go about serving the public good:

"What matters is not the largely empty rhetoric of 'free markets', but the reality of effective competition. And effective competition requires mechanisms that force companies to internalise their own costs and not push them on to others, that bear down on crony capitalism, rent extraction, 'insider' vs 'outsider' asymmetries of information and power, and political lobbying."

One really important message from this is that the system of capitalism may have some weak points that need to be managed, but it is not inherently flawed. Michael Gove acknowledged this when, despite his criticism, he also commended capitalism as *"the most successful wealth-creating machine the world has seen"*. This should be remembered especially in the context of political

temptations to address undesirable symptoms by reallocating wealth. Because such approaches don't actually solve underlying problems, they are harmful economically and therefore not sustainable. Combined with the CFA Institute report's definition of investing, these ideas establish some useful standards by which to judge investment strategies. For example, how well does passive investing hold up to these criteria? Certainly low costs advance the goal of wealth management. But then with purely passive strategies there is no explicit effort at risk management so that counts against. Further, the idea of allocating capital purely on the basis of size rather than with the intent to "mobilize capital for jobs and growth" also counts against. Nor does passive investing have any effective means by which to subdue crony capitalism, rent extraction, or political lobbying; if anything it promotes such behavior by being complicit. By these criteria, passive investing appears to be more a part of the problem than part of the solution. The bad news in all of this is that for the vast majority of us there really is no longer any meaningful sense of financial security through our retirement years. While this may feel painful for some, it is really just an "eyes wide open" admission of what has been developing for some time. The good news is that a clear diagnosis allows for much more productive responses. Further good news is that just because some financial constructs are not sustainable doesn't mean the end of the world. After all, there will be a time when financial assets are attractive again and in the meantime, there will be plenty of other worthwhile things in which to invest our time, effort, and energy.