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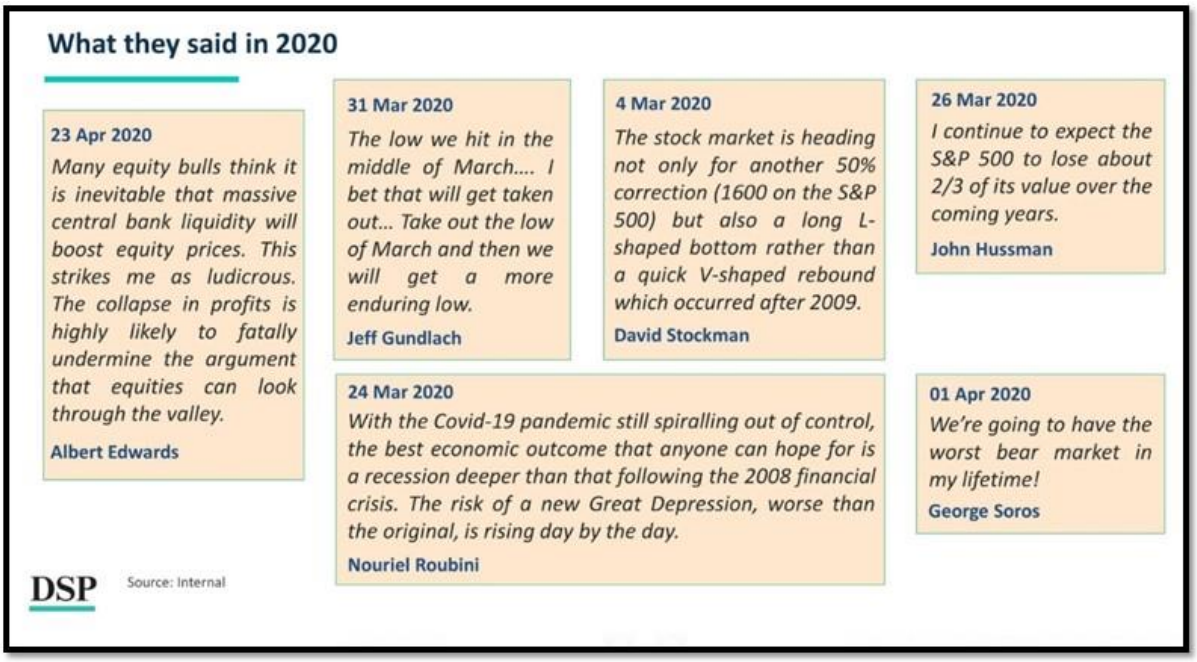
Developing A Process To Shut Out The Noise

The most frequent question we get from partners is what do you think will happen to the market.

Bitter truth: it is the wrong question to ask because no one knows.

Why is this so? Because markets move due to multiple variables, not all of which are visible or predictable.

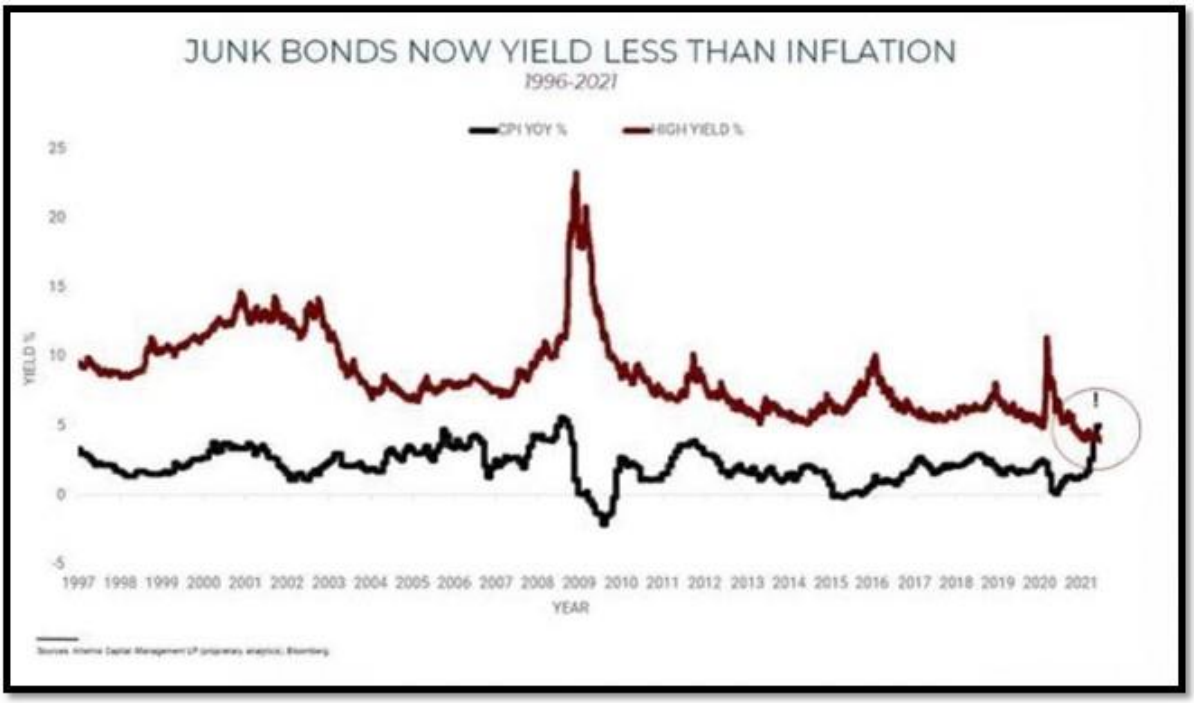
Enclosed is a slide with some interesting comments by market gurus close to the market bottom last year. (Chart Courtesy: DSP)



All of the above are legends. However, none of them would have imagined the scale of intervention/stimulus by Govt's and Central Banks. They extrapolated variables they understood but it was the unforeseen variables that moved markets.

We are at a similar juncture at present.   Central Banks are repressing interest rates. One does not know if the inflation spurt is temporary or a blip based on stretched supply chains which will normalize. Is more Govt stimulus coming? Will Central Banks start practicing yield curve control? Will they also buy Equities like the Bank of Japan?

The fact that we cannot extrapolate history is well explained in the chart below which shows historical yields on Junk Bonds vs inflation. Financial repression by Central Banks has resulted in Junk Bonds in the US now yielding less than inflation. If interest rates stay low for longer, it means lower Cost of Capital (higher PE multiples) and more allocation to Equities in portfolios (higher flows as savers are pushed to take more risk).



What does that mean for Investors? We all need to develop a process to shut out the noise that clouds clear thinking and frequently remind ourselves of the game we are playing and be better prepared to deal with surprises. Think of batsmen practicing an imaginary forward defense or golfers doing imaginary swings. They are training their minds to act in a particular way.

Some questions may help your introspection:

1. How do you eliminate noise: What do you read? Who do you listen to? Is the person giving advice playing the same game as you with the same time horizons?
2. How do you ensure one does not react in panic to a market fall: what % of your portfolio is in Equities? How have you historically reacted to a 15-20% market drop?
3. What time horizons do you operate with? Why? Will stretching time horizons result in better outcomes?
4. What is your plan to manage tail risks?
5. Does a 15-20% market drop really matter if you believe you can be materially higher in 5 years? If the 15-20% drop would matter, why is that portion of your Wealth in Equities?
6. How will you take advantage of a steep market correction, if it were to occur?
7. Do you need a Wealth Manager – who you can trust – to protect you from first order behaviour (fast thinking)?

How does Solidarity incorporate the above principles in our decision-making process?

1. Futures and Options trading is banned at our firm so we can focus exclusively on long-term outcomes.
2. We don’t keep a TV in our office so we are not affected by external stimulation. We “pull” information rather than get “lulled” to it.
3. We don’t make any attempt to forecast near term earnings or direction of key macro variables
4. We allocate capital based on where we think the best outcomes are on a rolling 5-year basis.
5. We appreciate the value of “slow thinking”.

6. We don’t buy fragility even if valuations are very attractive. This prevents deep drawdowns when the environment turns against you.
7. We are prepared to hold Cash to take advantage of declines.

The future is indeterminate. But chance favours the prepared mind. Are you prepared ?