

The Journal *of* Wealth Management

Weathering the Next Storm

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After two serious declines in asset markets in less than 10 years, wealth managers today must contend with increasingly concerned clients amidst increasingly volatile markets.

Enhanced investigation of global markets and economic data may help assess the future level of risk or safety for client investments but requires that managers sift through constantly increasing amounts of information. Armed with a fresh perspective and supporting data, conversations with clients about investment risk can be productive. It may even encourage clients to rethink their goals. This article explores techniques for managing the world of information overload and how it can help meet the evolving challenges of wealth management.

A weather vane tells which way the wind is blowing, but it will not tell if a storm is on the way. More detailed information is needed. Similarly, managing wealth requires more than a general overview of the economic climate. It calls for a process that can prepare clients for a dramatic loss of net worth if impending market imbalances revert to historical levels. This is especially true for clients in the distribution stage of life.

Wealth managers must be able to provide sound advice regarding the various asset classes clients invest in, whether they are public or private. Or U.S.-or foreign- currency denominated. This means preparing for the

evolving, complex, and dynamic forces that drive asset values today. As with other professions, wealth managers are occasionally required to abandon traditional processes, expand their knowledge, and apply it to serve the best interests of clients.

There are many ways to categorize information that can be helpful in managing client wealth. Data are often considered economic, fundamental, technical, or behavioral. Each type contains a mountain of information that can be used in forecasting both near- and long-term asset prices. The real beauty is in synthesizing the data in a wealth management practice.

THE BIG PICTURE

Like a weatherman monitoring the surface temperatures at the equatorial Pacific Ocean for the effects of unusually warm (El Nino) or cold (La Nina) weather patterns they can produce, wealth managers may need to take into consideration broad and long-term economic trends.

Often overlooked, perhaps because they tend to change slowly over long periods, secular economic trends, such as population age, can have a profound impact on an economy and, hence, asset prices. As a population of ages, several dynamics come into play. The workforce begins to shrink, tax revenues from wages fall, savings are reduced, and demand for healthcare services and leisure time activi-

ties increase. Superimpose that trend on a country running a budget deficit financed by the citizens at very low interest rates and there is likely a problem in the making. If the dwindling savings of that country force monetary authorities to attract capital from foreigners, rates may have to rise to make the investment attractive. This would increase the debt-servicing cost and potentially slow economic growth, as less money is available for more productive uses. So while a couple of sectors may benefit from the populations trend, overall economic growth may be stymied.

But it is not always that simple. Is it possible that the percentage of people working after the normal retirement age could increase, especially in a country where retirement savings are known to be low? This includes not just greeters at the local mega-retailer, but doctors, managers, and other professionals. What does this say about the prospects for new entrants into the workforce? How could a thin employment market for recent graduates affect the cash flow needs of clients?

Corporate profit margins and credit expansion are two areas that can move in one direction for a very long time, but eventually revert. Credit availability will shrink as the quality of borrower's declines and profit margins will be competed away. This is an important factor to consider when forecasting future earnings.

John Hussman of Hussman Funds recently provided great insight when he contrasted valuations extracted from short-term conditions with those derived from long-term metrics. In another commentary, he reminded us of the importance of historical evidence to support the forward valuation projections. While it might be fun to read the most popular post on Seeking Alpha.com, Huffman's analysis prompts more serious thought when he states, "If the past decade has been a lesson for investors, that lesson should have two components. The first is that valuations matter. The second is that the effects of wasteful misallocation of capital cannot be fixed by policies that encourage the wasteful misallocation of capital."

Long-term economic trends are often responsible for major economic shifts in an economy. In a credit based capitalistic market, monitoring credit levels can be enormously helpful in signaling the end of an economic boom. In terms of sovereign debt defaults, there is an important threshold where the debt to gross domestic product (GDP) ratio increases the likelihood of some form of default. Today, the unfortunate reality is that it appears several developed coun-

tries are near or past that threshold. Timing may not be exact, but knowing icebergs are floating in the water can lead to taking precautions.

Managing Risk

There are a number of ways to measure the level of risk in the marketplace. Small divergences can foretell of big changes ahead and at various times, different metrics provide the most accurate measurement.

The three-month LIBOR (London Interbank Offered Rate) rate rose dramatically in the summer of 2010, almost doubling. It rose to nearly 5% when Lehman Brothers collapsed; today is under 0.5%. This time around, however, LIBOR may not be as helpful, because European banks facing the immense European Union bailout largely set the rate. This might suggest greater importance be placed on other short-term credit measurements, such as credit default swaps or commercial paper metrics.

Indicators like VIX which attempts to measure the near-term volatility of stocks, can also be helpful in measuring risk in the market. It is a bit of an art form to interpret market indicators like VIX, which can remain in stubbornly overbought or oversold conditions for an extended period. After trending down as the market rally from early 2009 unfolded, VOX started to behave differently in mid April of 2010. Usually moving in the opposite direction of stock indices, there were two days in three-day trading period where VIX and the S&P 500 moved in the same direction-to the upside. In context with other indicators at the time, VOX offered an early warning of the coming market correction.

Notice the two indicators above cover different asset classes; LIBOR and commercial paper focus on the credit markets and VIX focuses on the equity markets. Look for data to come from different constituents. For additional data on the health of stocks, consider a regular review of several market breadth indicators (A-D Line, Highs-Lows, etc.). Intermarket analysis can also be a helpful tool in gauging market behavior. Understanding how bonds and stocks, bonds and commodities, commodities and stocks, or any number of other combinations are interacting can be informative.

The business cycle is perhaps the most influential of the indicators. Aside from the secular environment, the business cycle marches to its own drum. Like a farmer trying to seed clouds to produce rain,

the business cycle can be aggravated by fiscal and monetary actions, but it largely expands the contracts autonomously.

Business cycle data, which tend to more closely correlate with stock market returns (partially because stock prices can be used as one of the data sources), have done a reasonably good job of determining the likely direction for stock prices. The conference board is well known for its leading (LEI) and coincident (CEI) economic indices. As 2007 was coming to a close, the conference board's LEI was in decline. The CEI followed early in 2008 and both fell through the first part of 2009. In February, the LEI shot up, followed shortly by a move up in the CEI in July. Comparing those moves to broad stock market indexes reveals a similar pattern. These two indicators can provide clues about the near term environment that can be extremely valuable when managing portfolio longevity during a client's distribution phase. Dollar cost averaging or buy on the dip efforts have yielded few benefits the last 10 years; ask almost anyone with a 401(k) Using data from LEI and CEI might have helped investors make better informed decisions.

Forecasts, especially those associated with corporate earnings, are important in determining current stock prices. When economic conditions are transitioning from contraction to expansion, the art of forecasting earnings can become less reliable. The impact of monetary and fiscal policy on asset prices can be difficult to gauge beyond an initial response.

Another economic area that deserves careful monitoring is future inflation. When combined with a pulse on the business cycle, it provides a useful perspective on both future asset prices and purchasing power. Comparing the field between a treasury bond and a TIPS bond, watching changes in the yield curve and monitoring commodity prices can shed light on how market participants view future inflation.

Conflict Caution

Some government statistics have become almost laughable in terms of how they are constructed and seasonal adjustments, core versus headline: it is important to understand the source of underlying data. CPI is also used to make adjustments to Social Security payments and principal values on U.S. Treasury inflation protected bonds. One wonders how government officials overcome this conflict of interest.

A Closer Look

Close monitoring of some of the key business-cycle inputs can provide a better sense of the strength of the current state. Some data are better viewed as a trend versus report to report. The "Employment Situation" report, for example, where payrolls can fluctuate significantly, may be better viewed as a trend. Some reports need to be parsed. Looking again at payrolls, private nonfarm employment is the real driver for economic growth.

Data that cover a large swath of information might play a more regular, albeit limited, role. Bond yield spreads across maturities, quality, and type can provide insight regarding rest appetite and inflation. Housing starts, the Baltic Dry Index, and commodity prices speak to economic activity.

It can also be helpful to know if an index has sub index components and other related indices. The Baltic Dry index (BDI) is a good example. To get a full understanding of global shipping indices, a review of data from the Baltic Cape Index (BCI), the Baltic Panamax Index (BPI), and Baltic Supramax Index (BSI), each with its own story to tell regarding global shipping activity, is advisable.

Today's Key Challenges

One of the positive developments that may portend the growth engine for decades to come is the rising middle class in emerging economies. Taken as a whole, the BRIC economies still only represent approximately 60% of the U.S. economy based on GDP, but they are growing much faster and have large populations starting to consume more products and services. As a whole, emerging markets are now on parity with the United States in GDP; this is an asset class that will continue to command more attention. The challenges the emerging market monetary authorities in coming years may be how to keep inflation in check as their economies grow and attract a potentially unhealthy share of the world's investment funds.

On the subject of inflation, there is much to debate and investigate. Most clients would agree there appears to be both higher and lower prices of their holdings are likely still depressed. In terms of future inflation, Rob Arnott of Reasearch Affiliates as the following suggestions: "To deliver the knockout, inflation fighters need a combination of an expanded toolkit and disciplined practical exposure management.

Expanding Science

The most powerful computers in the world are often dedicated to helping better understand weather patterns, a complex science. Consider the number of economic, fundamental, technical, or behavioral data sources available today. It is a long list and growing. The real skill is interpretation, which calls for process, discipline, and discernment to determine which are more likely to offer value in prevailing conditions. A wool sweater guards against the cold but does no good if it rains.

There are many books that delve into both secular and cyclical economic data of the past and their effect in asset prices. *Devil Take the Hindmost* and *This Time Is Different* are two that come to mind (by Edward Chancellor and Carmen Reinhart and Kenneth Rogoff, respectively). Their content can update one's knowledge and be incorporated into a professional practice. It is even possible to purchase lectures by college professors on the economic dynamics of the interconnected world. While often labeled the "Dismal Science," because economists rarely hit the mark with their forecasts, the information is fascinating. It is more of an art, where interpretation makes all the difference. It is a skill that may take some time to sharpen, if a not already part of one's routine. Rather than looking at form-produced output, develop a list of trusted but many resources, track and update certain data, and keep an open mind to new sources and theories.

Asset Class Forecasts

When it comes to weather, a seven-day forecast is about the best we can expect. Investor time frames are typically much longer. While most forecasting is focused on monthly, quarterly, or annual data, one asset management firm, Grantham Mayo Van Otterloo, provides a seven-year asset class return forecast that is revised quarterly and illuminated with commentary by Chief Investment Strategist Jeremy Grantham and others at the firm. While the forecasts themselves are interesting, comparing changes from prior quarters and the factors that drove those changes is where the real value is found.

When some of the brightest minds in the industry shift their forecasts in as little as three months, wealth managers also need to be ready to change their thinking and advice to clients. New information can change everything. Consider where the U.S. dollar and the European euro were trading in the spring of

2010 versus after the federal second round of quantitative easing (QE2) announcement later that summer.

Animal Spirits

The bull likes to run on warm spring days; the bear hibernates through the winter. Integrating some technical analysis into one's practice can be incredibly helpful. During the summer of 2010, the 30-day exponential moving average (EMA) crossed through the 200-day EMA. Historically, this is considered a highly bearish development and increased the likelihood that stock prices were headed further down and into bear market declines. Knowing the type of market that exists can help guide purchase or sell decisions. In a bull market, the primary concern is with putting money to work as fast as possible. Corrections tend to be shallow and short. In a bear market, buy during the rally; buying the correction can be a dangerous proposition. Having a viewpoint on the type of market one is investing in can be another important toll in managing client assets well.

Beware of Biases

Everyone has biases. The real estate bubble was a recent example. One of the risks is information overload, that is to say, more information may increase confidence while simultaneously decreasing prediction accuracy. Anchoring can be another form of bias. Waiting for a price to come down to one's initial purchase level can prevent taking a full position if it continues to rally.

Sometimes the data indicate the need to do something counterintuitive. When a plane is about to stall, the nose must be pushed down to increase airspeed and lift. The intuitive reaction would be to pull back on the yoke, but that slows the plane further. The same is true with wealth management. At times, the need to exist to reduce or hedge exposure even if it means selling at a loss or watching a hedge decline in value because an asset class continues to rally. The challenge is to know when and accept that nailing it perfectly is unlikely. Sometimes, reversing course is the best option. Nothing works all the time.

One characteristic of the brightest minds in wealth management is their constant investigation of markets. While it is unnecessary to agree with every analysis, staying current with the work of John Hussman, Jeremy Grantham, and others, is bound to help manage the daunting task. Even Russell Investments has introduced a new information offering, suggesting

that too see value in monitoring an expanded data set. The staunch active management asset allocator has developed an economic indicators dashboard covering mortgage delinquencies, consumer spending, and other indicators.

Conclusion

The variables affecting wealth today are complex, varied, global, and personal. In order to successfully navigate the uncharted territory ahead, wealth managers who constantly improve their information gathering, discernment, and dissemination process and to separate themselves from the rest of the crowd to delight of their clients. One only needs to look at the discipline in place at PIMCO for a confirmation of the value in establishing a rigorous data interpretation framework for managing wealth.

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