Before we can begin to dissect all of the nuances as to why what has worked in the past may no longer work in the future, we must first start with a “30,000-foot view,” putting into perspective both the realities of the individual investor’s disposition and historical performance, as well as our current economic landscape. Once we have a general understanding of the challenges at hand, we can examine these issues more intimately and ultimately provide practical solutions as to how investors can more efficiently navigate this tumultuous environment (while inherently reducing the impact of outsized risks).

THE INDIVIDUAL INVESTOR

It has often been said that when you are in the thick of things, you simply cannot “see the forest for the trees.” Because of all of the obstacles that surround us (some real, others imagined), our vision is impaired and it is easy for even the most astute observer to become
overwhelmed; so much so that they can no longer see the path which lies ahead, nor the bigger picture at hand.

If we apply this analogy to the investment markets and the daily influx of market-moving headlines, prognostications, and so on, it is easy to see how one might get lost in the myriad of directional noise. After all, CNBC, Bloomberg, and the like need to drive ratings, and there is nothing better than sensationalizing a trivial nonevent for this purpose. For that matter, we must admit we find the circus to be mildly entertaining. In one segment, you’ll hear from some expert why the market is going up, and in the next you will hear from another why it is going down. It pains us to think how many people get their investment ideas (particularly stocks) from watching this drama play out.

In the past, we have had the good fortune of sitting in on a handful of small group presentations by renowned economist Dr. Bob Froehlich. While we may not always agree with his message, we can certainly appreciate his enthusiasm and the wildly compelling arguments he makes to support his well-articulated views. Reiterating our previous point, the one thing we heard Dr. Bob say that has stuck with us over the years was, “If you see someone on TV telling you to buy a stock, it is because they own it and they need to get out at a higher price.”

The reality is that we live in a world that is dialed into the investment markets 24/7, in the United States and abroad. Whether through TV, radio, the Internet, or a litany of industry-related publications, investors today are flooded with a plethora of information. They are inundated with commentary from very smart people weaving well-crafted messages to convey their views. These experts are backed by industry-related pedigree, impressive educational backgrounds, and fancy initials after their name—all of which leads us to believe they are qualified to know what is coming next, whether for the state of an individual company or the economy at large. But despite all of these superficial pearls of wisdom, more often than not they are wrong. It’s not their fault. It is by the conventions we have endeared ourselves to that they are obliged. They are simply purveyors of an ego-driven industry in which individuals believe they can know more than the markets.
OCKHAM’S RAZOR

“Pluralitas non est ponenda sine necessitate” (“Entities should not be multiplied unnecessarily”)

William of Ockham, a fourteenth-century Franciscan monk, born in the small village of Ockham in Surrey, England

While many of us may not be familiar with the name, historians today regard William as one of the central figures of Renaissance thought, at the epicenter of the major intellectual and political controversies of his time. William is most highly regarded for his contributions to the principles of parsimony. This later came to be known in academic circles as “Ockham’s Razor” and centuries later continues to provide one of life’s most important guiding principles.

Ockham’s Razor essentially states that if one can explain a phenomenon without making unnecessary assumptions, then there is no ground for assuming it, that one should always opt for an explanation in terms of the fewest possible causes, factors, or variables. Today, we know this as the KISS principle—Keep It Simple, Stupid.

When you look out into the landscape of the financial markets, you can see that we certainly don’t do a very good job of this. Click on CNBC, pick up your Wall Street Journal, or turn on your Bloomberg radio, and this much should be blatantly obvious. There is a whole army of financial wizards trying to decipher the behavior of the investment markets and sharing with us their opinion of what’s to come. The irony is that seemingly more often than not, their visions fail to come to fruition. And yet we as investors are encouraged to base our investment decisions on their collective wisdom.

Perhaps this is where William of Ockham comes in. Rather than attempt to predict the future price of a stock or the future state of our economy, encompassing a mountain of data and incalculable variables, rather than attempt the impossible by looking forward, wouldn’t it just be easier to “look back”?

The price movement of a security will tell you more than any analyst or economist ever could. In the spirit of Ockham’s Razor, price momentum is the one true metric we have that provides clarity to the
psychological underpinnings that move the markets. These psychological forces drive both short- and long-term trends.

In the investment world, we like to make things more complex than they need to be. Our industry is famous for as much, and it seems more and more the investment vehicles or methods used today have grown increasingly complex. Whether by virtue of some sort of masochistic, egomaniacal pursuit of proving one can consistently outsmart the markets or the result of simply adhering to the rules that have been laid out before us (attempting the impossible by predicting the future), the results remain the same. Investors have a long history of underperformance.

According to the 2013 Quantitative Analysis of Investor Behavior, conducted by Dalbar, Inc., over the past 20 years (1993–2012) the average rate of return for the retail equity investor in the United States has significantly lagged that of the S&P 500:

- 4.25 percent average annual return for the individual investor in the United States.
- 8.21 percent average annual return for the S&P 500.

Pulling out our financial calculators and computing a few simple time-value-of-money calculations, this would imply that:

- An investor starting with a $100,000 investment, with a 20-year compounded average annual return of 4.25 percent, would have seen their savings grow to $229,890.63 by the end of 2012.
- Conversely, an investor in the S&P 500 Index starting with $100,000, with a 20-year compounded average annual return of 8.21 percent, would have seen their investment savings grow to $484,560.42.

Surely this does not paint the individual investor in the most favorable light. Daily headlines, rumors, and stock market gossip invoke emotive responses out of investors. News that should be regarded as nothing but noise serves as a catalyst for action, either to buy or to sell. Successful investors are wise not to listen.

In one of the great literary works of all time, The Intelligent Investor, the father of value investing (and mentor to the iconic Warren Buffett),
Benjamin Graham, opined, “Individuals who cannot master their emotions are ill-suited to profit from the investment process.” On this point we wholeheartedly agree, as the psyche of the human condition is not wired to endure such gut-wrenching events as watching one’s net worth painstakingly decline by more than 50 percent. Suffice it to say this is easier said than done. History has proven as much. Therefore, it would make sense that investors adhere to an investment process devoid of emotion.

Consider the information in Table 1.1 of what it takes for investors to get back to even once they have experienced a significant loss of capital:

<table>
<thead>
<tr>
<th>If you’re down this much</th>
<th>You’ll need to gain this to break even</th>
<th>2%</th>
<th>4%</th>
<th>6%</th>
<th>8%</th>
<th>10%</th>
<th>12%</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>11%</td>
<td>5.3</td>
<td>2.7</td>
<td>1.8</td>
<td>1.4</td>
<td>1.1</td>
<td>0.9</td>
</tr>
<tr>
<td>20%</td>
<td>25%</td>
<td>11.3</td>
<td>5.7</td>
<td>3.8</td>
<td>2.9</td>
<td>2.3</td>
<td>2.0</td>
</tr>
<tr>
<td>30%</td>
<td>43%</td>
<td>18.0</td>
<td>9.1</td>
<td>6.1</td>
<td>4.6</td>
<td>3.7</td>
<td>3.2</td>
</tr>
<tr>
<td>40%</td>
<td>67%</td>
<td>25.8</td>
<td>13.0</td>
<td>8.8</td>
<td>6.6</td>
<td>5.4</td>
<td>4.5</td>
</tr>
<tr>
<td>50%</td>
<td>100%</td>
<td>35.0</td>
<td>17.7</td>
<td>11.9</td>
<td>9.0</td>
<td>7.3</td>
<td>6.1</td>
</tr>
<tr>
<td>60%</td>
<td>150%</td>
<td>46.3</td>
<td>23.4</td>
<td>15.7</td>
<td>11.9</td>
<td>9.6</td>
<td>8.1</td>
</tr>
<tr>
<td>70%</td>
<td>233%</td>
<td>60.8</td>
<td>30.7</td>
<td>20.7</td>
<td>15.6</td>
<td>12.6</td>
<td>10.6</td>
</tr>
<tr>
<td>80%</td>
<td>400%</td>
<td>81.3</td>
<td>41.0</td>
<td>27.6</td>
<td>20.9</td>
<td>16.9</td>
<td>14.2</td>
</tr>
<tr>
<td>90%</td>
<td>900%</td>
<td>116.3</td>
<td>58.7</td>
<td>39.5</td>
<td>29.9</td>
<td>24.2</td>
<td>20.3</td>
</tr>
</tbody>
</table>

The great Warren Buffett once said, “Unless you can watch your stock holding decline by 50 percent without becoming panic stricken, you should not be in the market.” On this point, we may find some common ground. We agree that investors simply can’t take watching their investments lose significant amounts of money; they fear they will never get it back. They also fear that things will get worse. Such fears begin to consume them and they simply pull the eject lever and get out, potentially locking in a permanent impairment of capital from which they may never recover.

Consider that if an investor is down 50 percent, they will need to go up 100 percent just to get back to even. If you have $100,000 and you
lose 50 percent, you are left with $50,000. Even if you go up 50 percent, you still only have $75,000. After losing 50 percent, at a respectable rate of return of 8 percent, it will take nine years to get back to even. Worse yet, if an investor makes the impulsive move into an even more risk-averse security averaging a 4 percent annual rate of return, it will take an astonishing 17.7 years to get back to even.

But who can stomach losing 50 percent?! Who’s to say you have not just bought the proverbial “falling knife” (as “value” investing can so often lead one to do)? Does this mean one should not invest? Do all investments bear such risk? We all know stocks do, and we also know that most people can’t handle seeing them go down precipitously.

*It only makes sense that any sound portfolio management process should provide a discipline for reducing participation in prolonged declines in the investment markets.*

Investing based on emotion will never work, but admittedly in a world where we are continually peppered with bombastic news intended to stoke feelings of fear and greed, we are playing in a game we can’t win. That is, if you care to listen.

**OUR CURRENT ECONOMIC LANDSCAPE**

Investors have a strong proclivity to take that which they have experienced in recent years and project that these returns will continue on into the future. Over the course of the past two decades, we have seen this notion play out in dramatic fashion, as the performance of the U.S. equity markets has provided investors with polar extremes from boom to bust. A period that peaked with insatiable greed and consumption morphed into a cataclysm of events that has left investors (and perhaps the U.S. consumer at large) broken and fearful.

During the 1990s, the S&P 500 averaged an astounding annual rate of return of 18.21 percent (see Figure 1.1). It was a decade of tremendous prosperity for Americans. The stock markets were so strong it made nearly anyone look like a market maven. One could throw the proverbial dart and come up a big winner. This created a false sense of confidence and encouraged investors to take on increasingly more risk.
At the same time, the Baby Boomer generation was entering their prime earnings cycle, incomes were going up, the unemployment rate was low, real estate was booming, consumption was strong, and so on. In fact, many Americans increased their level of wealth so much over the course of this decade that they began to borrow against existing assets to consume more. Whether taking out a home equity loan to buy their summer cottage, a Winnebago, or a new boat, investors did not seem to consider what might happen if the skyrocketing values of their investments were to fall; they assumed this growth could only continue.

At the time, there were even *New York Times* best-selling books trumpeting why and how this boom may be just the beginning! Take, for example, the *New York Times* Best Seller, *The Roaring 2000s: Building the Wealth and Lifestyle You Desire in the Greatest Boom in History*, in which author Harry Dent forecasted that the Dow Jones Industrial Average would reach as high as 35,000 by the year 2008. As one might expect, investors and consumers alike entered the new millennium
with high hopes, assuming what they had experienced in recent years would surely continue.

As we now know all too well, the following decade proved to be the most difficult economic period in the United States since the Great Depression. From the bursting of the tech bubble in the year 2000 to the end of 2009, the S&P 500 generated an average annual rate of return of –0.95 percent; prompting many to refer to this time period as the “Lost Decade” (see Figure 1.2). The Dow Jones Industrial Average once projected to reach 35,000 bottomed in early March 2009, closing at a 12-year low of just 6,547.

The average American lost as much as 50 percent or more of their net worth, as both the stock and real estate markets plummeted. Some of the most well-known and established companies in the United States found themselves bankrupt, as prominent companies such as Lehman Brothers and General Motors failed to escape the depths of the Great Recession of 2008. Unemployment rose to historical highs, and wage growth became nonexistent. In a nation where gross

![Investment Growth: The Lost Decade](image)

**FIGURE 1.2** Historical Performance of the S&P 500, 2000–2009

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domestic product (GDP) had been so historically reliant on consumer spending for growth, the consumer was badly wounded.

To put these losses into perspective, consider how much the cost of everyday staples have increased in price since the year 1999 (see Table 1.2).

Suffice it to say, when one takes into consideration both the average loss of capital for the U.S. consumer that has taken place since the turn of the millennium, as well as the price increases we have experienced in everyday staples, the past decade has been quite challenging.

Since our most recent market collapse in 2008, in an effort to thwart the perils of what very well could have become another Great Depression (or worse), central banks from around the world have worked in concert to avoid a deepening of the crisis. The Federal Reserve in the United States specifically has taken a litany of accommodative actions, attempting to facilitate growth in the economy and provide relief for consumers.

In an effort to reduce interest rates in the economy and thus increase spending and borrowing, the Fed has undertaken a massive stimulus program, including a large-scale asset repurchasing program. As we know it to date, the total cost of this stimulus is encroaching on $1 trillion. Concurrently, our country’s national debt is now nearing a jaw-dropping $17 trillion.

We all know this cannot continue; the government cannot prop up our economy forever. At some point in time, the baton will once again be passed along to the U.S. consumer to provide economic growth.

<table>
<thead>
<tr>
<th>TABLE 1.2 Historical Cost Comparison (U.S. City Average)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Gasoline, unleaded regular, per gal.</td>
</tr>
<tr>
<td>Ground beef, 100% beef, per lb.</td>
</tr>
<tr>
<td>Flour, white, all-purpose, per lb.</td>
</tr>
<tr>
<td>Potatoes, white, per lb.</td>
</tr>
<tr>
<td>Coffee, 100%, ground roast, all sizes, per lb.</td>
</tr>
<tr>
<td>Sugar, white, all sizes, per lb.</td>
</tr>
<tr>
<td>Apples, Red Delicious, per lb.</td>
</tr>
<tr>
<td>Electricity per KWH</td>
</tr>
<tr>
<td>Chicken, fresh, whole, per lb.</td>
</tr>
<tr>
<td>Milk, fresh, whole, fortified, per gal.</td>
</tr>
</tbody>
</table>

The question is whether U.S. consumers will be ready when the time comes, and what happens if they are not.

Many of the most well-respected and prominent figures in our industry have widely discussed what they believe will be a more difficult investment environment in the United States and abroad in the coming years. PIMCO has referred to this environment as “the new normal,” a period of slower, more muted growth, with more frequent recessions. Others have framed the years ahead as “the great deleveraging,” as developed countries around the world will be forced to take measures to pay down the massive debts incurred by trying to prevent a global depression during the Great Recession of 2008. This will lead to societal changes unlike that which we have seen in the past, as simultaneously governments and individuals alike aim to reduce debt. In this environment, many believe wage growth will be slow as corporations and small businesses adapt to lower levels of consumption (and potentially higher taxes). Unemployment is also likely to remain above historical norms. With increased uncertainty and businesses operating lean, why hire more employees when the ones you have are just thankful to have a job and are managing a workload previously assigned to two people?

Additionally, in the United States specifically, we are potentially faced with decades of demographic challenges. In the United States, nearly 30 percent of our population is composed of the Baby Boomer generation (those born between 1946 and 1964), and yet this demographic controls more than 40 percent of consumer spending. As these individuals grow older and move on into retirement, they are going to place increased strains on our current social programs (Social Security, etc.). These programs are already under pressure and woefully underfunded; imagine the impact it might have when this entire generation is retired! This generation controls the largest percentage of financial assets in our country; as such, they have incurred the biggest losses over the past decade. How might the spending habits of this generation change in retirement, and what impact will this have on U.S. GDP, 70 percent of which is historically composed of consumer spending? No one can say for sure, but suffice it to say these are valid concerns and questions to which we as of yet have no answers.

The aforementioned challenges will move structural reform to the forefront in the coming years, as political leaders grapple with how to
get elected, but at the same time present a framework for “righting the ship.” Conventionally, in order to reduce the federal deficit, our government must either reduce spending or increase taxes, or both. Consider what might happen if during a time of economic instability, with the world teetering on the cusp of recession, taxes were increased in the world’s wealthiest nation? Common sense will lead you to deduce that consumption would go down. It is a delicate balancing act, and one that must be executed with extreme caution.

So for those investors expecting the next 10 years to look like what they have experienced in recent years, market history cautions us to consider otherwise. Investors today are facing a whole new set of circumstances that have never before been seen in the modern capital markets. This environment will likely wreak havoc on those employing a traditional approach to asset management.

THE BOTTOM LINE

Taking a “30,000-foot view,” it is easy to see that we are facing a myriad of challenges ahead. These challenges will collectively make the investment landscape that much more difficult for investors. Timing, execution, and adhering to an investment process devoid of emotion and focused on discipline will provide investors with a margin of safety in these difficult times; it always has. With a process centered on “winning by losing less,” investors can better navigate the markets, through all market cycles (good or bad). What we are referring to specifically is employing a rotational approach to investing, rather than “buy, hold, and pray.”