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Blending Fundamental and Active...or why we invest the way we do

Investopedia defines investing as *the act of committing money or capital to an endeavor (a business, project, real estate, etc.) with the expectation of obtaining an additional income or profit.*

At its core, investing seeks opportunities where the addition of money can create value in excess of the original investment. With respect to publicly owned companies, the addition of money / capital occurs when the company makes a public offering, exchanging stock for money, or issues debt, promising to repay the money with interest. In the process, shares of the company or debt obligations are created that can be traded among investors.

Successful investments, Benjamin Graham and the fathers of portfolio management believed, come down to the fundamentals of the company - its ability to create value as a result of the right products or services, good management and financial capacity. As the company grows, so does the value of its investors' capital. Investors profit through (1) dividends from the company and (2) more valuable stock, or in the case of bonds, a predictable, competitive return on their loan.

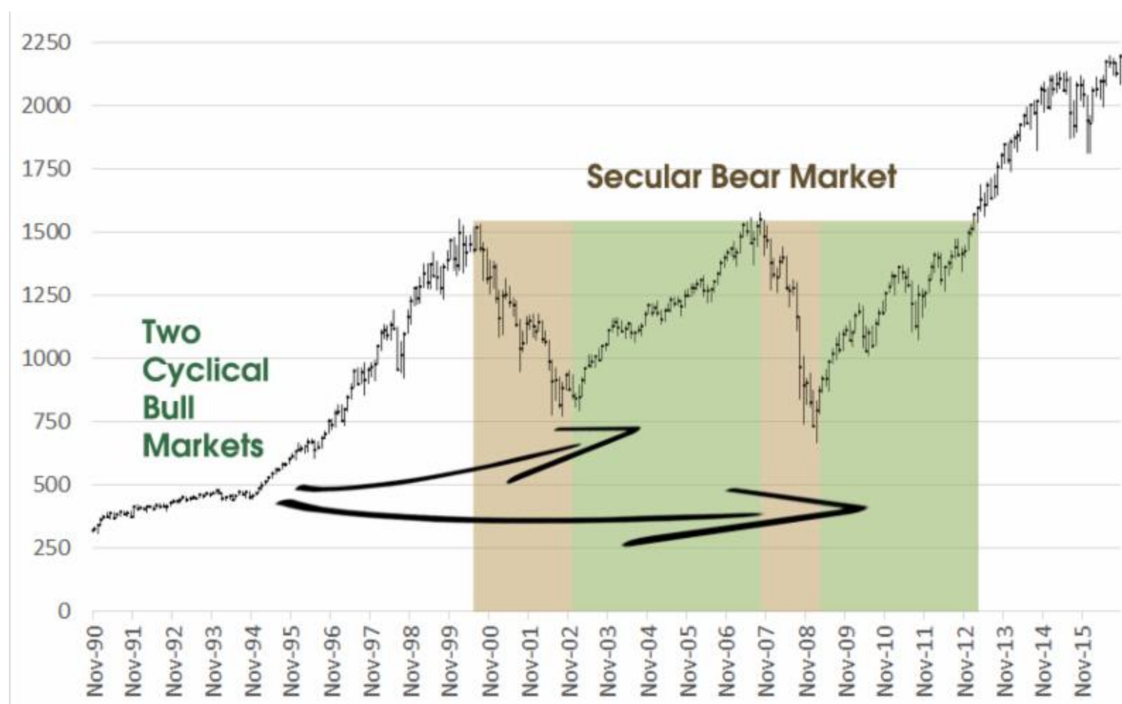
The fundamental value of the underlying company is the logic behind a buy-and-hold investment approach. One buys stock or bonds of a good company with good growth prospects and then lets time and compounding take effect. Diversifying one's investments among different companies and industries reduces the risk that the faltering of one company could destroy a portfolio. For many years, active mutual funds were used to diversify one's investments among multiple companies selected by the portfolio manager. While index funds have replaced the active mutual fund in many portfolios, the structure of the index often selects the biggest and best of an industry segment.

But picking good and even great companies still leaves the investor vulnerable to the extremes of market volatility.

"The market has a way of punishing those who forget that investing is above all else cyclical, and that extrapolating recent results into the future is not only dangerous, it is often 180 degrees from what happens next." Rob Isbitts

Financial markets in the U.S. have historically moved through overlapping cycles. Secular markets are long term trends lasting up to 30 years with bull and bear market phases taking from 10 to 20 years. Within the longer trend, cyclical markets occur, generally lasting around four years with bull and bear market phases taking some one to three years. Within these overlapping cycles, asset classes follow distinct cycles reflecting business and seasonal cycles.

S&P 500 Secular and Cyclical Markets 1990-2016



Data: Yahoo Finance Weekly S&P 500 High Low Close

Buy-and-hold investors will look at the chart above and conclude that regardless of how far the market has dropped in the past, it has always recovered, returning to prior highs. The problem with this approach is that the investor can never know for sure when a bear market will occur, how long or deep it will be, or whether circumstances will arise that will necessitate selling their investments. This is the true risk of investing - will your money be there when you need it?
The cost of a bear market is more than monetary. It also shakes the confidence of investors and makes them reluctant to trust their money to the volatility of the market. It creates personal strains, stresses relationships and causes individuals to forego opportunities, postpone retirements and more.

Active investment management adds a layer of risk management to the portfolio. By monitoring markets through trend and technical analysis, we seek to determine where the market is within its cycles and position portfolios to take advantage of uptrends and reduce exposure during downtrends. While not every trade will be successful, any time we can reduce losses to market downturns, we gain leverage to potentially profit when the market recovers.

Will active management outperform a buy-and-hold position? Not necessarily over a specific period, but properly implemented it should reduce volatility, minimize losses in down markets and provide an emotionally smoother ride. Equally important, by minimizing drawdowns, the portfolio is better able to accommodate withdrawals without destroying the ability of the portfolio to recover from bear markets.

One story often used to emphasize the important of risk management is that of Abraham Wald, who was assigned damage assessments to aircraft that returned from service over Germany during World War II to determine which areas of the aircraft structure should be better protected. He made a totally unconventional assessment: Do not focus on the areas that sustained the most damage. The heavily damaged areas did not contribute to the loss of the aircraft. Instead focus on essential sections that came back relatively undamaged, such as the engines. Protect essential assets from destruction, such as large losses (drawdown), and the investor will live to invest again.

Naturally there can be no guarantee that an active investment approach will be successful. But, our track records show its advantages during past market downturns. Past performance is not a guarantee of future returns, but ignoring the market's cyclical patterns can be a guarantee of disaster.

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