TW Advisors

June 2015 Newsletter

## TEMPERAMENT IS THE KEY TO INVESTMENT SUCCESS

Markets have been churning but not really going anywhere for a while. Convincing arguments can be made that both stocks and bonds are pricey. While this doesn't mean prices will go down in the near term it does mean returns in some future periods may be more modest. It's a frustrating environment that makes investors impatient and a great time to discuss a key characteristic needed to be successful at investing.

Most people assume a high intellect is needed to succeed in investing. While a certain level of intellect is helpful a much more important characteristic is temperament. At Berkshire Hathaway's 2005 Annual Meeting Warren Buffett said: "Financial success doesn't perfectly correlate with I.Q. ...but with temperament, which is hard to measure. You need some I.Q., but temperament is key." He elaborated on this theme the following year when he stated*: "There are no secrets in the investment business that only the priesthood knows. We do not go into temples and look at tablets that are only available to those who have passed earlier tests. It's all out there in black and white. It requires qualities of temperament way more than it requires qualities of intellect. What you do need is a certain temperament that enables you to think for yourself. Then you have to develop a framework. And then you have to look for opportunities that fit within that framework as you go through life."* (as reported in *Outstanding Investors Digest*)

Besides thinking for yourself, having the right temperament means being greedy when others are fearful and being fearful when others are greedy. **Easy to say hard to do.** Numerous studies of all classes of investors prove most do just the opposite and suffer with poor performance.

**TW's framework is to reduce risk when prices are high by raising cash, holding conservative stocks, and avoiding bubble stocks (being fearful when others are greedy).** In our record going back to 1998 we have consistently outperformed during down markets. During the tech bubble we owned virtually no technology stocks and in the financial crisis we avoided banks and most other financials.

Reducing volatility in the portfolio helps clients maintain their long-term investment discipline and makes it easier to take advantage of the cheaper valuations a correction creates (being greedy when others are fearful).

The stock market has recovered all its losses from the financial crisis and more and has been in rally mode for over six years. **Amazingly the S&P 500 hasn't had a correction of 10% or more since 2011 an unusually long stretch of time.** Not surprisingly good opportunities are rare. While it is impossible to know the exact timing this period of calm cannot last forever.

The absence of obvious bargains combined with an uncharted investment environment of chronic quantitative easing by the world's central banks, sluggish growth, and high global debt levels means having the proper temperament is critical. Now is not the time to take a lot of risk. At some point in the future stocks will offer double-digit growth. But until then patience is needed.

Please contact us if you have any questions.

James G Tillar, CFA Steve Wenstrup

**OUTSIDE COMMENTARY**
**Martin Barnes**
**BCA Special Report**
**Market Valuations and Returns-Conclusion**

Highly-stimulative monetary policy will remain conducive to market overshoots for at least another year. The Federal Reserve is desperate to raise interest rates and begin the process of policy normalization. However, it is constrained by ongoing disappointments about the pace of economic growth and the fact that inflation remains too far below its 2% target. Even if the Fed raises interest rates in September, as it hopes to do, the subsequent pace of tightening will be gradual. Markets are vulnerable when they start to anticipate that monetary policy will be restrictive, as opposed to just tighter. That is not imminent.

**So what is an investor to do? The recent backup in bond yields has improved the appeal of Treasuries and we are recommending long duration positions, from a tactical perspective. The trigger for a drop in yields might well be renewed weakness in oil prices given that the market is still being oversupplied**. Meanwhile, the benign interest rate environment suggests that the path of least resistance for stock prices remains upward. In sum, poor valuations are not an obstacle for both markets to perform reasonably well over the next 6 to 12 months. It is a different story when it comes to the long-run outlook.

Assuming the economy continues to grow, then the Fed will be able to slowly increase interest rates over time. Even if the terminal rate turns out to be far below historical norms, the Treasury market will be vulnerable to a repricing of the path of short rates. From a valuation perspective, 10-year Treasuries will not have much appeal until yields move into the 3% to 3.5% zone, and that might not happen until the second half of 2016 or later. On the way to that level, the stock market likely will suffer a significant drop in order to sustain the equity risk premium.

To conclude, U.S. investors who are concerned with short-term returns have an incentive to stick with these overvalued markets, but they should keep their running shoes beside the door. Long-run investors should maintain a conservative stance, waiting for valuations to return to more normal levels. That may take a while, but patience should be rewarded.

Finally, we have not extended the analysis to overseas markets, but clearly that would add another dimension to the topic. Not all global equity markets are expensive and we are recommending overweighting European and Japanese equities relative to the U.S. And with real bond yields in Europe lower than in the U.S., the relative attraction of equities in that region is even stronger. The only caution is that, given tight market correlations, any major sell-off in the U.S. would impact markets globally.

TW Advisors does not necessarily agree with the opinions of the outside commentary.