# The Zen Strategist

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Investing While Sitting Still

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# Calling the Top on the Trump Rally

# The Zen Strategist

*"Our life is shaped by our mind; we become what we think."*—The Buddha

*"I really don't know, I really don't know, what to do"*—The Rolling Stones, *What To Do*

*"Same as it ever was"*—Talking Heads, *Once in a Lifetime*.

Here at the Zen Strategist we try to avoid making market forecasts. We don't think anyone has much of an edge in this area, and focusing on the macro tends to obscure more interesting things to do.

Today is the exception to that rule.

That's right, I am "calling the top" on the Trump rally.

I will almost certainly be early, and of course could be flat wrong, but in my opinion the weight of the evidence has now become overwhelming, and investors should look to at the very least become much more cautious in allocating money.

This does not mean I'm expecting a crash—although one is obviously possible—but rather that a confluence of factors is now working against investors. Simply put, valuations are (very) high, sentiment is overwhelmingly bullish, and, most importantly, the narrative that has been driving markets since November is faltering. In other words, the wind is no longer at your back; instead, assets are priced for everything to go right…even as a lot seems poised to go wrong.

Let's look at the narrative piece first, since it is, to my mind, the most critical and arguably least discussed of all the factors. In fact, many market observers dislike even any mention of narrative, as it goes against our current obsession with quantitative "facts" over qualitative "stories." As John Skjervem, CIO of the $90 billion Oregon State Treasury, told the Wall Street Journal last year, "I'm very uncomfortable in the realm of the narrative. I want to listen to the data instead."

Don't worry…we'll get to the data. But let's begin with that narrative.

I was speaking with a friend—and one of the better investors I know—recently, and the topic of quantitative easing and its effect on asset prices came up.

"You know," he said, "around 2013 I realized I was an idiot, and the Fed didn't matter." He paused. "In fact, the Fed has *never* mattered."

That got us talking about narratives, and he eventually concluded (this was in February): "Today's narrative is all about Trump. But tomorrow it'll be something else."

Banal? Sure. But let's unpack this a bit.

***Quantitative Easing: Myth versus Reality***

*The Myth: QE has a direct influence on asset prices, particularly the stock market, and basically amounts to the Fed "printing money," which will ultimately lead to inflation in goods and services.*

*The reality: QE is a very simple process by which the central bank buys long-dated Treasuries from banks in exchange for, effectively, cash that the banks keep on deposit with the Fed as "excess reserves."*

*From a practical standpoint, QE works in two, both minor, ways: it increases banks' desire to lend (i.e. to boost profits, which are lower since they now have cash instead of Treasuries), and may encourage companies to borrow as purchases of longer-dated bonds should push down interest rates on loans.*

*Fears about excess reserves "leaking" into the economy and causing inflation are based on a misunderstanding of how the modern banking system works. While banks can individually lend out reserves, the amount of total reserves can only change through Fed activity or individuals choosing to hold physical cash.*

What he is saying—or at least my interpretation of it—is that it's not the underlying "facts" that matter so much as our collective reaction to them. We *do* create our life with our mind; we can quibble about what is actually "out there" (if anything…let's assume for the moment we are not brains in vats) but it is clear that our *perceptions* shape whatever we view as "reality."

To apply this to QE (how's that for a segue!), while its actual mechanics were pretty minor—basically a shifting of assets from banks to the Fed—the *narrative* was anything but (see sidebar[1]). In other words, while many observers lay most of the credit (or blame, depending on your point of view) for the post-2009 rally at the feet of the Fed—Jim Grant, for example, says investors should send them a thank-you note—*any effects of the policy came not from the actual process, but instead from investors' interpretation of it* (and, to borrow from Keynes' beauty contest analogy, their interpretation of how others would interpret it).

This narrative began to fade in the second half of 2016, particularly after the US election, as what had been billed by many as an unsustainable rally based on central bank activity, sure to crash and burn if and when they withdrew their support—remember how central banks "rescued" markets after Brexit?—suddenly morphed into the "Trump rally," with optimism driven by dreams of tax reform and massive spending on infrastructure. Suddenly rate hikes became signals of economic optimism rather than harbingers of doom.

Notice how none of this has *anything* to do with underlying fundamentals. Indeed, some observers have been worriedly pointing out that valuations are high and investors ebullient—not to mention that volatility is plumbing generational lows—for *years*, only to see markets tick ever higher.

Because…it's all about the narrative!

Thus, the recent failure of the healthcare bill, coupled with news that tax reform may take longer than expected—and most recently, military action in Syria and saber-rattling against North Korea—has punctured the "Trump rally" narrative…and is likely to replace it with something less bullish.

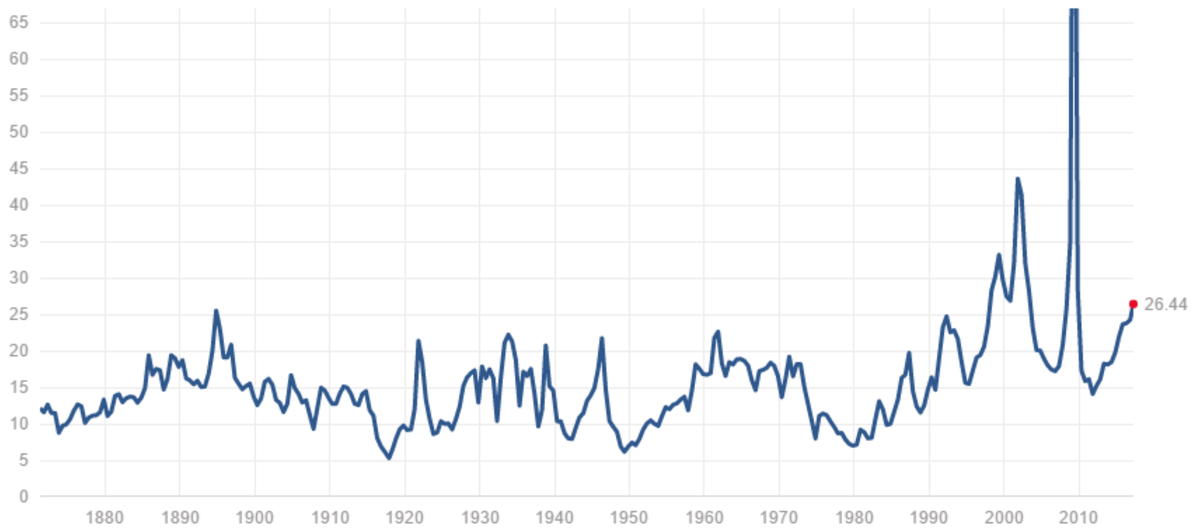
As another old friend likes to say, valuations (along with sentiment) are a necessary *but not sufficient* factor for a market top. Something also has to change. Well, in my opinion something just did, and those fundamentals are about to become a lot more important.

[1] For a wonderful explanation of this, please see *Repeat After Me: Banks Cannot And Do Not "Lend Out" Reserves* by Paul Sheard of S&P: https://www.kreditopferhilfe.net/docs/S_and_P__Repeat_After_Me_8_14_13.pdf

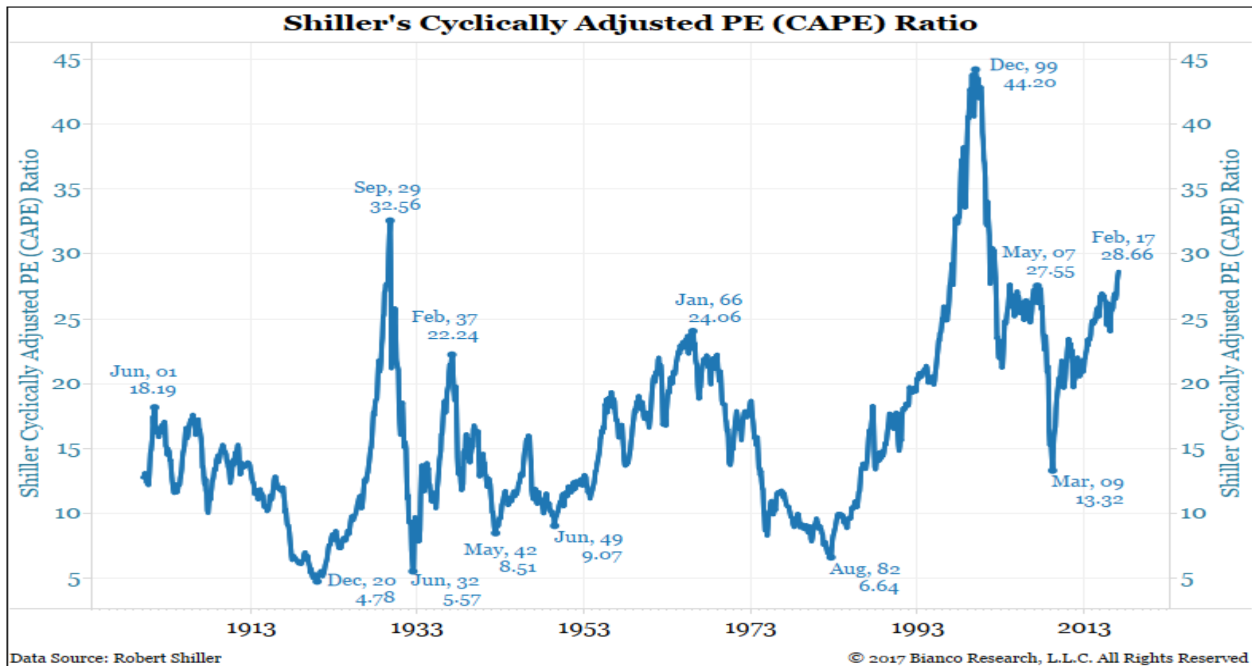
Let's get to the data!

While there is no agreed-on "best" metric for determining the valuation of the overall market—and indeed, some argue the whole exercise is akin to tilting at windmills—for the moment I think it is most useful to look at the price-to-sales (P/S) ratio. While price-to-earnings is the better known figure, earnings have become so distorted in recent years by financial engineering that it has lost a bit of relevance. Sales, on the other hand, cannot be faked.

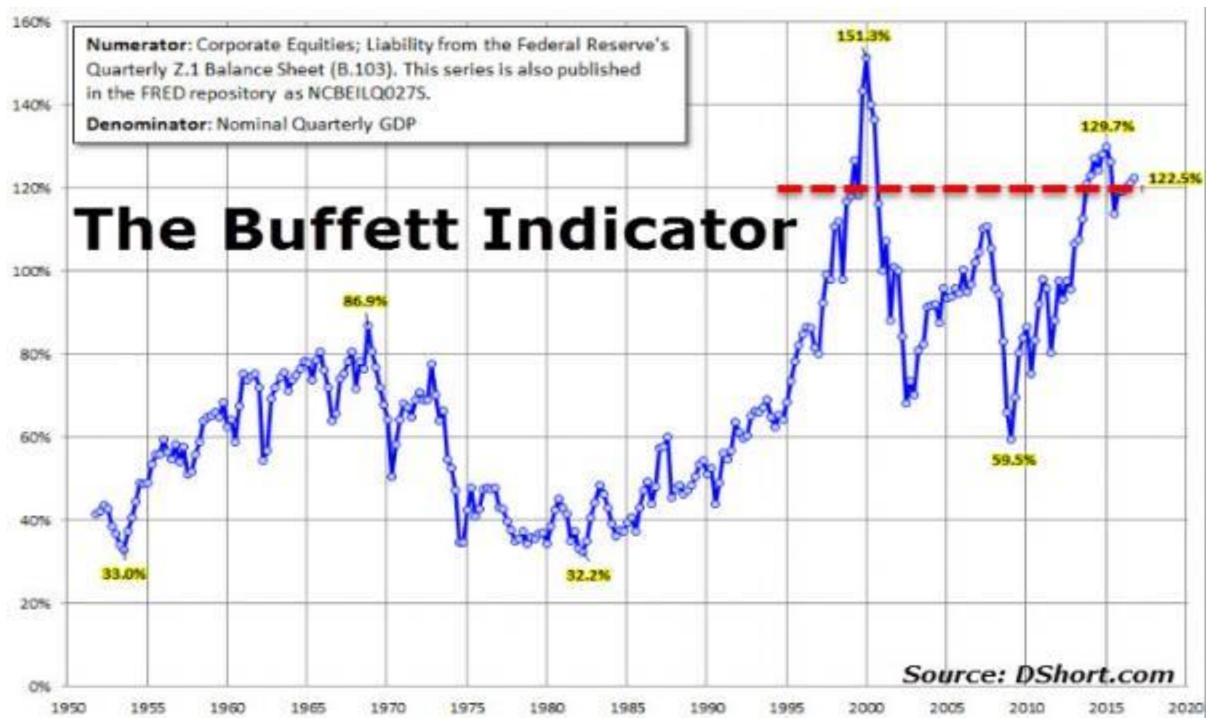
For argument's sake, here is the "standard" P/E ratio using earnings for the trailing 12-month period…



…and the cyclically-adjusted (or Shiller) P/E[2].




Finally, here is the ratio of total stock market value to GDP, often called the "Buffett indicator," as Warren has called it "probably the best single measure of where valuations stand at any given moment."

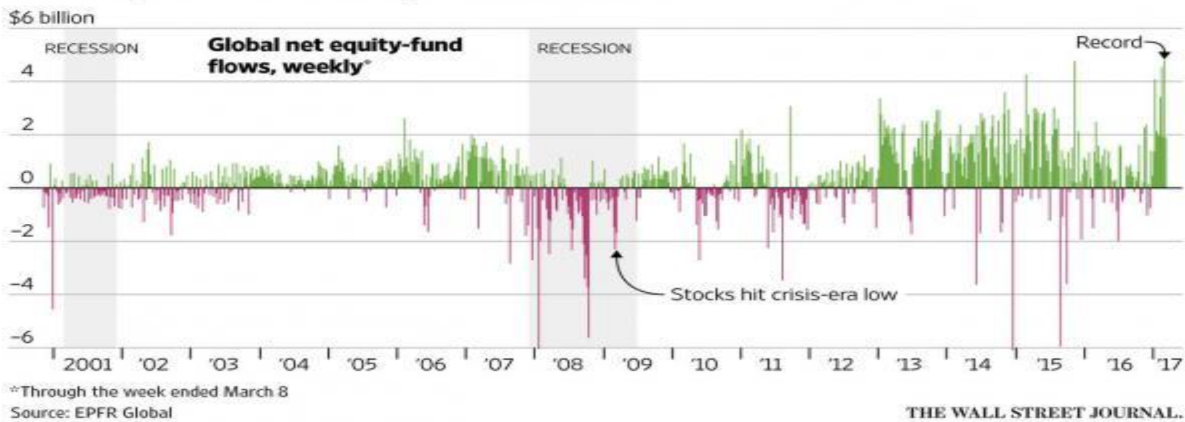



[2] The CAPE takes the past decade of earnings for the index, adjusts them for inflation, and averages them in order to get an earnings measure that, in theory at least, strips out the vicissitudes of the business cycle.

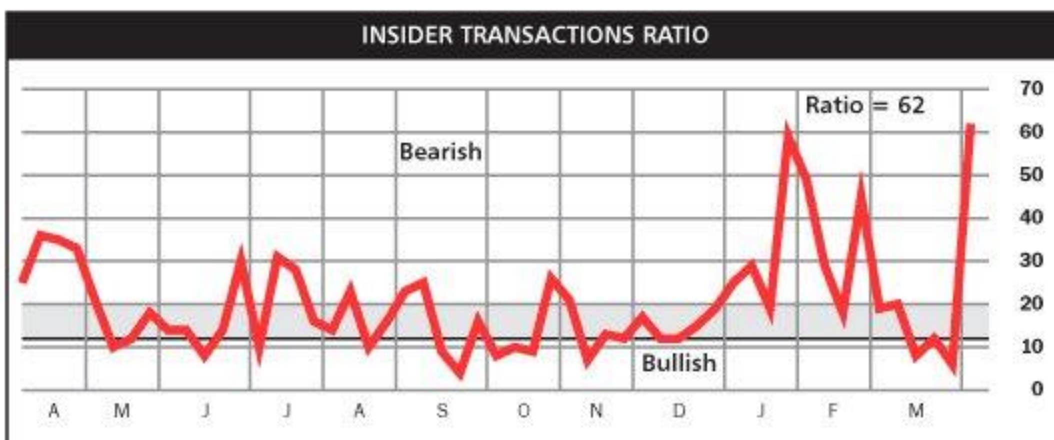
In other words, the stock market is now larger than the underlying economy. While there are reasons to question the "Buffett methodology"—e.g. US multinationals get a significant percentage of profits from non-US operations—it shows a similar picture to our other metrics.

In sum, we can safely say stocks are expensive, due to the (somewhat shocking) fact that corporate profits have been roughly flat for the past five years, while stocks have risen some 70%. Anecdotally, the best value investors I know are growing increasingly frustrated at their inability to find new ideas, always a worrisome sign.

Much of the recent rally, meanwhile, has been driven by retail investors…

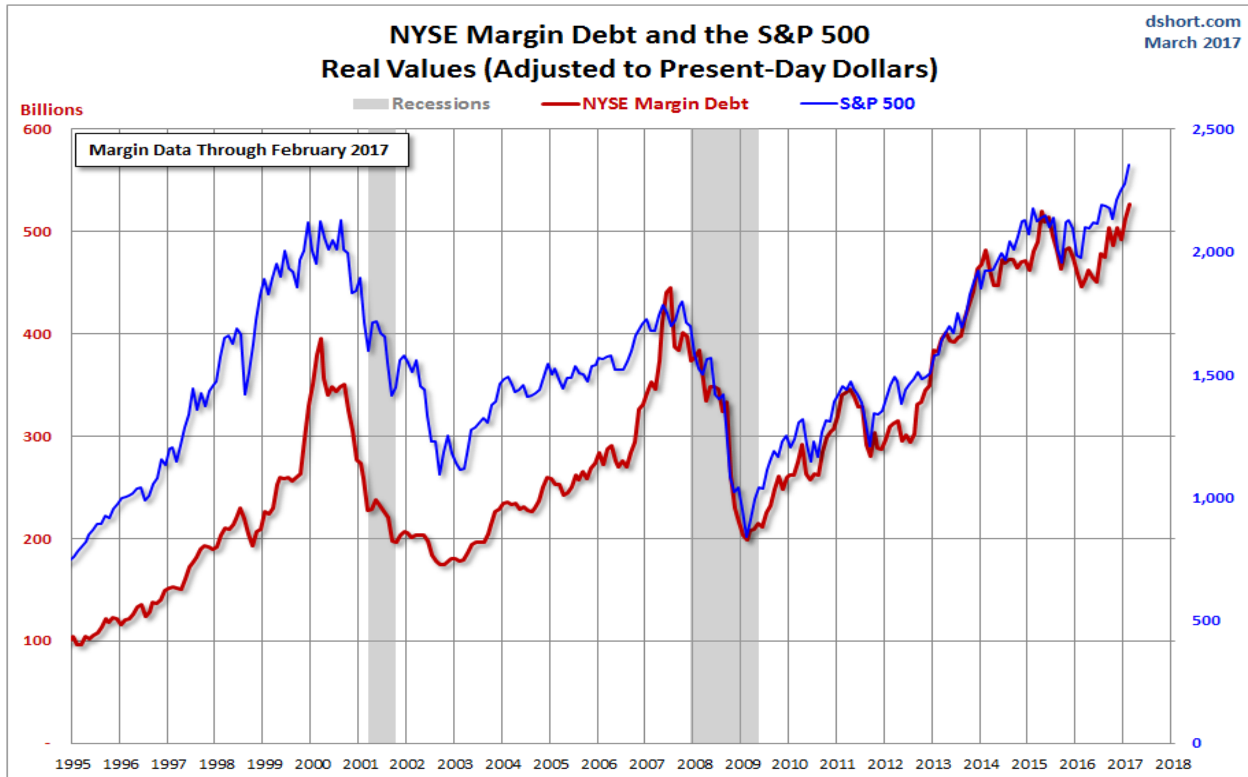



…while corporate executives are selling...




Ratio of Insiders Sales to Buys. Readings under 12:1 are Bullish. Those over 20:1 are Bearish.
The total top 20 sales and buys are 332,584,800 and 5,333,948 respectively; Source: Thomson Reuters

…and margin debt—money borrowed to buy stocks—continues to make new highs.




**A New Narrative?**

All in all, the market is expensive, perhaps historically so, the “dumb money” is buying at record rates (and borrowing to do so), and the “Trump as savior” narrative is faltering.

Doesn’t sound too appealing, does it?

The question, assuming I’m right, is what will replace the Trump narrative. As I see it there are a few alternatives, none of which are particularly attractive. Of course, I could be wrong and the Trump narrative continues; it wouldn’t be the first time he defied expectations.

But assuming the narrative does shift, the most likely candidates seem to be:

1) Partisan gridlock/incompetence. The failure of the healthcare law, along with pushed back tax reform and the “nuclear” installation of new Supreme Court Justice Neil Gorsuch—not to mention seemingly anything having to do with Steve Bannon and Jared Kushner—are creating the impression of incompetence and frustration. Add to this the ongoing investigations into Russian “meddling” and Obama administration spying, and you have an increasingly polarized country; not a particularly strong narrative for risk assets.

It’s important to note that while gridlock is often a positive for stocks—as it prevents politicians from doing more damage than usual—this is of a different magnitude where basic competence and ability to govern are being questioned; also, it would effectively represent a reversal of the Trump narrative.

2) War. Increased tensions with Syria, Russia, North Korea, and potentially China are very worrisome. While Trump *seems* inclined to shy away from conflict, there are clearly influential people in his administration who do not, and the bombing of a Syrian airfield is an inauspicious first step.

Again, while war can be positive for stocks (sad but true, thus the old adages about buying “on the sound of cannons,” or “when blood is running in the streets”), this is due partially to the fact that stocks have often been depressed when war breaks out, and also because it has tended to drive production (think WWII in the US) and be good for certain industries.

Clearly the first factor is not applicable today, and the second far less so. Further, it is difficult—although not impossible!— to imagine markets that have rallied on visions of tax cuts and the promise of having a business executive in the White House shifting to a “war is good” narrative.

3) Secular stagnation. Similar to the first, if Washington remains gridlocked we could simply see a return to the old narrative of permanently lower growth rates, but with a twist. While this was counteracted in recent years by the “Fed will save us” narrative, a return to *that* premise seems unlikely.

**What To Do**

While fundamentals have been worrisome for some time, markets have benefited from powerful *narratives* over the past several years. Assuming this is in the process of shifting to something less positive, and that there is no sudden sea change in fundamentals—this is also a possibility, of course, in which stronger economic growth drives a return to the Trump narrative *irrespective* of Washington dysfunction—it seems a less-than-ideal time to commit money to risk assets.

I have no specific recommendation to address this narrative shift other than to get (or stay) defensive; shorting equities on a tactical basis is something we don’t do at the Zen Strategist.

As hedge fund manager Harris Kupperman, one of the first to promote the Trump narrative, recently put it, “I'm now out of the bullish camp for the first time since Trump won. It's been an awesome ride.”

Don’t be a hero.

**DUST Update**

Selling DUST options, as discussed last month, is based not on my outlook for gold stocks, or the economy, or what the Fed will do, but rather on the mathematical certainty that increasing the volatility on an already highly-volatile asset will cause the price to trend down *over time*.

Thus, while it might seem like a mistake that I decided against recommending this trade last month given recent price action—DUST has fallen from $40 to less than $30, with the price of the January 2018

$90 call falling from $8 to about $3—to do so would have been a *bet* on short-term action, rather than a calculated gamble[3] based on probabilities.

In fact, I now view this trade as much more favorable. While the price of the options has come down significantly, thus limiting potential returns, the drop in risk has been even greater.

To illustrate this, let's take a look at where DUST and GDX were nine months ago—roughly the time left on the January 2018 options—and what has happened since.

On July 6, 2016, GDX closed at $30.57, and DUST at $28.40. Lest you think I am cherry-picking these dates, this was after gold stocks had rallied more than 35% in little more than a month. In other words, perhaps not a great time to bet on something that will do poorly if gold stocks fall.

And in fact…they did! The GDX plunged back to the low 20s by mid-October, below $20 in December, and even today trades at a mere $23.50. (For context, a similar decline and rebound from current levels would take GDX down to $15, then back to about $18.) Wow—talk about a poorly-timed trade…right?

As it happens, not so much. While DUST did rally, going briefly above $70 in December, it trades today at…$28.25. Said differently, over the past nine months gold stocks have fallen nearly 25%, and DUST has gone exactly nowhere.

This is why I like the trade more today than I did last month. While both were likely to play out well in the end, with a $90 strike price the risk of a short-term spike starting from $40 is far more dangerous and difficult to weather than one that begins below $30. I'm more than willing to trade the lower return for lessened risk.

**Recommendation: Sell January 2018 DUST call options with a $90 strike.**

Depending on the price of the underlying, you should be able to sell these for somewhere between $2.50 and $3, with a roughly equivalent "cost." So 10 options—each of which represents 100 shares of stock—will net you between $2500 and $3000, and will cost you, on net, about the same amount of capital. (The required capital is 20% of the underlying value, so if you sell 10 options for $3 with the stock selling at $30, your required capital will be $6000 less the $3000 in proceeds.)

**Important considerations:**

1) You need to have an options account that allows naked call selling. Check with your broker to make sure you have this ability.

2) Make sure you have additional cash/assets in the account to cover additional margin if/when the price moves against you. For example, if DUST goes back to $40 required margin will increase to $8000 ($5000 net), and if it doubles, margin will go to $12,000 ($9000 net).

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[3] Yes, a gamble is also a bet. But so is *all* investing. The difference is akin to counting cards versus spinning the roulette wheel.

3) *Do not look at this trade every day.* Or, if you can't commit to ignoring it, then don't do it. This is a trade that has a very high probability of working out…but also a high likelihood of making you very uncomfortable, and thus likely to bail out of it, over shorter timeframes.

Along similar lines, I am working on similar trades involving the area of the market I find most interesting from a math perspective these days—leveraged volatility ETFs, which, if used correctly, may represent the closest thing to money lying in the street.

**A Mea Culpa…and Lesson**

In my February issue I cited numbers from Dalbar about bad investor behavior leading to poor returns. I have since had reason to examine their work in more detail, and found it wanting.

The following is therefore an open letter to financial advisors and investors who may be unaware, as was I, of the misleading nature of Dalbar's work.

**The Myth of Bad Investor Behavior**

Individual investors are bad market timers, forever buying high and selling low. This mostly explains the large and persistent gap between market returns and those earned by mutual fund investors, who act against their own best interests by continuing with such behaviors.

Or so the story goes. I should know, having pitched this tale over the past decade and a half to large, sophisticated investors in my role as an advisor for Cambridge Associates.

One of my favorite exhibits to illustrate this supposed fact was the annual Quantitative Analysis of Investor Behavior (QAIB) published by Boston-based research firm Dalbar. According to the 2016 version (the 2017 report is slated for April release): "In 2015, the 20-year annualized S&P return was 8.19% while the 20-year annualized return for the average equity mutual fund investor was only 4.67%, a gap of 3.52%."

This is more stunning than it sounds. Due to the nature of compound returns, what Dalbar appears to be saying is that $10,000 invested in the S&P 500 over the past 20 years would have grown to nearly $50,000, while the average investor who started with $10,000 would—due mainly to poorly-timed decisions to get in and out of the market—have less than $25,000. (The 30-year figures are even more dramatic, with the S&P returning an annualized 10.35%—$10,000 growing to more than $190,000—and the average investor achieving a mere 3.66% return, for a total of less than $30,000.)

The report has charts that show this underperformance is no isolated event; in fact, according to Dalbar, "the average investor has *always* lagged the overall market" (emphasis added). The firm adds: "Investor behavior is not simply buying and selling at the wrong time, it is the psychological traps, triggers and misconceptions that cause investors to act irrationally. That irrationality leads to buying and selling at the wrong time, which leads to underperformance."

This is a reasonable story, and one which fits with anecdotal observations; investors *were* more optimistic in 1999 than in 2009, and we all have stories of friends (never you or I, of course!) who got greedy or fearful at the exact wrong time.

However, while this thesis may in fact be true, Dalbar's data do nothing to support it; they are at best highly misleading, and may represent an intentional effort to deceive investors. (I owe a huge debt to Wade Pfau of The American College in Bryn Mawr, PA, for his recent paper outlining these concerns.)

Put simply, Dalbar is comparing a market rate of return based on investing a fixed sum at inception (the S&P 500 return) with a return calculated on money invested *over time*. Or more visually, investor A inherits a lump sum of $10,000 in January 1996 and plugs it into the market, while investor B, lacking this windfall, instead invests $10,000 from his earnings *over the next 20 years*.

There is, of course, a method for calculating returns that adjusts for cash flows—internal rate of return (IRR), which is favored by private equity firms, among others, for exactly this reason—but Dalbar does not use it. In fact, in a written response to Professor Pfau's article, Dalbar CEO Robert Huebscher claimed "IRR is neither necessary or relevant."

This is absurd. You cannot castigate investor B for his poor decision-making skills when the real issue was lack of capital…and yet Dalbar does exactly this. Even worse, it is hard to believe this is accidental given that Dalbar lists "lack of cash" and "need for cash" as two of its four "Major Causes of Equity Investor Underperformance." The others are manager fees and "voluntary investor behavior underperformance"—defined as "panic selling, excessively exuberant buying and attempts at market timing"—although it is unclear how Dalbar knows what motivates investors at a given point in time.

(It is also worth noting that while Dalbar mentions these "causes," it nevertheless comes to the unsupported conclusion that "Investment results are more dependent on investor behavior than on fund performance. Mutual fund investors who hold on to their investments have been more successful than those who try to time the market." Again, while this may be true, Dalbar's data not only do not prove the thesis, but are effectively unrelated to it.)

Finally, and perhaps most revealing, Dalbar also calculates returns for a hypothetical "systematic equity investor" who invests a total of $10,000 in equal increments over the period in question. Amazingly, the average investor actually beat this return for the period ended in 2015 despite all the horribly bad timing decisions along the way. How can this be? Dalbar explains that the average investor had access to more capital earlier—according to their calculations, the average investor started with $3300 in 1996, and had invested $5689 by the end of 1999—which provided "a head start that it would not relinquish to the systematic investor over the next 16 years."

In other words, the reason the average investor "outperformed" the systematic investor is the *same reason* it lagged the S&P 500…and has nothing to do with investor behavior.

Dalbar didn't respond to my questions for this article, and perhaps they have a good explanation for how they calculate those "causes of investor underperformance" and the amounts invested by the

average investor over time. But there is no excuse for castigating investors for bad decisions when the real culprit is access to capital.

Let me put this as plainly as possible. While investors may indeed harm their returns by buying and selling at the wrong time, Dalbar's figures show zero evidence for this thesis, and investment advisors should immediately stop using them.

**Conclusion**

Markets are priced for perfection, while the "Trump as savior" narrative is foundering. Predicting a crash is always a mug's game, but the risk-reward balance looks particularly unattractive at present.

Much as Zen is about seeing the world as it is, not as we would like it to be, successful investing is about taking what the market gives you.

Be patient, practice your zazen, and I'll see you next month…

Thanks for reading, and here's to doing less!

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