Stewart Financial

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# Thoughts that count

## One inning is not a game

Standing 6'1", but weighing only 180lbs, William was not an imposing figure. This was significant because as a pitcher in the Major Leagues, intimidating batters was expected by team ownership. He had not been pitching in the Big Leagues for long and was having a poor start to the season. William possessed a decent throwing arm but felt his real opportunity was in unleashing a new pitch he had been developing. He had figured out how to throw a ball that dropped 9 inches before reaching the batter, but maintained the same velocity as a fastball. Management would not let him use this new pitching technique because it meant less balls would likely end in the strike zone. In 1938, this type of pitching was unknown.

William tried the best he could, but management's lack of confidence wore him down. He ended the season with 21 losses, the most of any pitcher in the entire Major Leagues. Shortly after season end, he was traded. He was disappointed. However, William was told he was acquired by the new team precisely because of his ability to throw a unique pitch. Management instructed him to use his unconventional pitch, and use it extensively. William did, and led his new team to consecutive Championships, and in the process surpassed all pitchers in wins, ERA (earned run average), completed games and innings pitched.

(William) Bucky Walters went on to become one of the best baseball pitchers of his era. Over his career he was named an All-Star 6 times, was a 3 time leader in wins, game starts and complete games, and threw 42 shut outs. In 1958, he was in the first group of players inducted into the Cincinnati Reds Hall of Fame.

The team who traded Bucky Walters, the Philadelphia Phillies, did not recognize the talents he possessed. In fact, after trading Walters, the Phillies finished last place in the league 7 of next 8 years (the only year they did not finish last, they finished second last). They did not evaluate his capabilities correctly and made a rash decision to trade him. Had they been more patient, perhaps Walters would be in the Philadelphia Hall of Fame and not Cincinnati's.

I am sure that 1938 was not a lot of fun for Walters. Though I am far from a professional athlete (with every passing year this gets more obvious), I can imagine the pressure he would have felt, from others and from himself. Competitive people hate losing. Of course, we do know one group of people who were not bothered by Walters poor year, and in fact saw someone's else's short term fixation as an opportunity; the Cincinnati Reds.

From Philadelphia's perspective, they had a pitcher who had a poor current season record and felt they needed to replace him right away (in fact, the actual trade agreement stipulated that if the player traded for Walters did not perform up to expectations, the Phillies received yet another player until they were satisfied). How were the Reds able to succeed with Walters talents where the Phillies were not? The short answer is that the Reds were able to be patient; they knew pitchers needed time to develop and careers were not made in one season, good or bad.

Patience is difficult. Patience is something the world is of short supply. Having the ability to order a coffee, a date or a car ride through a handheld device, on command, makes it difficult to wait for all the things which can't or shouldn't be hurried. Of course knowing this fact does not necessarily help any of our actual behaviours. Most people are consciously aware that patience is needed when investing for the future. Unfortunately, human emotions challenge this knowledge at the exact time it is most required; when we experience unintended or unanticipated results. Volatility is something we all know exists, but most investors seem surprised when it occurs, especially because it can occur without prior warning.

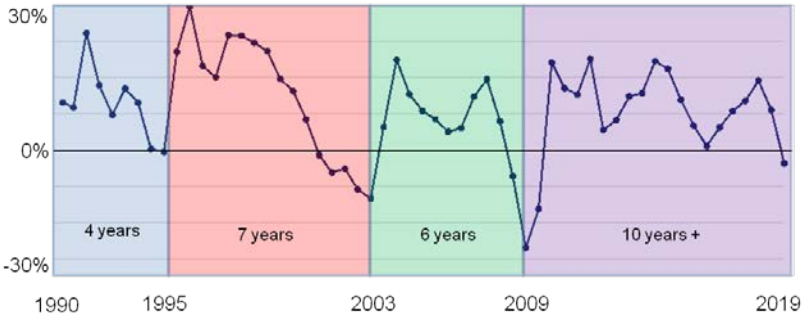
In 2018, market volatility returned. There have only been four times in the last 100 years when growth assets and fixed income assets (aka stocks and bonds) both lost money in the same calendar year (1931, 1941, 1969, and now 2018). In other words, traditional diversification did not work in 2018. The primary reason for diversification is to protect investments against moving in the same direction at the same time. Stocks and bonds should generally move in opposite directions. This is true in just about every type of investing environment. In 2018, interest rates moved significantly enough to violate this standard relationship. In fact, even more advanced diversification didn't help over the last 12 months as gold, real estate and commodities all lost ground. Basically, 2018 was a year where no asset class performed well, there was nowhere to hide. When these kinds of years occur, how should investors react? Investors have two choices; they can respond like the Phillies or the Reds.

The Phillies response is to make dramatic changes. This might be the correct action to take, but is a severe behaviour and proper timing is critical. Hasty decision making is a high risk proposition, whether in baseball or investing. Determining a player's value after only 1 season seems awfully impulsive given the average career length of a major league pitcher is 11 years. It is human nature to feel that doing 'something' is better than doing 'nothing'. Not making changes in the face of undesired results can feel like surrender. However, decisions made under duress are more likely to compound issues, rather than be a solution.

The Reds response would be to take advantage of others impatience. In a baseball context, this means understanding that over a career, which on average lasts 11 years, even the best pitchers will experience highs and lows. For the Reds, this meant a willingness to add a player with recent weak performance because there was a high probability of significant future potential. The added benefit of having this perspective is that because the unhappy team was making a hurried decision, the price demanded was minimal; Walters had a low perceived asset value and the team just wanted to be rid of him. In fact, both players exchanged for Walters were traded away by the Phillies within a year.

If a baseball pitchers career spans on average 11 seasons, what is the equivalent length of an investment market cycle? Looking over the past three decades, an investment cycle has lasted on average 7 years. Just like the career of a baseball player, an investment cycle has a beginning (growth stage), middle (plateau) and an end (decline). The graphic below, on the left, illustrates the four market cycles since 1990, based on twelve month rolling returns of a 'balanced' portfolio (60% stocks and 40% bonds). The first data point is the twelve month return January 1990 to January 1991; 10%, the second data point is February 1990 to February 1991; 9%, and so on through to the end of 2018. There are 336 twelve month periods since 1990. The graphic on the right shows the cumulative growth of the same 'balanced' portfolio over the same 28 year period; 883%.

**Market Cycles: 12 month rolling returns**




**Cumulative Growth**


If you choose to be diversified, the only relevant timeframe for evaluation is over an entire business cycle. A shorter period (such as 1 year) is very sensitive to misinterpretation. The length of a cycle varies because of specific economic circumstances, but all of them are multi-year. Over this 28 year time series, the average return has been 8.5% per year, and 83% of the time the twelve month rate of return was positive. 2018 happens to fall into the 17% of time a calendar year return has been negative. It is only over a full cycle that investors are rewarded for their patience.

Given the sharp increase in volatility in the fourth quarter of 2018, the market finds itself at a much lower valuation to begin 2019. The market is again prepared to trade Bucky Walters for a much lower price than just a few months ago. This sets up the year for a reasonable chance at a significant rebound. We are approaching the end of the current market cycle, so conservatism is the correct positioning, but there are plenty of teams looking to unload their unwanted players, simply because they erroneously believe one year makes a career.

Your *going outside to throw some snowballs and pretend I am Bucky Walters* investment advisor,

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