



Investors Should Loiter Around the Lifeboats

Imagine it's 1912 and you find yourself on the Titanic's maiden voyage. You know that the ship is going to sink but you're sketchy on when it's going to happen. What should you do? This scenario is similar to the current predicament for investors where almost all asset classes are expensive when using standard valuation techniques. The answer for both situations is the same; you should spend your time loitering around the lifeboats.

The Current Environment

In recent months many have called out the predicament faced by investors. Global price/earnings ratios for stocks are high and the [quality of earnings](#) used in those ratios is questionable. Credit spreads are low for both investment grade and high yield debt in pretty much every jurisdiction. Commodities have performed well this year, in large part due to the credit inflated economic growth of China. Emerging markets can look cheap, but their continued growth could be threatened by a weaker China, a stronger US dollar or domestic instabilities. Returns on cash and short term debt instruments are profoundly negative after tax and inflation in Europe, Japan and the US. Investors seem trapped everywhere they turn.

The Temptation to Just Keep Dancing

The former CEO of Citigroup's infamous comment that "as long as the music is playing you've got to get up and dance" highlights a major behavioural impediment to solid long term returns. The temptation is to ignore the risk right in front of you and buy investments that hold out the prospect of a quick win. Institutional fund managers are measured quarterly or monthly and can feel pressure to constantly outperform, especially if they charge substantial fees. Individual investors can lose focus when their friends and neighbours brag about how much they have made on the latest fad investment. We all struggle to keep the discipline and focus needed in these exuberant times.

Don't Play Pick the Trigger

Many investors spend their time speculating what will be the trigger that starts the next downturn. The theory is that if you pick the trigger you can sell out prior to others, capturing all of the upside and none of the downside. In practice, the trigger for market peaks is rarely knowable in advance, most times the trigger event is a narrative created after the event to fit the facts. Rather than focussing on potential triggers, investors should focus on the risk/return characteristics of what's in their portfolios. Stock prices and credit securities follow earnings and cashflows over the medium term. Time spent on detailed earnings and cashflow analysis (which increasingly few do) will be far more fruitful than time spent analysing the widely known economic, political and geopolitical risks.

The Lifeboats in Credit

In my home ground of credit, loitering around the lifeboats means staying short in credit duration and staying senior in the capital structure. Fortunately, making these shifts is often easy to execute when markets are exuberant as the increase in yield for taking extra risk is minimal. For instance, the gap between spreads on BB rated and B rated credits is currently low as is the gap between senior secured leveraged loans and subordinated high yield bonds. Going against the trend will cost a little in the yield achieved now, but that gap can be made up ten times over when the next downturn occurs. If correctly implemented, in the next downturn an investor will have cash from maturing assets to redeploy into bargain credits rather than a portfolio of distressed debt with substantial mark to market losses.

The Lifeboats in Equities

Equities is a tougher sector to implement a loitering around the lifeboats strategy as there is more potential upside to be missed by keeping a conservatively positioned portfolio. Stocks that are based on hope and hype rather than



fundamentals, like Netflix and Tesla, have the potential to push much higher before correcting. Greater discipline is required to persist with a value orientated approach when growth stocks are shooting the lights out.

In this regard I look to the equities managers I respect most, who all have a track record of long term outperformance of benchmarks. Whilst they each have slightly different approaches, there are consistent themes in their recent commentaries. First, they are all holding higher than usual cash levels. Second, there's a willingness to push beyond the large capitalisation benchmarks in order to find cheap stocks. Third, there's a strong focus on finding companies that are savvy in their deployment of capital, shown by consistently high returns on equity. Fourth, their preferred stocks have a low market capitalisation relative to their future earnings. This might be a low P/E for a mature company or an average P/E for one with above average growth prospects. Lastly there's minimal exposure to cyclical stocks.

Conclusion

The innate human desire to want to keep up with the Joneses is an investor's worst enemy in bullish markets. Ultra-low cash rates and quantitative easing have helped markets to continue to post gains beyond what company earnings and GDP growth support. [Investors are increasingly all-in](#), having become numb to risk in a time of record low volatility.

By implementing a loitering around the lifeboats strategy, investors will likely miss out on some late stage gains. However, the potential pay-off is far larger than the missed gains if the overdue correction occurs. The more investors believe that markets are unsinkable, like the Titanic, the more likely it is that an iceberg is dead ahead.

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