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Have Your Cake and Eat It Too Investing

Knowing When to Panic

By Jeff Woods

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Sam Rogers: *"You are panicking."*
John Tuld: *"If you're the first out the door, that's not called panicking."*

'Margin Call'(1) (movie about an investment firm at the start of the U.S. banking crisis)

This is one of my favorite quotes from the movie. Although it was a difficult movie to follow (unless you are a finance geek) due to the industry lingo, I thoroughly enjoyed the movie for its candid portrayal of how management dealt with a potentially disastrous situation. In the quote mentioned above, Sam Rogers (played by Kevin Spacey) is the head trader in the firm being asked to dump all the mortgage-backed securities at the initial stages of the credit crisis. John Tuld is the CEO (played by Jeremy Irons), trying to convince Sam to get his traders to sell all the company's inventory before the crisis, still mostly unnoticed by the other Wall Street firms, becomes visible. Sam is reluctant, because he knows that if the crisis picks up steam and unfolds as John Tuld expects, then his team of traders is going to be selling mostly worthless bonds to their unsuspecting colleagues and forever destroying those relationships (and possibly their careers).

Sam Rogers (talking to his traders): *"Thank you all for coming in this morning. I know yesterday was pretty bad and I wish I could say that today is gonna be less so, but that isn't gonna be the case. I've been here all night… meeting with the Executive Committee. And the decision has been made to unwind a considerable position of the firm's holdings in several key asset classes. The crux of it is… the party's over as of this morning. There's going to be considerable turmoil in the markets for the foreseeable future. And *they* believe it is better that this turmoil begin with us. As a result, the firm has decided to liquidate its majority position of fixed income Mortgage-Backed-Securities… today."*

I bring all this up because investors got a full dose of market turmoil this summer, culminating with the big swoon on August 24th of about -770 points at the open (on Toronto). At the time, fear was rampant. When the sky *is* actually falling, it always begs the question "How much worse is this going to get?" Like Sam Rogers mentions above, if the party's over and market turmoil is about to get worse, the sooner you take action the better off you will be (before the panic spreads and the buyers disappear).

Every time a market correction occurs, Dave and I get inundated with well-intentioned and thoughtfully written “reassurance” articles from a wide variety of financial companies detailing the reasons why we shouldn’t panic. Sometimes, the advice is sound. However, advice that consistently advocates the same stance, i.e. ‘Focus on the long term; be patient; markets always go up eventually…’ is more of a reiteration of a specific philosophy (buy-and-hold), rather than an objective assessment of the current market conditions.

We would agree that *as long as the trend is up*, every dip, no matter how severe, sudden, or scary it feels should either be ignored or bought into. But what to do when the trend is no longer your friend? And, just as importantly, how do you know? Buying the dip, or ‘focusing on the long term’ during the 2000-2002 dot.com bust, or the Great Panic of 2007-2009, turned out to be a soul-crushing, insomnia-inducing, financially-destructive experience. I still meet people that have not fully recovered from the last market crash, despite the fabulous market recovery over the last 7 years.

The key is having an objective tool to tell the difference between a correction (about -5% to -20%) and a Bear market (as bad as -25% to -85%). In a correction its business as usual. In Bear markets we want to reduce equity exposure as quickly as possible.

John Tuld: *“So, what you’re telling me, is that the music is about to stop, and we’re going to be left holding the biggest bag of odorous excrement ever assembled in the history of capitalism.”*
Peter Sullivan: *“Sir, I’m not sure I would put it that way, but let me clarify using your analogy. What this model shows is the music, so to speak, just slowing. If the music were to stop, as you put it, then this model wouldn’t even be close to that scenario. It would be considerably worse.”*
John Tuld: *“Let me tell you something, Mr. Sullivan. Do you care to know why I’m in this chair with you all? I mean, why I earn the big bucks.”*
Peter Sullivan: *“Yes.”*

John Tuld: *"I'm here for one reason and one reason alone. I'm here to guess what the music might do a week, a month, a year from now. That's it. Nothing more. And standing here tonight, I'm afraid that I don't hear – a – thing. Just … silence."*

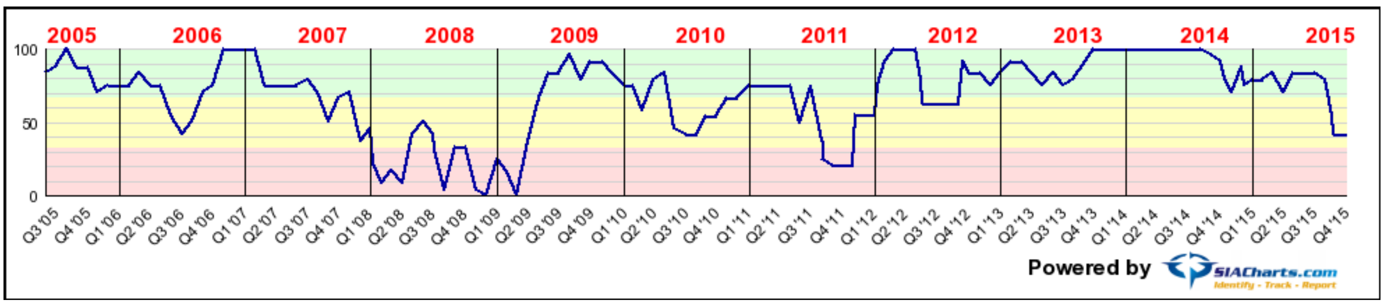
Sadly, we do not have the acute market sense of John Tuld, who earns the big bucks because he can intuitively tell when the stuff is going to hit the fan. So, how do we know when the odds have changed? Great question!

In addition to our own analysis we work with two research firms specializing in the development and use of objective indicators that analyze and measure the health of the broad markets (US, Canada and International). Working together we increase our odds of differentiating between temporary market corrections and a long term negative trend change. If the odds have changed then so must we. The biggest value we can add to our investors is to 'be the first out the door' (if not the first, at least we can be the next). As we have said many times before, our first priority in managing client money is to avoid large losses. We have seen the damage inflicted (both financially and always emotionally) by the last two bear markets.

So you ask, "How do we know when to panic"?

Let's have a look at the market drop in August through the lens of our market measurement tools:

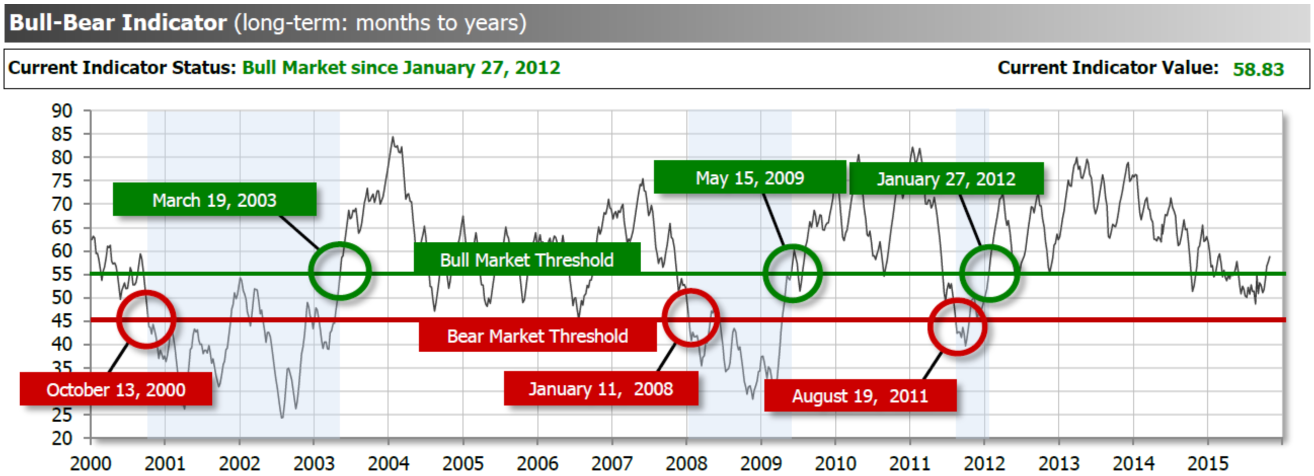
Has the music stopped? - Tool #1: SIA Equity Action Call:



The SIA Equity Action Call takes a variety of objective market inputs and outputs a simple qualifier - green is good, yellow is neutral, red is bad. A move from green to red suggests a start of a new Bear market, like at the end of 2007. A move from red to green suggests the start of a new Bull market (see Q2 of 2009). A move from green to yellow or red to yellow is not a reliable enough signal to warrant taking action. Notice in 2011 as the world was coming apart with the European sovereign debt default crisis, the indicator went red for a few months. By early 2012 it had recovered to green again and enabled us to fully participate in the robust market rally of the last three years.

You can clearly see that the market plunge this summer was enough to push our indicator lower in the yellow/neutral zone, but did not warrant reducing our equity positions by entering the red/sell zone.

“Has the music stopped?” Tool #2: Sherman Bull/Bear Indicator:



Bill Sherman’s Bull/Bear indicator uses different inputs than SIA in their measurement calculation, but interestingly gives similar readings. With this indicator, a move from above the ‘Bull Market Threshold’ (at 55) to below the ‘Bear Market Threshold’ (at 45) suggests odds are high equities have entered a cyclical bear market decline (average loss -40%, average duration 3.75 years)[2]. The reverse also holds true – a move from below the Bear Market Threshold to above the Bull Market Threshold indicates odds are good that equities have entered a cyclical bull market rally (average gain +178%, average duration 5.5 years)[2].

Sherman’s Bull/Bear indicator declined from a high of near 80 in early 2014 to as low as 48 in August. Like the SIA Equity Action Call above, it signaled caution, but did not cross the bear threshold at 45. As we are rule-driven we have stayed fully invested in our equity models all year.

It’s worth mentioning that using this tool would have quite successfully allowed an investor to avoid nearly all of the 2000-03 bear market, and nearly all of the 2008-09 market collapse. “Nearly all” is what we are looking for. We strive to capture nearly all the gains and avoid nearly all the losses.

To be able to truly manage the risk of large losses in an equity portfolio you have to know when the right time to panic is (if you don’t like the term ‘panic’, then rephrase it as ‘a strong, clear warning to act quickly to reduce market risk as much as possible’). It’s not about always staying invested, or trying to guess what the future may hold, if in the present the facts suggest you should be running for the exits.

The above two indicators serve as vital tools in our process and we continue to strive to make every year count for you. It pays to know when it’s smart to panic.

Would you like to know when the music has stopped?

Call or email us to become a subscriber to our newsletter. We promise to update readers when the time comes to play it safe.

If this strategy of managing the risk of large losses appeals to you, give us a call for more information about our strategy and how it would apply to your own personal situation.

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[1] Margin Call (2011, Lionsgate, http://margincallmovie.com/)
[2] Bull and Bear market duration and returns taken from the research article "What the Bull Giveth, the Bear Taketh Away" referenced here (http://gestaltu.blogspot.ca/2013/04/what-bull-giveth-bear-taketh-away.html), and based on the S&P 500 from 1871 to April 2013.

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