HALF & HALF: WHY ROWING WORKS

By Ed Easterling
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So you're in line at Starbucks. The guy in front of you orders a drink that takes longer to explain than it does to consume. You want a drip…with room in the cup for milk. Then YOU take longer to decide whether it'll be cream, half and half, or some watered-down version of the natural product from cows. Decisions, decisions…

This article addresses two key questions for investors today: why do secular stock market cycles matter, and how can you adjust your investment approach to enhance returns? The primary answer to the first question is that expected returns and the market environment should drive your investment approach. The investment approach that was most successful in the 1980s and 1990s was not successful in the 1970s nor over much of the past few decades.

Therefore, an insightful perspective about market conditions will determine whether you have the right portfolio for investment success over the next decade and longer. In today's relatively highly valued market, returns over the next five to ten years are likely to be below average.

Now, assume for a moment that you must pick one of two investment portfolios. The first one is designed to return all the upside—and all the downside—of the stock market. The second portfolio is built such that it often gets one-half of the upside and one-half of the downside. Which would you pick?

In a generally rising market, the first portfolio—even with the market's ups and downs—will be most successful. In a sideways, declining, or high-valuation market, however, the second portfolio of half and half can enhance cumulative returns and reduce portfolio volatility. More about this shortly—and the insights may surprise you!

SECULAR STOCK MARKET CYCLES

Why should anyone take the time to assess the secular environment when investors are so focused on the next quarter's (or month's!) account statement?

Steven Covey writes in *Seven Habits of Highly Successful People*:

> *Once, a woodcutter strained to saw down a tree. A young man who was watching asked: "What are you doing?"*
>
> *"Are you blind?" the woodcutter replied. "I'm cutting down this tree."*

The young man was unabashed. "You look exhausted! Take a break. Sharpen your saw."

The woodcutter explained to the young man that he had been sawing for hours and did not have time to take a break.

The young man pushed back… "If you sharpen the saw, you would cut down the tree much faster."

The woodcutter said, "I don't have time to sharpen the saw. Don't you see I'm too busy?"

Too often, we are so focused on the task at hand that we lose sight of taking the necessary actions to best achieve our goal. With investments, the goal is to achieve successful returns over time. We should not be distracted by a focus on this week or month; we need successful returns over *our* investment horizons—which often extend for a decade or two…or more.

And this is where Starbucks, Covey, and secular cycle strategies converge. Investors are too often tempted to focus on immediate returns. In periods of above-average returns from the stock market, that's fine. But today, in a high-valuation market, reach for the half and half. Take the time to assess the goal, as Covey emphasizes, and sharpen your investment strategy.

DON'T ACCEPT BREAKEVEN

Over the past few decades, investors have experienced several full cycles with some hopeful surges upward. While there's no better feeling than coming from behind to break even, watching a gain wither to a loss is a terrible feeling. However, investors did not need to experience the same rollercoaster performance in their investment portfolios that the overall market traversed.

Some portfolios—generally the ones that are indexed to the market using exchange-traded funds (ETFs) or mutual funds—"participate" in the market's ups and downs. That's fine; market participation is what those funds are designed for. That works well in extended periods of above-average returns like the 1980s and 1990s. But it does not always work well in all market conditions.

To illustrate, assume that the market drops by 40% and then recovers by surging 67%. An investor with $1,000 will decline to $600 and then recover to $1,000. So if you take the full cream option—all the market gives—the illustrated cycle provides a breakeven outcome.

> *"The effect on the portfolio is cumulative gains while the result for the market is recurring breakeven."*

Chapter 10 of *Unexpected Returns: Understanding Secular Stock Market Cycles* contrasts the concept of a more actively managed and diversified approach to the more passive, buy-and-hold approach to investing. The chapter explores the concepts with the boatman's analogy of "rowing" versus "sailing."

Sailing is analogous to the passive investment approach of buy-and-hold—using ETFs and certain mutual funds to get what the market provides. Rowing, on the other hand, seeks to capitalize on skill and active management. Rowing uses diversification, investment selection, and investment skills to limit the downside while accepting limits on the upside. When the stock market plunges, portfolios built by rowing generally experience only a fraction of the losses suffered by those dependent on sailing. The expectation, however, should be that the "rowing" portfolios will also experience (only) a fraction of the gains.

The investment industry analyzes such fractional performance by assessing the so-called down-capture and up-capture of securities or portfolios. In other words, when the stock market declines, down-capture is the percentage of the decline reflected in your portfolio. If your portfolio declines ten percent when the market drops twenty percent, then your portfolio has a down-capture of fifty percent. Likewise, for market gains, up-capture is the relative percentage of your gains to the market's gains.

During choppy, volatile markets, most investors want little or none of the declines, but they want much or all of the gains. *Beat the market!* Other than for the luckiest market timers (who usually enjoy such success for relatively short periods), such a strategy is unrealistic over most investment horizons. There is a more realistic expectation; however, that does fit with many risk-managed and actively managed portfolios.

USE THE HALF & HALF

Returning to the previous illustration, a portfolio structured to limit downside risk while participating in the upside would have fared better than breakeven. Although most investors seek somewhat less than half of the downside while achieving somewhat more than half of the upside, let's assume that you have a half-and-half portfolio—50% down-capture and 50% up-capture. From the previous illustration, as the market fell 40%, your half-and-half portfolio would have declined 20%—from $100 to $80. Then as the market recovered 67%, your portfolio rose by just over 33%. Your $80 increased to almost $107. So, while the market portfolio gyrated from $100 to $60 and back to $100, your portfolio progression was $100, $80, and then $107.

> *"Yet the disproportionate impact of losses over gains is a formidable power."*

Even better, consider the impact across multiple short-term cycles. The effect of multiple cycles on the "rowing" portfolio is cumulatively compounding gains, while the result for the "sailing" portfolio is recurring breakeven. The second cycle (using the same assumptions) drives the "rowing" portfolio from $107 to $85 and then to $114. The score after the third cycle: Mr. Market = $100 and your portfolio = $121. Three cycles of breakeven for the market still result in breakeven—you can't make up for it with volume.

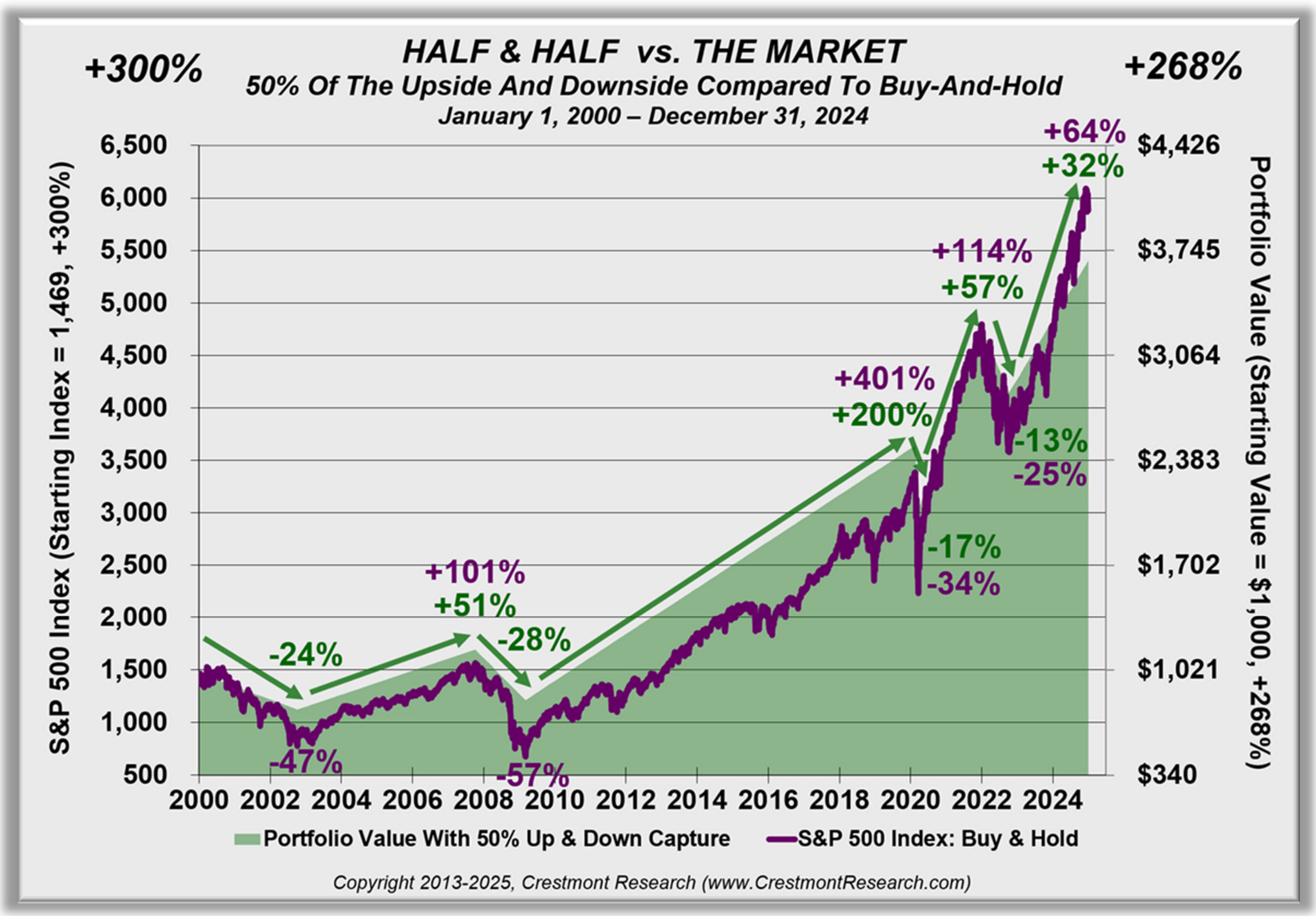
Of course, skeptics will respond that there's often a difference between theoretical illustrations and empirical experience. Further, the S&P 500 Index has, at least at this point, increased 225% since 2000. Nonetheless, the disproportionate impact of losses over gains is a formidable power.

As reflected in Figure 1, the S&P 500 Index started at 1469 and then took an early dive, ending 47% lower at 777 in October 2002. Five years later, the S&P 500 Index peaked at 1,565—up 101% from its low. By March 2009, the S&P 500 plunged 57% to 667.

Then came 2020. The year started with a surge to new highs. By mid-February, the S&P 500 Index peaked at 3386, a gain of 401% for the market. Twenty-three days later, after a plunge of 34%, the market bottomed at 2237, down 34%. Well into correction territory, the short and brutal swing creates another cycle in the series. Less than three years later, on the first trading day of 2022, the market reached new highs at 4,797, up 114.4% from the prior trough.

The next 195 trading days of 2022 clipped the trend and trimmed 25.4% off the first day's peak. The effect on cumulative returns reduced the cumulative gain to 143% over the 23-year investment period. Then, since October 2022, the market recovered all of the previous decline and more with 64% surge. Cumulatively, the buy-and-hold portfolio (excluding dividends, transaction costs, and taxes) is up 300% since the start of 2000.

Figure 1. Half & Half vs. The Market



For the alternative approach, let's divide the percentage moves in half and apply them to your portfolio: -23.6%, +50.7%, -28.4%, +200.3%, -17.0%, +57.2%, -12.7%, and +16.7%. Your initial investment of $1,000 declined to $764 in less than two years. With half of the market's gains, your portfolio climbed to $1,152 five years later. Then, applying just half of the subsequent market decline, your gain sank to a loss of $825. Ouch!... a gain yields to a loss. Note, however, that while the market found its bottom below its 2002 trough, your portfolio avoided breaching the previous dip.

Then, with just half of the market's gains over the 11-year surge, your portfolio again advanced to new highs. The head-spinning air pocket in February and March of 2020 taketh away, but quickly restored new highs. As 2022 started, half of the first-day gain from the market's new high further added to your portfolio. But despite the hopeful optimism that opened 2022, half of the loss by mid-October of the year dented the portfolio. From there, it has mostly been up, up, and away!

Whereas the market is up 300% since 2000, compounding at 5.7% annually, your portfolio is up 268%, providing similar returns at 5.3% annualized, yet with less anxiety and a smoother ride. With other income from your "rowing" portfolio, you likely have solid real (inflation-adjusted) returns with much less volatility than the overall market over the multi-decade investment period.

The hedged "rowing" portfolio not only worked over the past few decades, but it was also successful for the secular bear market from 1966 to 1981. After that sixteen years, the S&P 500 Index portfolio showed gains of 33%, while the "rowing" portfolio delivered 44%.

Keep in mind that there are many ways to build a "rowing" portfolio. Most of all, rowing does not require market timing; rowing involves the diligent selection of a combination of skill-driven investments to achieve a lower risk profile and better returns over time. It changes the driver of returns in a portfolio from risk-based (i.e., diversification that delivers market risk and return) to skill-based (i.e., diversification that mitigates market risk and drives returns from investment selection). It is beyond the scope of *Unexpected Returns* and Crestmont Research to develop or present specific alternatives. Nonetheless, rowing-based portfolios often consider—and include when attractively valued—a variety of components, including but not limited to: specialized stock market investments (e.g., actively-managed, high-dividend, covered calls, long/short equity, actively-rebalanced, preferred stocks, etc.), specialized bond investments (e.g., actively-managed, convertible bonds, inflation-protected securities, principal-protected notes, etc.), alternative investments (e.g., master limited partnerships, royalty trusts, REITS, commodity funds/advisors, private equity, hedge funds, timber, etc.), annuities, variable life, and others.

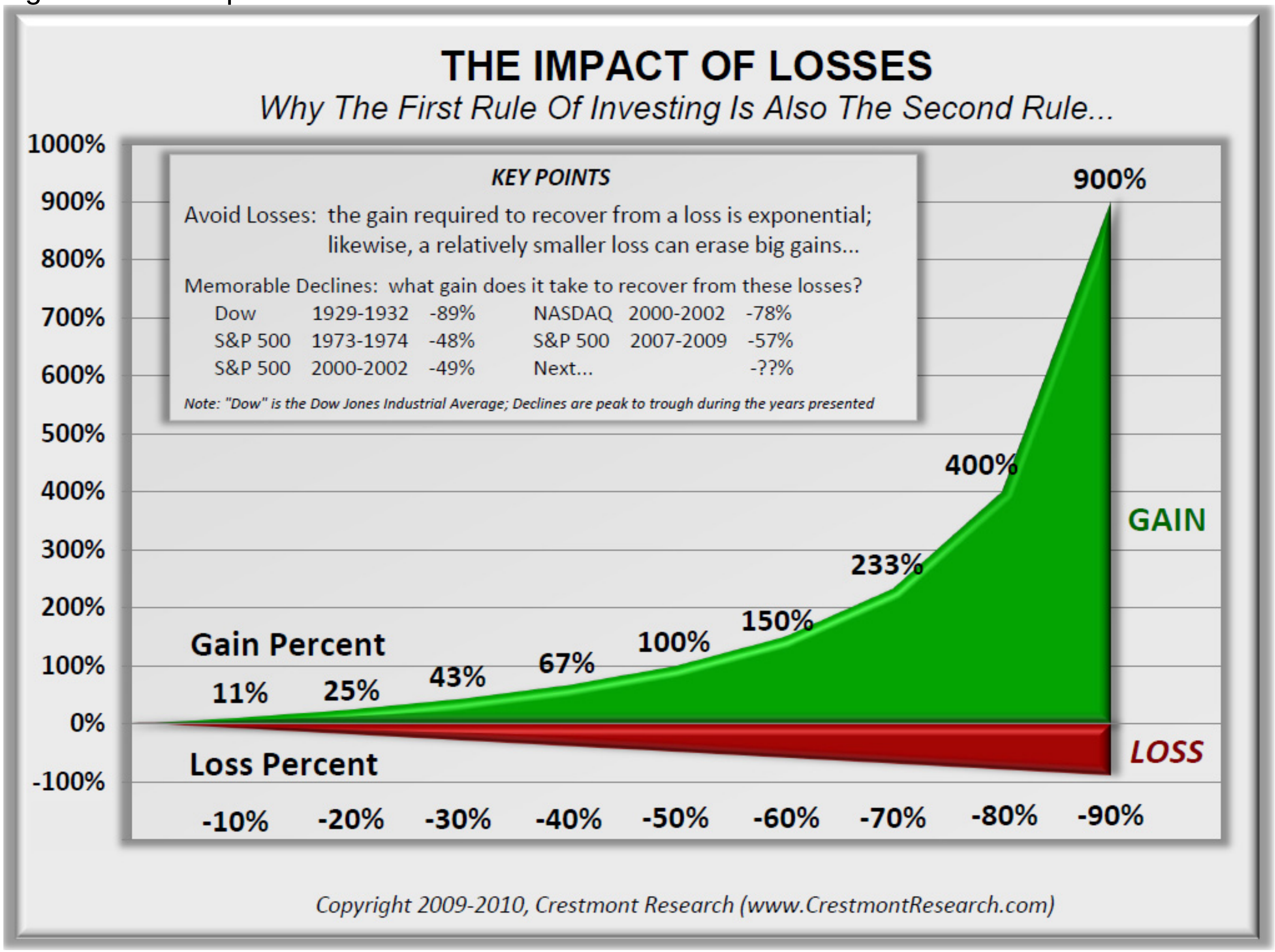
"Keep in mind that there are many ways to build a "rowing" portfolio."

Clearly, some people will be skeptical about structuring portfolios to achieve (or improve upon) fifty percent up and down capture. Others will be looking for this article to present proof of a system that will lock in those results; it does not. But many others will relate today's discussion to their own or their advisor's experience. For the last group, this discussion intends to reinforce that good performance is not a coincidence; rather, it is the product of applying skill to portfolios that historically relied solely upon risk for return.

HOW IT WORKS

Hedged portfolios outperform traditional portfolios in highly valued markets and below-average return markets because of the disproportionate impact of losses relative to the gains required to recover losses. Most significantly, as the magnitude of the loss increases, the required recovery gain exponentially increases.

Figure 2. The Impact of Losses



In above-average return markets, on the other hand, gains significantly overpower losses. So although cyclical swings deliver the occasional "correction," the recoveries far exceed the losses. The result is that above-average returns from sailing cumulatively exceed those from hedged rowing. In highly valued markets and below-average return markets, however, gains across the period are cumulatively below average. The result is that losses overpower the gains. Hedge portfolios mitigate some of the negative effects and enable investors to succeed cumulatively.

Figure 2 presents the dynamic of offsetting gains and losses. As the losses increase, the required gain to reach breakeven exponentially increases. To illustrate the half-and-half effect within hedged portfolios, note that the required gain for a 20% loss is 25% and the required gain for a 40% loss is 67%. Those two points are chosen because 20% is half of 40%, consistent with the earlier "half-and-half" illustrations.

While the market investor needs 67% to recover from a 40% loss, the hedged investor only needs 25% to recover from one-half of the 40% loss (i.e., 20%). When the hedged investor receives half of the market's 67% surge to fully recover to breakeven (i.e., 33%), the hedged investor has exceeded the required 25% recovery return. As a result, the hedged investor achieves a net gain across the cycle.

"…a market that has run up substantially is more susceptible to correction or decline than it was before its surge."

So, the gains from a hedged portfolio are not coincidental to the few decades or the secular bear market of the 1960s and '70s. The gains occur whenever overall market gains are muted, including highly valued markets and below-average return markets.

The current relatively highly valued market environment is not positioned for a long-term above-average return market. The normalized price/earnings ratio (P/E) for the overall market is relatively high. The period since 2000 worked off the bubble levels from the late 1990s, but P/E has not declined to levels required to drive long-term above-average returns.

YIELDING TO TEMPTATION

After the past few years, hopeful investors are susceptible to Siren's call to overweight equities today. Too often, investors desire a return to the bull market of the 1980s and '90s. Yet highly valued markets are more vulnerable to correction or decline than they are to experience a decade or longer of surge. One of the documented weaknesses of human nature in investors is the tendency to ride winners despite their waning fundamentals (and sell some losers despite their newly attractive fundamentals).

Isn't it ironic—in a Gary Larson *Far Side* kind of way—that the investor sticking his neck out may not be the tortoise-like rowing investor after all?!

Although the temptation to follow the momentum of recent years might drive an overweighting of equities, this may be just the time to consider leaning away from passive buy-and-hold strategies and investments. We may soon be approaching the start of the next cycle—from the top.

Ed Easterling is the founder and president of Crestmont Research. He is the author of award-winning Unexpected Returns: Understanding Secular Stock Market Cycles and Probable Outcomes: Secular Stock Market Insights*. In addition, he previously served as an adjunct professor and taught a course on alternative investments and financial markets for MBA students at SMU in Dallas, Texas. Mr. Easterling publishes provocative research and graphical analyses on the financial markets at www.CrestmontResearch.com.*