Gaia Capital Management Inc.

Safety Check: Mixing Risk and Return in the Right Proportions?

Saturday's With Jim

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Dear Friends,

To borrow a well-worn idea, safety is in the mind of the beholder. This said, we can discuss how we are placing your portfolios (accounts) in service for what could be the last leg of this eight year rising market. Following is a series of recent statements and actions by investors and pundits accompanied by our thoughts and actions. Please keep in mind that we need to speak in general terms as your accounts have risk and return profiles across a wide spectrum.

The Sovereign Fund of Norway recently increased its stock weighting to 70%, 10% above what some would consider the "normal" allocation.

Gaia thoughts: Norway's stock portfolio is much like ours, full of quality income producers that hold up very well in mild downturns and crater less in severe, longer lasting downturns. Norway's Sovereign Fund is probably concerned with maintaining a rising income stream in all economic conditions. Given low bond yields, Norway's action is both a statement of need and a guess that the long rising market cycle we are enjoying will last longer.

Gaia's positioning: We have actually reduced stock weighting a bit from about 80% in moderate accounts to 70% while keeping lower risk/return accounts at their 50% stock weightings. We will be reducing the stock weighting in the high return accounts from 90% to 85%.

David Rosenberg, well-known former Merrill Lynch economist and now a Canadian strategist and newsletter writer, believes that we are in the last stage of the market cycle (close to the 9th inning in baseball terms), citing high U.S. stock and bond valuations and that recent economic activity is not at all supportive of these current valuations. He finds emerging markets, Europe and Japan far more attractive now and over the next few years.

Gaia thoughts: It is common for professional investors to look for value. Rosenberg also points to the U.S. economic and market outperformance over Japan, Europe and Emerging Markets for six to eight years, noting that economic growth outside of the U.S. is picking up.

Gaia positioning: We are on board with Rosenberg, while still having 50%-60% of our stock allocation in the U.S.

Since this long rising market cycle began on March 9, 2009, a litany of voices have called for an impending slowdown either due to overvaluation, inflation, policy errors or some other thing. Yet the U.S. bond and stock markets kept grinding, if not racing, forward with few breaks. When will the pundits be right?

Gaia thoughts: Eventually the market naysayers will have their day, but probably not until a lot of people are giddy and are discussing stocks in every venue they can. Markets don't crash for months or years on end without a shock administered by rising interest rates, war, adverse economic events or some systemic failure of huge proportions, usually brought about by out of control speculative impulses that spread through the population. They don't die of old age.

Gaia positioning: As noted earlier, we have raised bond levels a bit for moderate accounts, staying with quality.

Rob Arnott, often called the father of a passive active management strategy referred to as fundamental investing or "smart beta," and Jeremy Grantham of GMO capital, among others, project that U.S. stock returns after inflation will be flat to slightly up over the next seven to ten years, citing that future gains are already baked in market calculations. Emerging market stocks should gain about 6.5% annually after inflation. Why? They cite valuations, demographics and improving governance.

Gaia thoughts: As a wise person once told me when disagreeing with my wife, "She might be right." But do we have the wisdom and the courage to act contrary to the way most people are positioned – heavy on the U.S.?

Gaia positioning: We are wary of basing today's allocations on a very long-term forecast. For example, average rainfall could be 35 inches a year, but it could all fall in a short time, making most of it unusable due to runoff. We agree with the view that the great run in the U.S. is likely to taper or go in reverse over the next seven to ten years. But we will move slowly to capture the expected gains, verifying as we go.

So what?

While we can't predict the future, we can use history and our experience to understand that the current buoyant market won't last forever. But we won't act in haste, preferring instead to undertake slow and calculated defensive moves to reduce volatility exposure, just as we increased volatility exposure in 2009. Adding exposure to other geographies where the business cycle is younger than that of the U.S. should extend account gains beyond what we could get domestically.

We are grateful that you chose us to facilitate your financial journey. Thank you for investing with us.