Gaia Investment Process I: What Is "The Market" and Why Should We Know?

Saturdays With Jim

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Dear Friends,

"The Market" is common parlance for the stock market, or the place(s) where stocks are originated, bought, sold and (sometimes) die. But what is "The Market" really and why is knowing important to investors like us?

Inspired by a post by Cullen Roche who writes in Pragmatic Capitalism (www.pragcap.com), I began thinking about just what should be the comparison for our account results and behavior. The Market for most people consists of one or more of the well-known U.S. indexes (a group of securities selected by some standard or another) such as the Dow Jones Industrial Index or the Standard and Poor's 500 Index. Yet, the 30 stocks of the Dow Industrials and the 500 stocks of the S&P 500 don't even begin to touch the entire U.S. stock market, not to mention that of the world. Furthermore, if we are to be truly broad, "The Market" should mean all securities which can be purchased, held or sold anywhere in the world whether they be stocks, bonds, real estate, commodities, cash or some derivatives of each of them. There are upwards of 8,000 exchange-listed (where stocks are traded) stocks in the U.S. alone, and perhaps an equal number of securities which are not registered on an exchange. The U.S. has about 18% of the entire economic output of the world and about 35% of its stocks. If we think at a world level, the entire supply of stocks that we can own about triples from what we can own of U.S. origin. Most people, though, can't get their arms around global investing. The media covers mainly U.S. stocks. The rest of "The Market" goes unnoticed by the media barring a crash or some other newsworthy event. Our home market bias helps our portfolios when the U.S. outperforms the world and vice versa.

For example, investors made a lot of money not investing outside of the U.S. in most of the 20th Century, more than they would have made if they were globally diversified. Why? U.S. companies were by far the strongest among their world brethren. But the U.S. is no longer as dominant as it was from about 1950-2000, not so clearly outpacing the rest of the world. How can we turn economic facts to our advantage as we allocate our investments between the U.S. and the rest of the world? Do investors have a guide which might help in being profitably overweight or underweight in U.S stocks relative to the rest of the world?

The strength of the U.S. dollar versus foreign currencies offers a huge clue about where we should prioritize investment. For example, the U.S. dollar began to strengthen in the late 1980's and got super strong in the years leading to the 2000 crash and subsequently weakened from about 2002-2009. In those seven years, emerging country shares were on a tear, followed closely by European shares. In 2014, the U.S. dollar has appeared to have broken the spell of relative weakness that it occupied during the first decade of the century and may well be headed higher, supported by the strength of the U.S. economy and the relative strength of U.S. banks.

What's the takeaway? It makes sense to diversify at all times, but how far afield we should go and how we should prioritize our "market baskets" depends largely on how far along these market baskets are in their rise or in their fall. U.S. stocks, still under-believed by most Americans, are accelerating to new highs while most of the rest of the world languishes. We think that we will see a reversal of fortunes between the U.S. and the rest of the world over the next couple of years. We plan to be on board with world securities as global leadership changes.

Thank you for being with us today and for entrusting some of your wealth to our care.