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Sun Tzu, Strategy, and the Investment Landscape

Philosophy and history are two of my favorite subjects. I earned my undergraduate degree in the former and am an ongoing student of the latter. I find the combination of the two to be vital in my investing work. History tells us *what* we might expect in the markets given the cycle of human events, while philosophy offers insights into *how* we should react and proceed.

In that spirit, I present this quarter's commentary in the context of an historical figure whose legacy to the world was the concept we know today as "strategy". It may seem hard to believe, but until the 5th century B.C. Chinese general and philosopher Sun Tzu penned his thoughts about successfully waging wars, there was no universally-recognized methodology for *winning*. Sun Tzu's philosophies on achieving victory through the use of thoughtful and time-tested strategies have become relied-upon principles used by leaders throughout the world in a wide variety of disciplines beyond the military.

Sun Tzu elucidated his ground-breaking theories in a book that continues to be a best-seller today, The Art of War. This classic is an often-referenced text in many realms, and is a highly relevant and useful philosophical guide for many serious investors. Indeed, with the securities markets essentially being a tug of war between buyers and sellers, a successful outcome depends on a combination of wisdom, science and art – or, in other words, on a sound strategy.

As a first step in applying a successful strategy, Sun Tzu stressed the importance of knowing the lay of the land, saying ***"The terrain is to be assessed in terms of distance, difficulty or ease of travel, dimension, and safety."*** Common sense, perhaps, but vital for success as well.

The Current Investment Landscape

The 2009 Bull Market is Intact

I am frequently asked by clients and friends for my views on the stock market, and more specifically, *when* I think the current bull market will end.

My short answer is that we are in the late stages of a multi-decade economic cycle that has carried the stock market to new heights especially over the past ten years. When that economic cycle begins to weaken and eventually becomes unfavorable to steady corporate earnings growth, then the bull market will end.

History gives us a very clear picture of the circumstances that may signal such a change. Therefore, an important dimension of my role as your investment advisor is to exercise constant vigilance for the appearance of factors that evidence a turning point.

For the moment, both economic activity and earnings growth remain favorable to stock market growth and we can expect further highs in the stock market averages over time. That said, in previous letters, I have pointed out that we are in the midst of a stock market correction that will carry stocks lower, prompting some to ask how we can be both in a bull market and in a "not bull market" simultaneously?

To clarify, a stock market correction is usually defined as a 10% or more drop in the market from its recent highs. Investopedia defines a correction as "A reverse movement, usually negative, of at least ten percent in a stock…or index to adjust for an overvaluation." While these commonly used definitions are fine up to a point, they do not take into consideration the many complex patterns that corrections can form. In reality, corrections come in a variety of shapes, depths, and durations. At times the market trades in sideways up-and-down increments that are less than 10%, but that analysts still consider to be a correction. At other times these same sideways patterns can take the market down by more than 10% from recent highs. And during other corrections, the market can actually rise as part of the corrective process that eventually takes it further down - this can be confusing to investors. Corrections can be much trickier than the popular definition implies, but in all cases corrections mark a time of uncertainty among investors, and often denote a wait-and-see period in investor psychology.

I continue to believe that what we have been seeing throughout 2018 is a correction within the 2009 bull market. Investors appear to be waiting for clarification on some kind of significant news, possibly the outcome of the mid-term elections next month, or the resolution of the tariffs issue, or simply the outlook for 2019 corporate earnings.

The correction notwithstanding, the 2009 bull market continues to demonstrate longevity as it approaches its tenth anniversary in March 2019. The market's long endurance has, in part, been a function of the slow economic growth that we have seen from 2009 to 2017 where GDP grew at about 2% per year, on average. That slow growth helped to extend the bull market by muting at least two of the negative factors that normally derail bull markets, namely inflation and interest rates. These economic barometers had both been fairly benign throughout that post-2009 period. The Fed's highly accommodative policies after the Great Recession kept cash cheap, fueled corporate borrowing, and boosted the stock market. For most of that same period interest rates were

at rock bottom levels after traveling on a secular downtrend from the Reagan/Volker era of the early 1980s.

The Economy is Still Strong and Companies are Still Growing
In its latest quarterly report, the Commerce Department stated that gross domestic product, GDP, grew at 4.1% in the second quarter of the year. That was the highest level since the third quarter of 2014 when GDP rose 4.9%. Commerce Secretary Wilbur Ross attributed this to President Trump's economic plan, which has involved tax cuts, deregulation, and trade tariffs. The Federal Reserve's estimate for third quarter GDP growth is 4.0%. On the corporate side, Factset Research reports that the consensus earnings growth rate of the S&P 500 for the third quarter is 19.1%, indicating that the largest companies in the country are expected to experience robust growth.

Rising Risks on the Horizon Threaten the Bull Market

We are now in a new economic era in Washington, marked by a reversal of decades-old economic policies that historically had been a reliable guide to corporate managements in their planning and capital deployment decisions. The new economic paradigms are raising the level of uncertainty among corporate CEOs, many of whom are finding it difficult to plan for future business activities or who are warning of the immediate negative effects of Washington's new policies.

Compounding the potential effects of these policy developments on the corporate sector are the current economic and stock market landscapes, which I referred to above as being in the latter stages of a long uptrend.

Given this new terrain, it is worth reviewing the risk factors that are the ongoing subject of my quarterly letters. Please refer to the charts at the end of this letter for further clarity on these factors.

> ***Corporate EPS Guidance*** - According to Factset, a number of S&P 500 companies have issued negative earnings guidance for Q3. From Factset's September 21 Insight report: "Heading into the end of the third quarter, 98 S&P 500 companies have issued EPS guidance for the quarter. Of these 98 companies, 74 have issued negative EPS guidance and 24 companies have issued positive EPS guidance. The percentage of companies issuing negative EPS guidance is 76% (74 out of 98), which is above the five-year average of 71%. If 76% is the final percentage for the quarter, it will mark the highest percentage of S&P 500 companies issuing negative EPS guidance for a quarter since Q1 2016 (79%)."
>
> ***Interest Rates and Inflation*** - The Fed has raised its Fed Funds rate three times this year, may do one more increase in December, and has indicated that another three increases are possible in 2019. When all is said and done, the Fed Funds rate could stand around 3.25%. In 2015 when the Fed started tightening rates, the Fed Funds Rate stood at 0.25% and had stood there for six years while the economy recovered from the Great Recession.

Inflation is also on the rise. The Consumer Price Index, a measure of inflation at the retail level, now stands at approximately 2.5% whereas in 2015 it was essentially nonexistent.

China Tariffs - For the first time since the Trump Administration's decision to impose tariffs on more than $250 billion in Chinese goods, I am of the opinion that the tariffs war is likely to continue for longer than many expect. The argument made by proponents of tariffs is that this strategy is an effective way to force the Chinese to practice free and fair trade with the United States. Without a doubt China has not been fair to either American or other foreign companies doing business on the mainland.

However, I have noted in past letters that America's objectives go beyond free and fair trade when it comes to China and the tariffs. The tussle between the two nations is really about global supremacy and shaping the world order in the image of one country or the other in the 21st century.

The Chinese have formulated a long-term plan via strategies like the "Belt and Road Initiative" and "Made in China 2025". The former aims to tie China to much of the world in a series of large infrastructure projects aimed at boosting China's presence and influence globally, while the latter seeks to move Chinese goods higher up the manufacturing chain thereby directly challenging U.S. primacy in the technology field.

As strategic weapons, tariffs will have to be applied for possibly a very long time until either U.S. objectives are met or one side or the other develops a different strategy. For American companies, this may mean that China will become a less profitable part of the world in which to do business than they have been anticipating it to be for the last thirty years or so. Tariffs over the long-term could put American companies at a competitive disadvantage in China against global competitors.

Median Household Income - On a net basis, this measure of the economy's health has been on a positive trajectory since the Great Recession. Of late, however, the growth rate of the median household income in the U.S. has been on a decline. In other words, household incomes are not growing as quickly as they were. This could be problematic for economic growth as the consumer sector represents roughly 70% of the U.S. economy and is very much dependent on consumer incomes.

Leading Economic Indicators - The Federal Reserve Bank of Philadelphia maintains an index of leading economic indicators for the United States that takes into account "state-level housing permits (1 to 4 units), state initial unemployment insurance claims, delivery times from the Institute for Supply Management (ISM) manufacturing survey, and the interest rate spread between the 10-year Treasury bond and the 3-month Treasury bill." The index is starting to roll over, meaning that future prospects for these key indicators of the economy are beginning to wane.

Yield Curve - Historically, the difference between the 10-year treasury yield and the 2-year treasury yield, commonly called the yield curve, has been a good indicator of future recessions. When the trend turns negative, that is, when the 2-year treasury yields more than the 10-year treasury, a recession generally ensues 6 to 24 months later. We are not yet in negative yield curve territory, but are clearly headed in that direction and need to be mindful of the possibility of a recession.

Stock Market Valuations - By many measures, stock market valuations are high on an historical basis. At the end of the third quarter, the Shiller P/E had notched up one more point since the second quarter and stood at 33 versus 32. The Shiller P/E's historical median is 16. Another interesting long-term measure of valuation is the Dow-to-GDP ratio, which now stands at its highest level since the 1960s at 1.20, having recently hit 1.30. By comparison the ratio stood at 1.15 just before the bear market of 2000 and roughly at 0.95 just before the bear market of 2008. In a perfect world the stock market, should rise and fall more or less in line with the GDP growth. In reality, the stock market is always either ahead of or behind GDP.

The Importance of an Investment Strategy

In The Art of War, Sun Tzu writes ***"Strategy without tactics is the slowest route to victory. Tactics without strategy is the noise before defeat."*** Indeed, investing without a clear plan of action is merely using tactics, buying here, selling there, creating noise without having an overarching plan to succeed. A clear-cut strategy combined with tactics is vital under all market conditions, even in the best of times when the sailing seems effortless.

Perhaps the most important advice for an investor from Sun Tzu's arsenal of wisdom relates to the need to protect your assets. ***"You always win by preventing your defeat"*** is one of my favorite Sun Tzu quotes because it is true! Preventing substantial and permanent loss is a victory in itself because it allows you to keep investing and growing your portfolio.

This concept implies the need for planning and forethought as ways to stave off loss, otherwise loss is almost certain. For investors, it suggests that doing thorough research, having a plan of action, knowing what you are buying, knowing the condition of the markets and the condition of the economy, can put you in a more favorable position to win by preventing loss. By extension, it also means that adhering to a sound investment process combining both strategy and tactics, can minimize risk, which is one of the key components of my investment process.

My execution of this risk minimization concept is based partly on the idea that cash should be deployed slowly and methodically. For some clients, this approach feels like a slow drip, an annoyance, an impediment to faster-paced profit making. Investors often believe that cash should be fully invested at all times so that unforeseen opportunities are not missed. This makes sense to some extent, but at the same time it may not sufficiently consider the balance between risk and

opportunity. Sun Tzu writes, ***"Move not unless you see an advantage; use not your troops unless there is something to be gained…If it is to your advantage, make a forward move; if not, stay where you are."*** This is great wisdom for investors and even greater wisdom for portfolio managers.

Cash is akin to an investor's troops. Cash can either be deployed onto the field when there is a clear benefit to be gained, or it can be kept in the barracks to do the job at a later time when better opportunities present themselves. Warren Buffett and other successful investors are great believers in this strategy. They believe in having a reserve of cash that they can deploy when attractive investments come along. Buffett routinely keeps 20% or more of Berkshire Hathaway's assets in cash, awaiting buying opportunities.

Investment returns depend to a large extent on what securities you buy with your cash and when you buy them. It is true that holding excessive cash can be harmful particularly in clearly bullish markets where there may be significant opportunity costs, but a quantity of cash that allows for calm and rational decision-making by the investor can be beneficial to overall returns.

The popular phrase "past is prologue" has considerable validity in the investment world, and Sun Tzu's admonition to ***"learn from the history of successful battles"*** leverages that concept. The markets move up and down on the basis of historical trends, and investors react to current market conditions on the basis of past developments and past experiences. For investors and investment managers alike, the past informs the present and the future. The investment strategist's aim is to succeed by learning from what has worked and what has not. This can only come from personal experience and by studying the great investors such as Warren Buffett, Peter Lynch, Richard Driehaus, and John Templeton, among many others. Each of them has used a different strategy forged from experience and, no doubt, from the careful study of strategies used by other great investors.

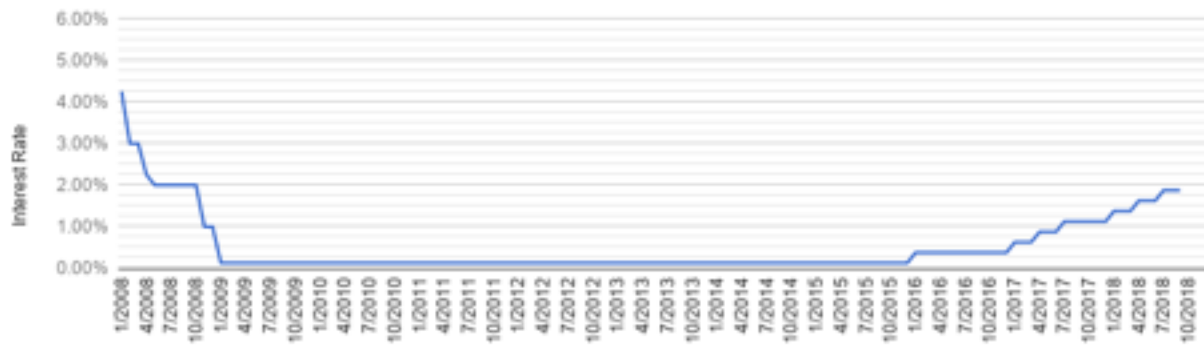
Waterstone's overarching strategy is to profit from the long-term movements of the markets while simultaneously minimizing risks to clients' portfolios. Within that context, the parts of this strategy can be summarized as, a) understand where the markets and the economy are in their respective cycles and how stocks and bonds are likely to behave at each stage, b) select companies that have a proven track record of good earnings and dividend growth, c) research each purchase candidate and understand the opportunities and risks they present, and d) deploy cash slowly and methodically to reduce risk, knowing that long-term investment opportunities can often be purchased at good prices for much longer periods of time than short-term opportunities might allow. And to tie it all together, assess, re-assess, and learn to improve outcomes by learning from history and sticking to a sound investment strategy. Sun Tzu would have advised nothing less.

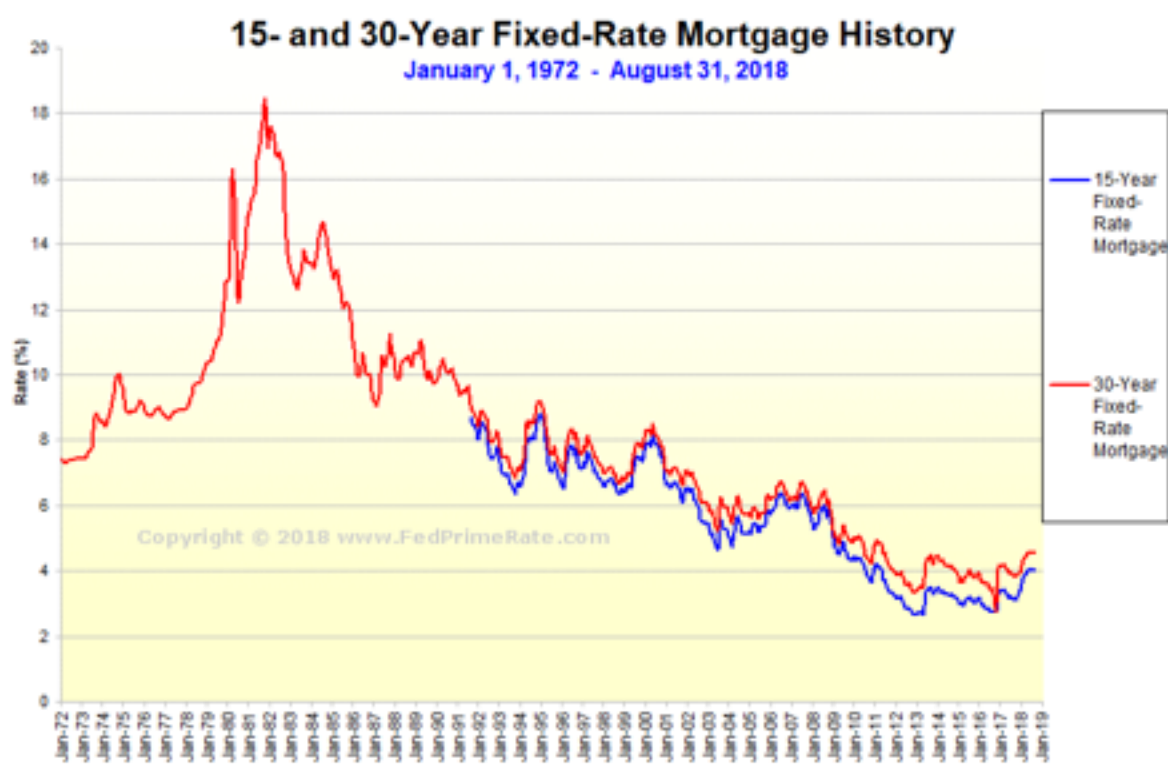
Consumer Price Index

Yield Curve

Dow Jones Industrial Average to Gross Domestic Product

Source: macrotrends.net




15- and 30-Year Fixed-Rate Mortgage History
January 1, 1972 - August 31, 2018
Rate (%)
15-Year Fixed-Rate Mortgage
30-Year Fixed-Rate Mortgage
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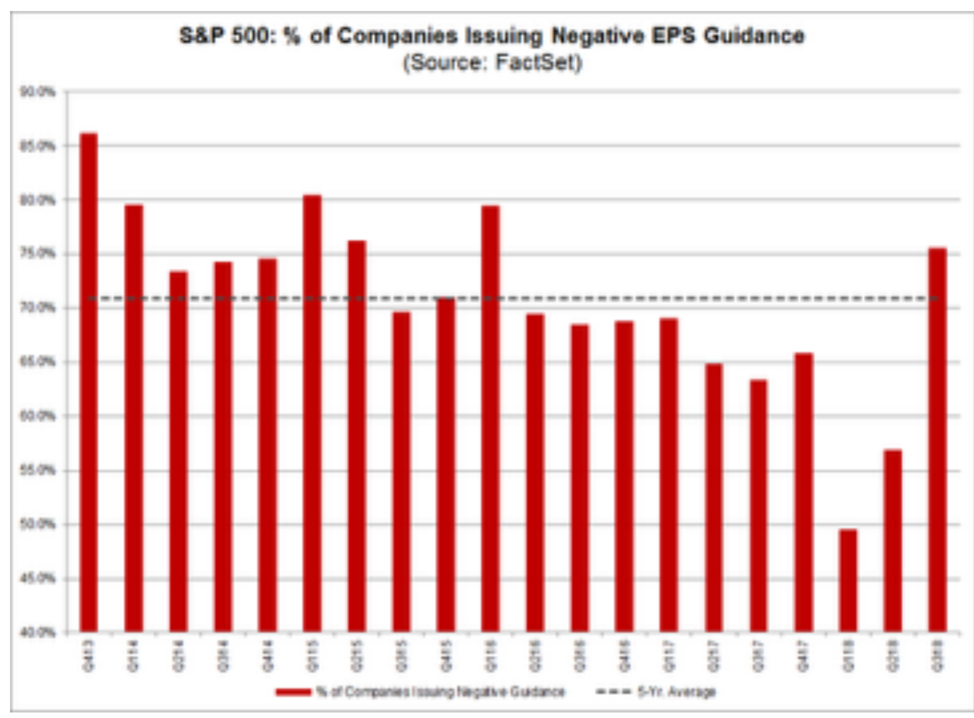
S&P 500: % of Companies Issuing Negative EPS Guidance
(Source: FactSet)
% of Companies Issuing Negative Guidance
5-Yr. Average

Leading Economic Indicators

Household Incomes

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