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VIEWPOINTS

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IN THIS ISSUE OF VIEWPOINTS, THE PERPETUAL CHALLENGE OF MEASURING RISK IN THE MARKETS.

A noted public speaking consultant we know offered simple guidance when constructing a speech: tell them what you are going to say; say it; and then tell them what you said. Perhaps this advice is more applicable to a commencement address, but in the field of economics these days keeping an explanation of seemingly intractable events as simple as possible can go a long way to understanding otherwise complex issues.

Our publications and videos over the last couple of years have attempted to explain (and warn) in reasonably simple language just what was going on in the broader economy, especially when events were so unprecedented and unsettling. Most of what we consider important in our day-to-day responsibility of managing our clients' money revolves around our perception of risk, how to define it, how it is priced, and ultimately how to minimize it. The science of behavioral finance attempts to quantify many of these questions leading to the inevitable conclusion that risk is largely created, or at least magnified, by human nature. We could easily suggest that greed is an important driver of market prices when they exceed realistic levels on the upside. Fear, the counterpoint to greed, can also lead to unattractive investment outcomes on the downside.

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We have quoted Warren Buffett's (he is eminently quotable!) picturesque reference to risk: *It is when the tide goes out that you see who is swimming naked.* He refers here to the inevitable impact of higher interest rates after a long period of inordinately low rates, particularly when investors have increased risk fueled by that cheap money. Risk happens slowly, then all at once, and it can appear as a deadly bolt out of the blue to those unsuspecting risk-takers.

With the Fed keeping interest rates at the zero-bound for so long and enacting what became known as Quantitative Easing (QE), another experimental way of manipulating interest rates lower, this stimulated new levels of risk-taking, displacing prudent analysis in favor of speculation in deploying investment capital. In time, the makings of a bubble took over the markets as the smell of quick profits ultimately sucked in small investors who at this point in the cycle were merely throwing the dice as in a casino.

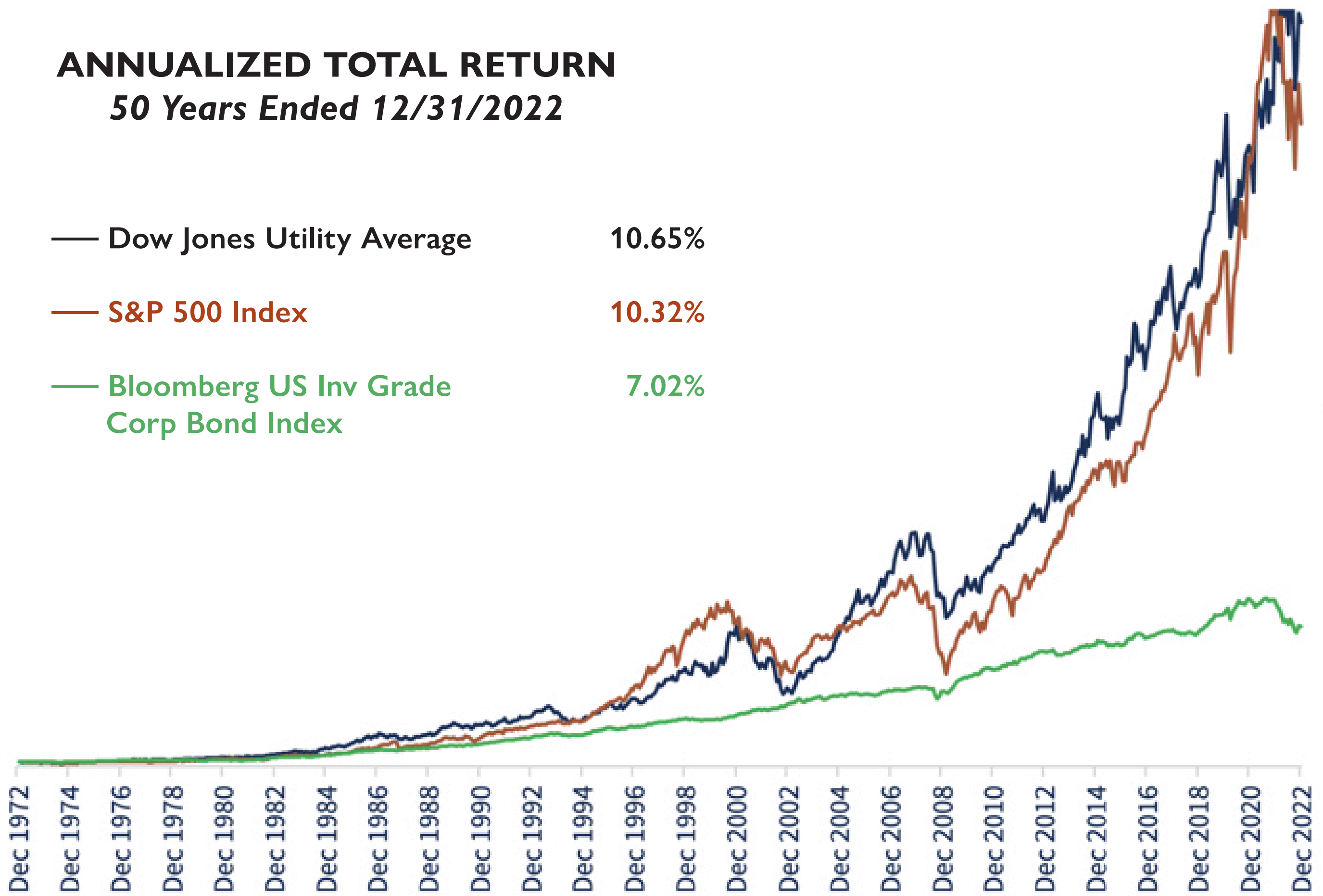
Finally, after years of essentially free money from the Fed and "helicopter" money from the government during Covid, inflation careened to levels that were last seen in the 1970s. Stocks in those darlings of Wall Street kept ballooning higher, creating what Warren Buffett and his partner Charlie Munger called the "Mother of All Bubbles." Recognizing that the burgeoning inflation problem was not in fact as transient as they initially thought, the Fed instituted a game-changing regime of dramatically higher interest rates, and the bubble finally burst, reversing course for those high beta (risk) stocks.

The second derivative of risk in markets is credit risk when rates move from zero to 5% virtually overnight. Banks are now in the crosshairs of this new risk environment with three not insignificant banks fallen by the wayside: Credit Suisse, Signature Bank, and Silicon Valley Bank. There will be more to come, no doubt.

Credit is now tight, the money supply shrinking, and the Fed has stated that their interest rate policy will keep rates higher for longer to wring out of the system the inflation they helped create.

The single-family housing boom that was fueled by easy credit and low mortgage rates has now reversed as the Fed's interest rate hikes have spread to mortgages. Also, with rising interest rates, SPACs—"blank check" companies—have cratered along with crypto with Bitcoin as its centerpiece, which we have long regarded as a likely Ponzi scheme. These spectacular collapses are certainly not unexpected, but probably not big enough collectively to put the economy into a tailspin. The spreading bankruptcies of medium-sized banks led by Silicon Valley Bank are, however, an increasingly troublesome issue.

Our portfolio management philosophy tries to steer clear of investment fads and popular narratives from talking



SOURCES: BLOOMBERG, EVESTMENT

PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS

heads in the financial media, and the inevitable manias and their painful counterpart, panics. For example, there may be no less exciting and dull-sounding investment than an electric utility. In earlier days, one would find utilities populating portfolios for widows and orphans in bank trust departments. Nowadays, their detractors opine that while utility stocks have a good dividend yield, there is not much excitement on the capital gain front.

Well, in our case, electric and gas utilities have been very much an important part of our clients' portfolios for years. We see them as essential elements for a strong economy, and particularly an increasingly digital economy that relies on a consistent and uninterrupted stream of electricity for their customers. These companies have very low implied relative risk in their stock characteristics (low beta, high and rising dividend yields, generally good liquidity) and have often been regarded as bond substitutes because of these conservative attributes. So, it may come as a surprise to note on the chart above that the annualized return of the Dow Jones Utility Index for the 50 years ending December 2022 exceeded the S & P 500 Index.

In our opinion, this is the perfect example of seeking returns from investments without exposing the portfolio to excessive risk and volatility. Certainly, over the last 50 years there have been booms and busts, manias and panics, and vast technological advances, but in the end, these stocks have performed superbly, and importantly for us, under the radar of speculators and flashy hedge funds and have done so with minimal risk.

> Investing for the long term is a marathon, not a sprint, where good judgment and patience are essential.

IN CONCLUSION

Navigating the shoals ahead will take patience and a steady hand. Reflecting our current investment strategy, we have increased cash reserves, now yielding a compelling 4+%. Where we own equities, they are for the most part low beta (risk) securities with good dividend yields, and the bonds in portfolios have only the highest credit rating. As history shows repeatedly, these cycles come and go in a capitalist economy, and this very unsettled and troubling period will also pass. But, like a good mystery novel, it will take time for the storyline to evolve to its conclusion when all is finally resolved.

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