

Aviator Update – December 2020

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2021 Investment Strategy Planning

It's that time of year again. The time when every sell-side analyst, financial pundit and many an adviser is obligated to provide their thoughts on what the coming year will bring, often together with some targets for the major market indices and/or strategy recommendations.

One of the pleasures about being on the buy-side is not sensing any obligation to provide projections (make guesses) on what the next 12 months will bring. I am however happy to share what will be a key feature of our portfolio management strategy in the coming 12 months.

I expect 2021 to be a challenging year for investors. I'll elaborate on what I mean by that, but before I can do that we need to take a detour...

I've spent a lot of time over the Christmas break playing around with market data. It's something I've done fairly frequently over the years. I think all investors should do this – it's incredibly valuable in terms of really understanding how markets move, what we should expect and how we should go about managing our investments. Sure, price charts are good, but they don't pack the same punch as seeing the yearly movements (especially when they are normally compressed into a "logarithmic" chart format).

I've been playing around with the last 100 years of data for the USA's S&P 500. I've selected this mostly because of the data history available. The index actually dates from the 1870's and the data is easy to get a hold of. By contrast, our "All Ordinaries" index goes back to 1980 and our ASX 200 only started in March 2000. 20 years sounds like plenty, but as we'll discover it can be very misleading.

Here's the data... 100 years of the S&P500 from 1st January to 1st January, with the percent change through the 12 months:

	Value	% change		Value	% change
Jan 1, 2021	3756	14.58%	Jan 1, 1970	90.31	-11.46%
Jan 1, 2020	3278.2	25.73%	Jan 1, 1969	102	7.32%
Jan 1, 2019	2607.39	-6.54%	Jan 1, 1968	95.04	12.54%
Jan 1, 2018	2789.8	22.62%	Jan 1, 1967	84.45	-9.50%
Jan 1, 2017	2275.12	18.58%	Jan 1, 1966	93.32	8.36%
Jan 1, 2016	1918.6	-5.40%	Jan 1, 1965	86.12	12.65%
Jan 1, 2015	2028.18	11.29%	Jan 1, 1964	76.45	17.51%
Jan 1, 2014	1822.36	23.10%	Jan 1, 1963	65.06	-5.81%
Jan 1, 2013	1480.4	13.83%	Jan 1, 1962	69.07	15.66%
Jan 1, 2012	1300.58	1.40%	Jan 1, 1961	59.72	2.91%
Jan 1, 2011	1282.62	14.15%	Jan 1, 1960	58.03	4.33%
Jan 1, 2010	1123.58	29.81%	Jan 1, 1959	55.62	35.26%
Jan 1, 2009	865.58	-37.22%	Jan 1, 1958	41.12	-9.49%
Jan 1, 2008	1378.76	-3.19%	Jan 1, 1957	45.43	2.90%
Jan 1, 2007	1424.16	11.37%	Jan 1, 1956	44.15	24.02%
Jan 1, 2006	1278.73	8.24%	Jan 1, 1955	35.6	39.83%
Jan 1, 2005	1181.41	4.32%	Jan 1, 1954	25.46	-2.75%
Jan 1, 2004	1132.52	26.42%	Jan 1, 1953	26.18	8.23%
Jan 1, 2003	895.84	-21.43%	Jan 1, 1952	24.19	14.05%
Jan 1, 2002	1140.21	-14.63%	Jan 1, 1951	21.21	25.65%
Jan 1, 2001	1335.63	-6.31%	Jan 1, 1950	16.88	9.90%
Jan 1, 2000	1425.59	14.16%	Jan 1, 1949	15.36	3.57%
Jan 1, 1999	1248.77	29.63%	Jan 1, 1948	14.83	-2.50%
Jan 1, 1998	963.36	25.73%	Jan 1, 1947	15.21	-15.59%
Jan 1, 1997	766.22	24.71%	Jan 1, 1946	18.02	33.58%
Jan 1, 1996	614.42	32.06%	Jan 1, 1945	13.49	13.84%
Jan 1, 1995	465.25	-1.64%	Jan 1, 1944	11.85	17.44%
Jan 1, 1994	472.99	8.68%	Jan 1, 1943	10.09	12.99%
Jan 1, 1993	435.23	4.60%	Jan 1, 1942	8.93	-15.36%
Jan 1, 1992	416.08	27.83%	Jan 1, 1941	10.55	-14.23%
Jan 1, 1991	325.49	-4.26%	Jan 1, 1940	12.3	-1.60%
Jan 1, 1990	339.97	19.12%	Jan 1, 1939	12.5	10.52%
Jan 1, 1989	285.4	13.93%	Jan 1, 1938	11.31	-35.70%
Jan 1, 1988	250.5	-5.29%	Jan 1, 1937	17.59	27.83%
Jan 1, 1987	264.5	27.04%	Jan 1, 1936	13.76	48.60%
Jan 1, 1986	208.2	21.33%	Jan 1, 1935	9.26	-12.14%
Jan 1, 1985	171.6	3.12%	Jan 1, 1934	10.54	48.66%
Jan 1, 1984	166.4	15.32%	Jan 1, 1933	7.09	-14.58%
Jan 1, 1983	144.3	23.02%	Jan 1, 1932	8.3	-48.06%
Jan 1, 1982	117.3	-11.80%	Jan 1, 1931	15.98	-26.39%
Jan 1, 1981	133	19.93%	Jan 1, 1930	21.71	-12.67%
Jan 1, 1980	110.9	11.22%	Jan 1, 1929	24.86	41.81%
Jan 1, 1979	99.71	10.48%	Jan 1, 1928	17.53	30.82%
Jan 1, 1978	90.25	-13.05%	Jan 1, 1927	13.4	5.93%
Jan 1, 1977	103.8	7.16%	Jan 1, 1926	12.65	19.57%
Jan 1, 1976	96.86	33.49%	Jan 1, 1925	10.58	19.82%
Jan 1, 1975	72.56	-24.50%	Jan 1, 1924	8.83	-0.79%
Jan 1, 1974	96.11	-18.83%	Jan 1, 1923	8.9	21.92%
Jan 1, 1973	118.4	14.62%	Jan 1, 1922	7.3	2.67%
Jan 1, 1972	103.3	10.49%	Jan 1, 1921	7.11	-19.48%
Jan 1, 1971	93.49	3.52%	Jan 1, 1920	8.83	

Some initial observations:

It's pretty incredible how large the typical annual change is – a 20%+ annual change is almost normal!

That said, note that markets tend to fall a lot quicker than they go up. Now, be careful when pondering this observation... Yes, markets often bounce back quite strongly after a fall. But the percentage gain off the lower base still leaves you behind. If you start with \$100, endure a 50% fall and then a 50% gain, you have \$75 and are thus still down 25% from your starting point. You of course need a 100% gain to offset a 50% fall.

Another observation based on this last 12 months is how much focusing on “point-to-point” data can mask what's going on. If you crawled out of a cave high in the Himalayas, having missed the past 12 months and checked the markets, you'd probably conclude that 2020 was quite uneventful. One of my favourite sayings with respect to markets is that *The journey is much more important than the destination.*

If we count the positives and negatives, we note that there's been 71 positive years and 30 negatives – markets do normally go up. That's comforting although as we will see, if this premise represents 95% of your investment strategy (like it does for many individuals, including financial advisers), then you stand to be blindsided by the “abnormal” market moves that happen oh so frequently.

So, let me ask you... what's a reasonable expectation to have in terms of an average annual return? Well, let's crunch the data...

The average annual return for this 100-year period has been 6.18%.

Now, this of course represents capital growth only so an additional allowance could be made for dividends. However, in order to simplify matters, we'll omit any dividends. I'd suggest that for most of us, capital growth really is our main focus in any case.

(As a further aside, remember that in finance-land, for analysis like this we will use a “Geometric Mean” when calculating the average rather than a simple “average” (“arithmetic mean”). The geometric mean calculation will deliver the true average yearly growth figure for the period in question – the “Compound Average Growth Rate” or “CAGR”. The geometric mean will always be slightly lower than the arithmetic mean.)

Okay so that settles it... Over 100 years the average return has been 6.18%. Surely this is therefore the right number to use for all our financial planning and forecasting activities... right?

Well, maybe... I guess if we have a 100-year investment horizon, this would be a good number to use. Unfortunately, I don't think I have 100 years.

What about a 50-year return?

If we take the average for the second half of this data set from 1970, we arrive at 7.58%. Okay, that looks good.

But hold on... the average for the first half of our data set up to 1970 yields just 4.76%. Nearly 3% per year lower – that's a big difference! Which 50-year return is "right"?

Okay maybe if we focus on the past 25 years since 1995. That yields an average return of 8.36%. Great! Best number yet and surely 25 years is a good "long term average". And surely focusing on the last 25 years is the most relevant/appropriate for today's market?

We could keep doing this all day and it doesn't really matter. I'll leave it up to you to decide what you want to use as a reasonable long-term average return. The key point is that arriving at a sensible long term "average market return" is remarkably subjective.

I'd suggest that for most of us, we'd say that the coming 5 years or 10 years is our "investment horizon". Even if we strictly have a much longer horizon, we're really focused with what we can achieve during this next period. I sure know I am.

On that basis, here's another way of looking at this data... Suppose we look at rolling average annual returns over 10-year periods. Year-1 to year-10, year-2 to year-11, year-3 to year-12 and so forth. Here's what we get:

2012-2021	11.34%	1989-1998	14.42%	1966-1975	-1.70%	1943-1952	10.48%
2011-2020	11.30%	1988-1997	11.22%	1965-1974	2.31%	1942-1951	7.23%
2010-2019	11.66%	1987-1996	11.43%	1964-1973	6.17%	1941-1950	3.22%
2009-2018	7.30%	1986-1995	10.49%	1963-1972	4.11%	1940-1949	2.08%
2008-2017	4.80%	1985-1994	11.01%	1962-1971	4.58%	1939-1948	2.75%
2007-2016	4.14%	1984-1993	11.67%	1961-1970	4.52%	1938-1947	-1.44%
2006-2015	5.55%	1983-1992	13.50%	1960-1969	6.25%	1937-1946	2.73%
2005-2014	4.87%	1982-1991	9.36%	1959-1968	8.74%	1936-1945	3.83%
2004-2013	5.15%	1981-1990	11.85%	1958-1967	6.40%	1935-1944	1.18%
2003-2012	1.32%	1980-1989	11.09%	1957-1966	7.77%	1934-1943	3.59%
2002-2011	-0.40%	1979-1988	10.75%	1956-1965	9.24%	1933-1942	0.73%
2001-2010	-2.35%	1978-1987	9.81%	1955-1964	11.62%	1932-1941	-4.07%
2000-2009	-3.60%	1977-1986	7.95%	1954-1963	9.53%	1931-1940	-5.52%
1999-2008	3.65%	1976-1985	8.99%	1953-1962	11.06%	1930-1939	-6.64%
1998-2007	6.39%	1975-1984	5.64%	1952-1961	10.91%	1929-1938	-4.29%
1997-2006	7.60%	1974-1983	2.00%	1951-1960	13.14%	1928-1937	2.76%
1996-2005	9.77%	1973-1982	1.28%	1950-1959	13.73%	1927-1936	0.84%
1995-2004	9.12%	1972-1981	3.59%	1949-1958	10.74%	1926-1935	-1.32%
1994-2003	7.49%	1971-1980	2.08%	1948-1957	11.56%	1925-1934	1.79%
1993-2002	10.61%	1970-1979	-0.23%	1947-1956	9.37%	1924-1933	-2.25%
1992-2001	15.16%	1969-1978	-0.52%	1946-1955	10.19%	1923-1932	1.29%
1991-2000	15.41%	1968-1977	2.08%	1945-1954	7.95%	1922-1931	8.44%
1990-1999	15.91%	1967-1976	0.37%	1944-1953	10.00%	1921-1930	9.41%

Notice there's been thirteen 10-year periods in the last 100 years where the average annual return has been negative. There's been an additional thirteen periods where your average annual return has been less than 2.5%.

I want you to really think about that. Twenty-six 10-year periods in the past 100 years where the market return has not even kept up with inflation.

They say that timing is everything if you're a short-term speculator. Well, according to the data, timing is everything if you're an investor with a 10-year time horizon!

If you went "all-in" in 1990, you were partying when it was 1999 - having enjoyed average annual returns of nearly 16% for the past decade! Conversely, if you picked 2000 as the year to enter the markets, by 2009 you're furious at anyone that says you should expect to generate around 6.18% p.a. over the long-term, given you have just watched your investments lose an average of 3.6% p.a. over the last decade!

Let's overlay these 10-year returns with our raw year-on-year data. Remember we observed above that annual returns are pretty all over the place and often large. Whatever you want to use for your expected average annual return (6.18%, 8.36%, 7.58%...), it's probable that the return in any given year has NEVER actually come it at your expected return!

Instead, for any period where average annual returns have been poor, this can normally be traced back to a couple (or often just one) really poor year. To illustrate, let's focus on the period 2005 to 2014.

Our rolling returns data shows a relatively satisfactory 4.87% annual return during that 10 years. Here's the yearly data from around then:

Jan 1, 2016	1918.6	-5.40%
Jan 1, 2015	2028.18	11.29%
Jan 1, 2014	1822.36	23.10%
Jan 1, 2013	1480.4	13.83%
Jan 1, 2012	1300.58	1.40%
Jan 1, 2011	1282.62	14.15%
Jan 1, 2010	1123.58	29.81%
Jan 1, 2009	865.58	-37.22%
Jan 1, 2008	1378.76	-3.19%
Jan 1, 2007	1424.16	11.37%
Jan 1, 2006	1278.73	8.24%
Jan 1, 2005	1181.41	4.32%
Jan 1, 2004	1132.52	26.42%
Jan 1, 2003	895.84	-21.43%

2008 – ouch! 37.22% loss during the year.

Now, just for fun, let's change that -37.22 to zero in our spreadsheet. What happens?

Our average annual return number for that 10-year period jumps to 9.87%. A full 5% per year higher.

So if you had a simple, passive, market-tracking investment strategy and you somehow managed to miss 2008, that act of doing nothing for just one year has seen you out-perform the market by an average of 5% per year for that entire 10-year period.

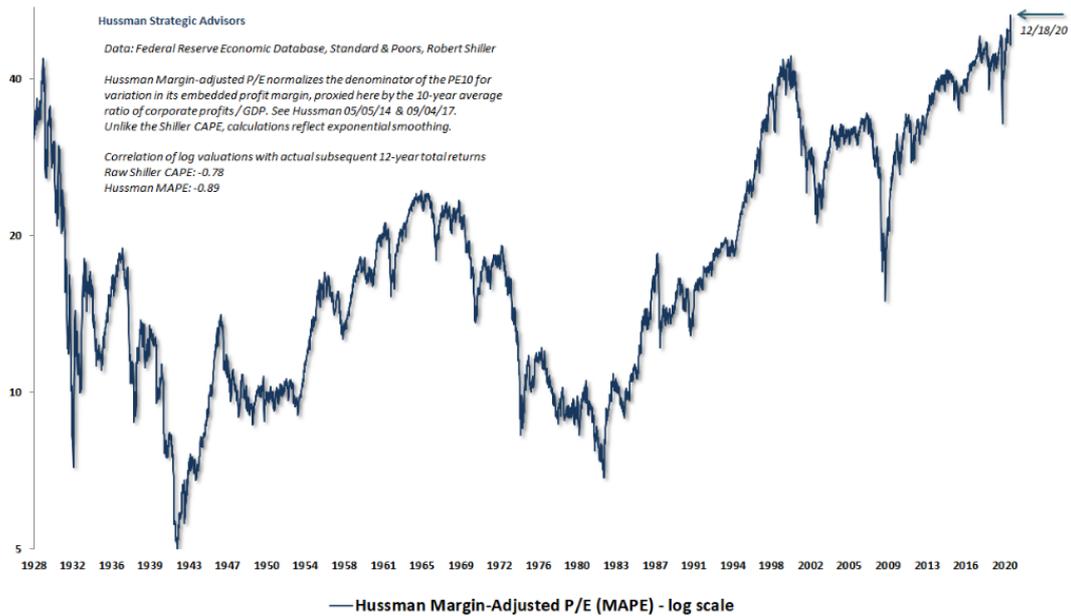
The moral to the story... Perhaps the single best way you can improve your long-term average returns is to avoid the significant market losses that come along periodically.

Simple, right? Well, no – of course it's not "simple". But it is possible.

Another important point to add before moving on... The period we're referring to above (2008) is of course the Global Financial Crisis. The S&P500 dropped around 55% during the GFC. Therefore, we're not talking about "picking the top" and/or "picking the bottom". We've removed the 2008 calendar year return of -37.22% from our returns. Maybe we sold early and missed out on some added upside. Maybe we bought too early and endured some of the falls. Maybe we were partially invested the whole time and thus wore a 55% decline but only on a portion of our capital. (Maybe we even went short too early, endured losses as the market advanced and then experienced significant gains as it fell!) Whatever eventuated, we're not suggesting we managed to avoid anywhere near the entire 2008 market decline.

How can we predict when the market is about to suffer a major fall? Unfortunately, we don't have some amazing timing algorithm or charting system that tells us when the market is about to fall. Nobody does. Market history shows that one of the most powerful tools we can all use to evaluate where we're at and what we might be in for is a good valuation model.

We've talked about valuation models frequently in the past. There's a bunch out there. One data-cruncher I frequently reference is Dr John Hussman. Here's one of his models that, as noted below, has around 90% correlation with actual market returns:



The above goes back to 1928 – it doesn’t quite reflect our 100 years of market data, but it does capture a handsome chunk of modern market history (i.e. not just the last 10 or 20 years).

Have a close look at our market return data compared with the above chart. If you invested at times when valuations were depressed, you typically enjoyed periods of “above-average” returns as valuations expanded.

Let’s look at the period from 1980 to the tech bubble bust in the early 2000’s:

Jan 1, 2003	895.84	-21.43%
Jan 1, 2002	1140.21	-14.63%
Jan 1, 2001	1335.63	-6.31%
Jan 1, 2000	1425.59	14.16%
Jan 1, 1999	1248.77	29.63%
Jan 1, 1998	963.36	25.73%
Jan 1, 1997	766.22	24.71%
Jan 1, 1996	614.42	32.06%
Jan 1, 1995	465.25	-1.64%
Jan 1, 1994	472.99	8.68%
Jan 1, 1993	435.23	4.60%
Jan 1, 1992	416.08	27.83%
Jan 1, 1991	325.49	-4.26%
Jan 1, 1990	339.97	19.12%
Jan 1, 1989	285.4	13.93%
Jan 1, 1988	250.5	-5.29%
Jan 1, 1987	264.5	27.04%
Jan 1, 1986	208.2	21.33%
Jan 1, 1985	171.6	3.12%
Jan 1, 1984	166.4	15.32%
Jan 1, 1983	144.3	23.02%
Jan 1, 1982	117.3	-11.80%
Jan 1, 1981	133	19.93%
Jan 1, 1980	110.9	11.22%

Off a low valuation base the market posted solid returns through the '80's. Even the 1987 stock market crash washed through with just 5% fall for that year.

The '90's started at historically quite elevated valuations, but boomed regardless.

This highlights an important point. Valuation models don't make good trading models. "Trading" off the above valuation model is about as useful as trading off a price chart. There are periods when over-valued simply became more over-valued and when under-valued stocks just kept falling.

If trading off valuations, you might have sold around 1997 when valuations eclipsed all of recent history except for prior to the crash of 1929. Had you sold in 1997, you missed out on a couple of years more spectacular gains. (As an aside, the declines from 2000 to 2002 would look a lot more spectacular if we were looking at NASDAQ data.)

Another observation... Since the GFC in 2008, the markets have enjoyed pretty spectacular returns – look at the most recent rolling 10-year averages – above 11% p.a. But realise that whilst investors have been delivered these returns the markets have worked their way to being the most richly-valued they have ever been! That's right, the most highly valued in history.

We've noted that valuations alone are not enough to trade off – for decision-making, we need to overlay this with more – sentiment backdrop, economic factors, technicals...

What reliable valuation models are best for is forecasting longer-term returns. Investors have bid up share markets to be around the most expensive in history (depending on the valuation model you use). From this point, poor medium-term returns are a given. The market will almost certainly be "unchanged" from today at some point well into the future.

But look back at what markets do – how they move. We're not likely to see "poor returns" delivered via a string of 3% years. Oh no. We're predictably going to see a year (or possibly two/three years) of minus 20, minus 30 returns. Whilst we can predict this with near-certainty, frustratingly, we don't know when that will unfold.

Through all this, we've been referring to "market returns". Of course, you, perhaps with the assistance of one or more investment advisers, is out to "beat" the market.

You've got a strategy... maybe its comprehensive fundamental analysis with focus on "blue-chips", maybe you're enhancing returns or hedging downside risk via options, maybe selling Call options over your stock holdings to generate added return... maybe you're beating the market via a carefully-selected portfolio of small and mid-cap growth stocks that stand to greatly outperform the market. Maybe you're diversified with holdings in other assets such as Bitcoin, currencies, gold and property... Maybe you're actively managing your portfolio

via technical trading signals. Maybe you're utilising margin lending to boost returns over time...

That's all good – we're out to beat the market too! But remember that its only logical that your return should be linked to the market/s from which you are investing.

And so it should be... Earlier on we noted that the market goes up a lot more frequently than it goes down and, over the longer-term, the market delivers a very satisfactory average return. The point to these observations is that we should be “using” the market to deliver us our returns – we don't need to make things excessively hard for ourselves. Sure, its periodically very fulfilling to deliver a return that's uncorrelated to the market (provided your return is positive!), but if you are spending a lot of time managing your investments in creative or elaborate ways, I sure hope your longer-term returns are outperforming the market by a sufficient margin to make your efforts worthwhile.

Note that I'm not advocating a “buy and hold” strategy. Quite the opposite – I'm saying that I suspect a “buy and hold” strategy employed today will most likely generate particularly poor returns over the coming years – perhaps even another one of those rolling 10-year periods where returns are barely even positive.

What I am advocating is having an understanding market history:

- Over-valued markets have reliably delivered poor medium to long-term returns
- These poor returns have typically been delivered to investors via one (or perhaps two) very poor years, often followed by several years of very good returns
- It therefore follows that disciplined investors can take measures to limit their maximum drawdown relative to the market and substantially improve their long-term returns in the process

I said at the start that I predict 2021 to be a tough year. Let me now explain what I mean...

Warren Buffet famously said “be fearful when others are greedy”. It's time to be fearful. We're beginning to see some of the hallmarks that historically have only been seen towards market peaks... at a time when valuations are as elevated as they ever have been.

There's no limit to how high valuations can go. There's no reason why markets can't go up 15% in 2021. If they do, it will likely be a difficult year for us (and every other value-conscious investor). We'll do what we can and hopefully generate some return here and there. But we sense no pressure to chase the market higher and will probably under-perform a rising market.

Conversely, if the market goes down 30% we are hopeful of delivering substantial outperformance. In this scenario, 2021 will be considered a difficult year for most investors, but hopefully not us!

This brings me to our core portfolio management focus during 2021. Here it is – highly insightful... highly analytical...

Don't lose money.

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