Aviator Update – July 2023
Lindsey Lawrance

AVIATOR CAPITAL

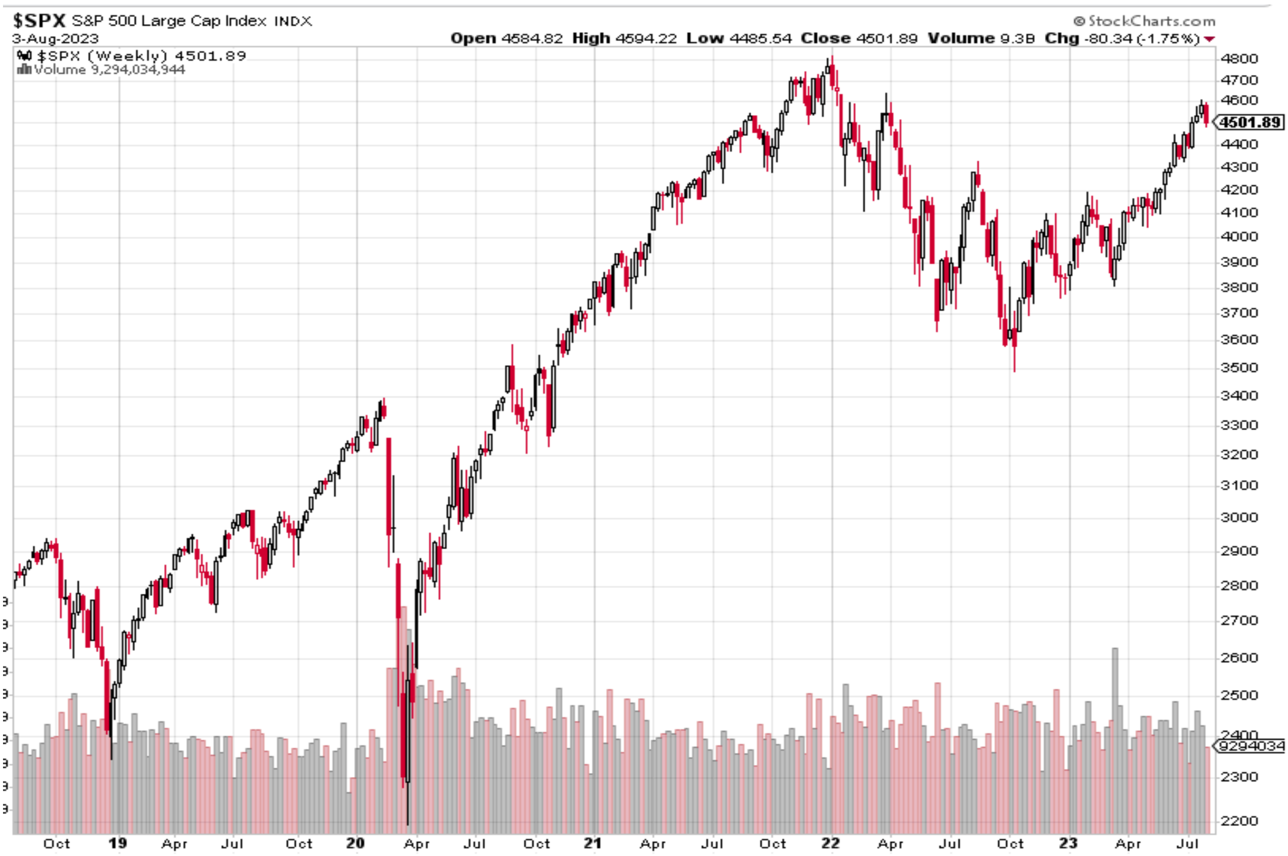
Midyear Stocktake

And just like that, 7 months of 2023 pass us by. We're in the final stretch of winter here in Australia – looking forward to the longer, warmer days around the corner.

Of course, July means the peak of the summer in the U.S. Trading desks more sparsely populated, especially on a Friday afternoon, as the New York crowd escape the city for a weekend in the Hamptons. The summer months often come with lower volumes and a continuation of the status quo.

Bank panics and recession fears seem to have melted away in the summer heat. Narratives again shifting…

It's been another rather amazing year for share markets so far. The weekly chart of the U.S. S&P 500 illustrates it nicely. We ended 2022 and started 2023 with plenty of volatility – the market whipsawing in both directions. That ceased around March and it's been a one-way street higher since then:



Alas, for Aussie investors, it hasn't been quite as positive – stuck in that trading range we've been in since 2021:

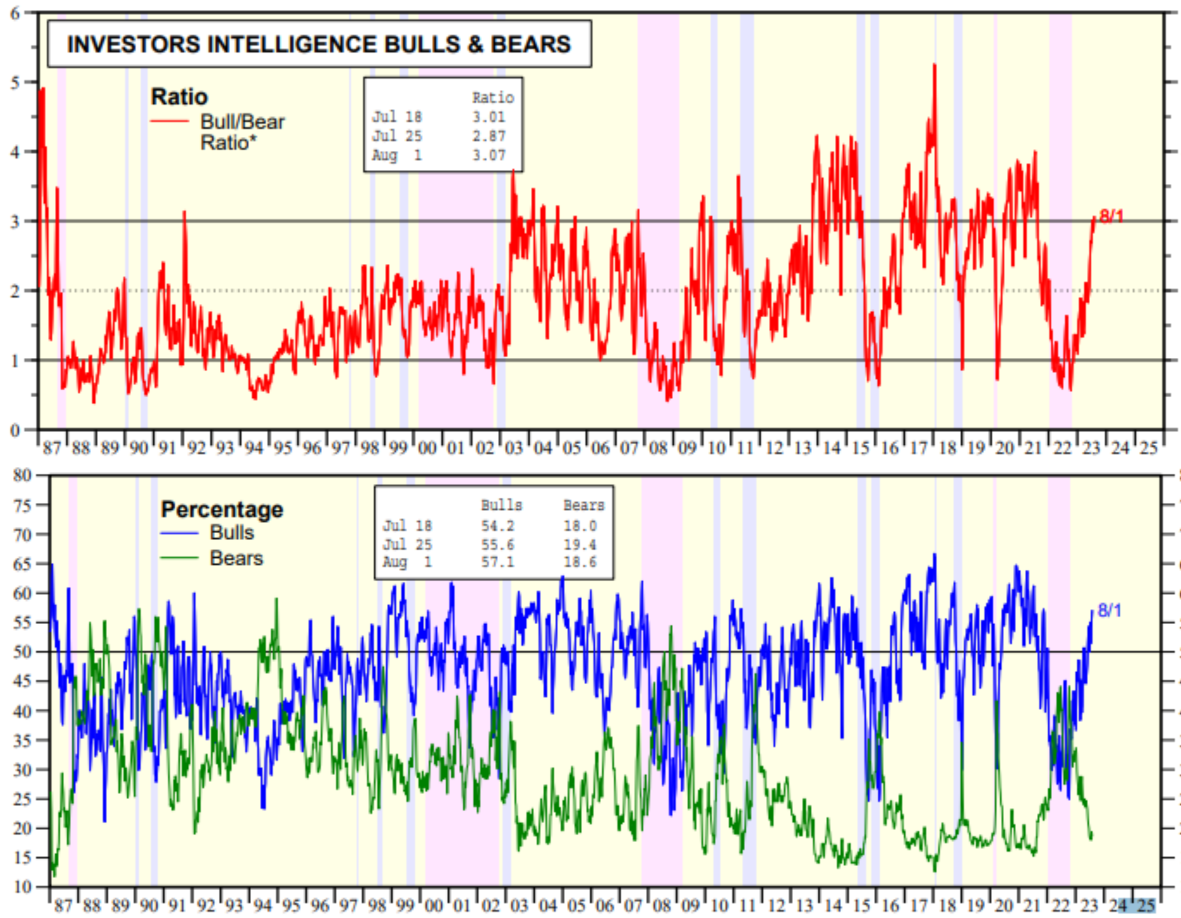
As I expect you've heard, the U.S. market strength is attributable to those "magnificent seven" – seven major tech names that have roared higher and become an outsized influence on the market itself owing to their market capitalisation.

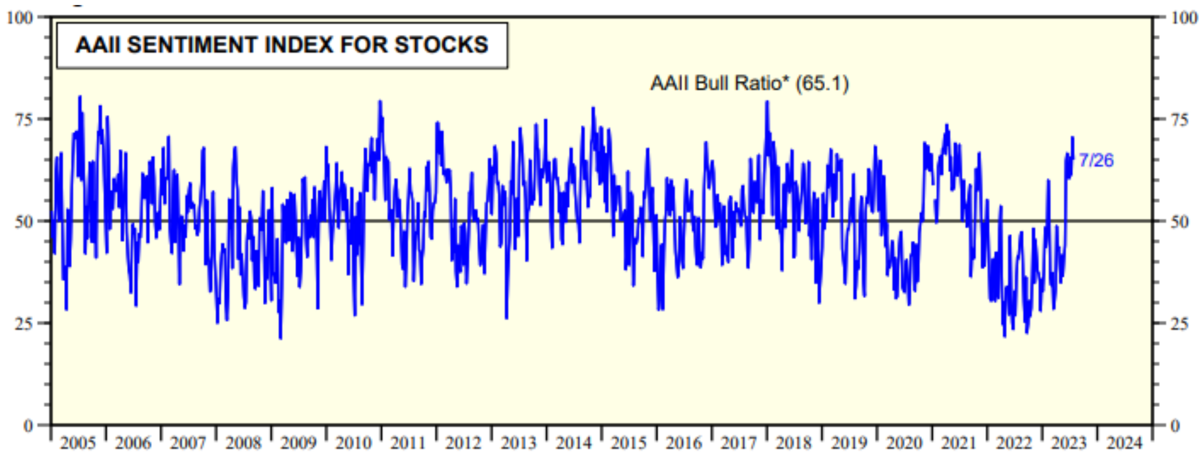
Despite being completely different markets, the above two charts do a good job at displaying what's been happening – whilst sentiment has been positive and major indices strong, the rally has been very narrow with most things barely holding positive. Certainly not a broad-based rally.

Predictably, relative calm has meant volatility sinking back towards lows. Here's the U.S. VIX. Not quite approaching the single digit range we saw a few years ago, but readings in the low-teens are very low on a historical basis.

In terms of prevailing “narrative”, we’re almost back to one of those “price is news” periods. Sure, there’s a bit of “the recession is cancelled” narrative together with the “artificial intelligence will supercharge growth and earnings” narrative (those “magnificent seven”). But really, at this point in the march higher, the narrative as much as anything has been “market is going up”! Charts look good – albeit over-extended. Sentiment is positive.

In terms of sentiment, after a solid run in one direction we would suspect the sentiment backdrop is beginning to look a little lopsided. When we check in on the major sentiment indicators (courtesy of Yardeni research), that’s pretty much what we find:





Certainly not “euphoric”, but fair to say “exuberant”…

Thanks for the update on what has happened Lindsey… How about some thoughts on what to do now!

Yes indeed – good point. That’s one of the wonderful things about investing (as well as life on earth in general) – every day is a new day! Yesterday is in the past and what happened doesn’t really matter.

Remember that I can’t tell you what to do – even if I wanted to, I’m not allowed to provide you with personal advice. One of my goals with these missives is to stimulate thinking (both mine and yours). Importantly, our philosophies and approach are quite different to most other people you might read or listen to. As part of that, I’m confident I share viewpoints you don’t normally get – you might not agree with them and that’s fine.

Recapping what we do in our capital markets portfolio, we’re in search of that illusive “absolute return”. What this means is we’re trying to make money constantly all the time regardless of market conditions.

We provide ourselves a broad mandate in terms of asset classes and strategy. That said, my background and our focus is global equities and equity derivatives.

As I’ve noted, my unofficial motto for what we do is “making sensible investment decisions based on a deep understanding of financial market operations and history”. We’re not day-traders. Not bottom-up stockpickers. We’re interested in making good medium-term strategic decisions.

Back to that “absolute return” thing, “trying to make money constantly” probably sounds just normal, right? But let me tell you, it’s not. Critically, it requires one very important thing;

You need to be willing to underperform the market. You need to be willing to be wrong on your own.

There’s all different kinds of funds managers out there. They might be a “funds manager” in the sense that they run a managed investment fund, soliciting investments from financial planners and the like. Or they might be your financial planner or stockbroker, managing portfolios directly for clients.

Their selling point is that they have the means to generate superior returns over the longer-term. Typically, their barely-engaged clients merely glance at performance and return occasionally – this is especially the case for superannuation investments that, for most young-ish people, are truly long-term investments.

What happens if, as a funds manager, you start under-performing the market? What do you think goes through the adviser's mind each day during a period of sustained under-performance? Is their mind free and focused on applying their investment framework to generate the best ideas they can? Or are they fretting "need to stop under-performing… need to find a way to raise returns by just a little bit…"

Cause they know if they keep under-performing, they risk losing clients. Their days are spent uncomfortably explaining to clients why they've underperformed but to trust them – better returns will come.

Under-performance is very bad for investment managers of all stripes. Us too, but managers like us have the support of each other and clients to not feel that constant pressure. Its liberating – we can make decisions that might result in under-performance but might also deliver significant out-performance.

Perhaps a simple example is useful:

Say you currently had 85% of your portfolio in cash earning around 5%
You held some short positions on major stocks or indices

If the market fell 20% over the course of 12 months, maybe your shorts yield a 15% return, measured against total funds (depending on their specific nature).

You've also made a 5% return on the 85% of your portfolio sitting in cash.
To top it off, depending on the type of short instruments used, you might even have received interest income on your short position too!

Add it all up, maybe you've made 20% return in that 12 months when the market has fallen by 20%. Not bad…

In contrast, say the market goes 20% higher. Again, depending on the type of positions you've got, maybe you lose 10% (after interest income).

If you're right, 20% return in market down 20% - hooray – massive out-performance and very happy clients!

If you're wrong, 10% loss in a market up 20% - 30% under-performance – disaster!

Understandably, very few investment managers/advisers can ever adopt or promote such a strategy. The prospect of 30% under-performance is a career-killer.

Even if you convinced clients to have a portfolio 80% cash / 20% long equities, there's risk of significant under-performance in a rising market. If the market went up 20% you will likely have a hard time convincing that client to keep trusting you.

Conversely, if you've guided clients to be 85% equities / 15% cash and the market falls 20%, it's all good. You're wrong with everyone else and that's totally fine!

This is the key reason why most investment managers of all kinds will always assist clients achieve a return closely resembling "the market". There's not many "secrets" - out-performing the market requires strategies that may lead to under-performance. Under-performance is a recipe for client angst and loss of funds under management.

(Important Disclaimer – the above does not represent any Aviator portfolio at this point and I am not suggesting/endorsing such an "aggressive" short strategy. However, Aviator may certainly hold some positions or enter some positions described here!)

Where to from here:

Whilst reflecting on the last few months, I've reflected on some of my commentary from the last 12 months or so. As I often say, one of the things I most like about writing these missives is to create a record of thoughts – moments in time. Sometimes right, sometimes wrong, always honest.

Overall, I'm pleased with our calls.

In September 2022 I wrote a piece called "give me your best ideas". In it, I discussed the following:

Over the past 100 years or so, the markets have been within "normal times" probably 85 or 90% of the time.

The rest of the time, well, the markets have deviated significantly away from anything resembling "normal" when viewed from a trend valuation perspective.

There's been some periods where valuations have fallen well below trend although these periods have been very brief and rare – the early '80's was the last time and before then was around World War 2.

Slightly more common have been periods where valuations have greatly exceeded anything resembling "normal". The markets have spent perhaps 10% of the last 100 years at valuation levels significantly exceeding "normal".

When valuations have previously deviated far from "normal", its culminated in a market selloff that has restored valuations back towards "trend". With respect to U.S. shares, these include 1929 and 2000. To a slightly less extreme extent, extremes were witnessed in 2008 as well as in the mid '60's.

It's my thesis that several years ago, U.S. equities markets entered an "abnormal period" of extremely extended valuations. In fact, reliable valuation models show that the highs reached in 2021 have never been seen before – it was the most over-valued in the last 100 years.

As I've repeatedly stated, stretched valuations are not informative of short-term movements.

However, as just observed, all previous periods of extended valuation to the extent observed over the past several years have culminated in a decline back towards "trend" – there is no compelling reason to believe this time will be different.

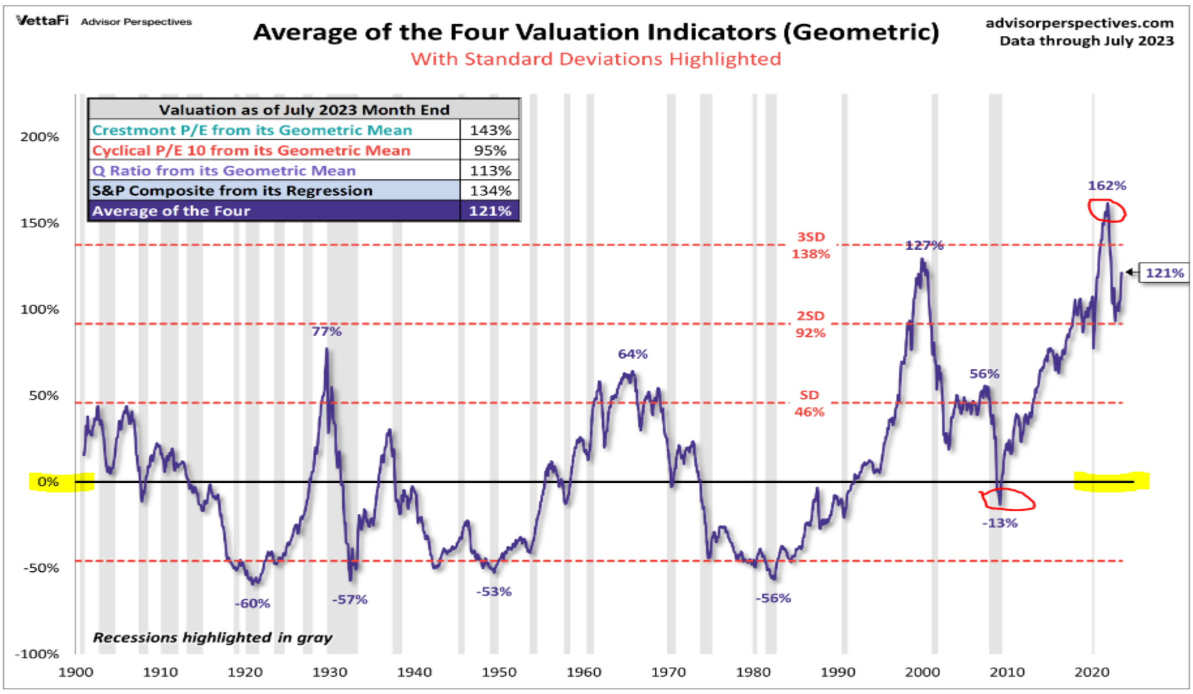
With that in mind, how about we check in on U.S. market valuations.

I frequently discuss that fact that when you look at "valuation", you need to look at the longer-term – at very least a period that spans a full market cycle. You need to look at a model that's proven to have a solid correlation with subsequent market returns. The classic "forward PE" is, well, useless – stocks aren't a claim on next year's earnings.

The team at Advisor Perspectives do us all a service in tracking and updating four models that have proven to be informative on a long-term perspective:

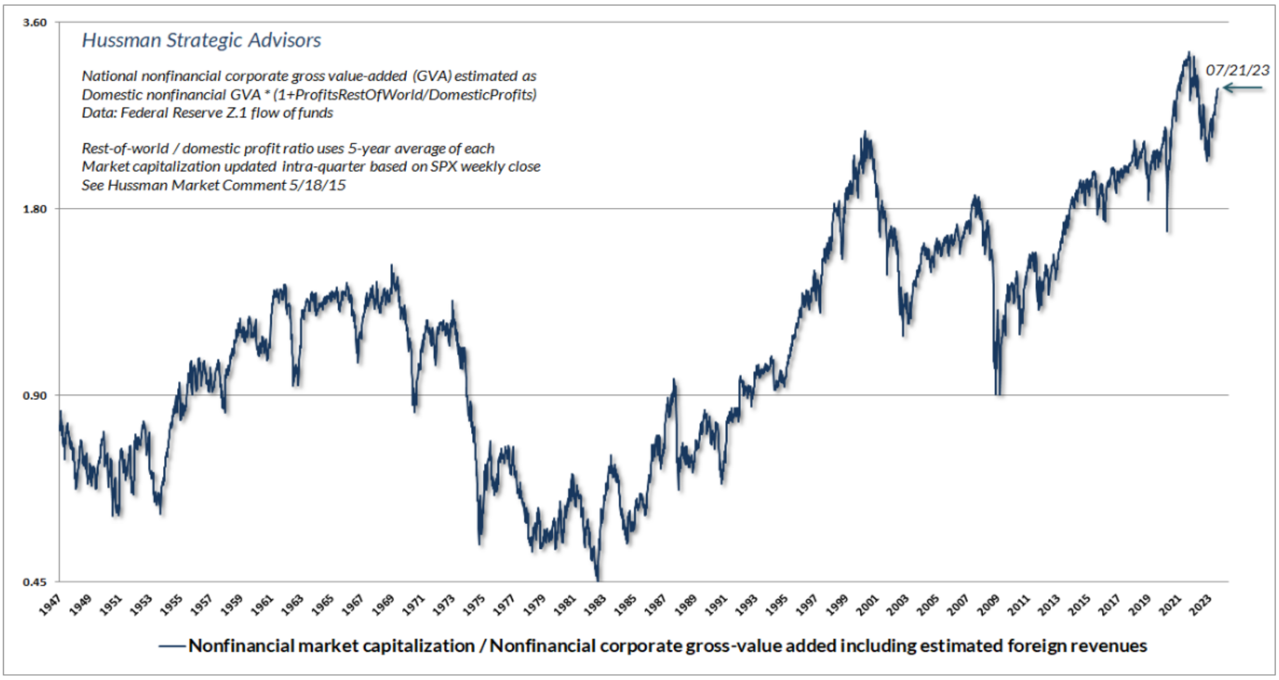
The Crestmont Research P/E ratio
The cyclical P/E ratio using the trailing 10-year earnings as the divisor
The Q ratio, which is the total price of the market divided by its replacement cost
The relationship of the S&P composite price to a regression trendline

Here's a chart of how these all look – the average of the four over the last 120 years:



I’ve highlighted there the “zero” line. Understand what this is – it’s the “average – average” – it’s the point where all these models are reporting “average” valuations. It’s a long way below current levels. (I’ve also circled in red what’s happened over the last 14-year bull market. A transition from modestly under-valued to the most over-valued in history!)

In addition to the above, funds manager and data-crunching expert Dr John Hussman also does us a big favour in sharing his decades of research into market valuation. His model below has proven to be the most accurate of all they have analysed (so far) – having a correlation to subsequent market returns in the high 90’s:



Similar to other historically-reliable models, it demonstrates that U.S. equity markets are about as over-valued as they have ever been in modern history.

All these models indicate a substantial decline is necessary to restore markets back to something that resembles “normal”. It’s uncomfortable to even discuss because the scale of declines required are absurd – in the order of 50 to 70% needed just to get back to “normal” – we won’t even contemplate the prospect of “under-valued”.

I’ve described multiple times in the past few years what all this means. It doesn’t mean markets must fall a lot right now. It means that future average returns are going to be poor.

(That said, for what it’s worth, market history shows that periods of significant over-valuation have generally been resolved via a significant fall…)

Could this be wrong?

Of course, this assertion might turn out to be wrong. But understand that if you believe that, you basically believe one of three things (or a combination thereof). Below, I've laid out the three options:

Option 1:

I just… I don't believe you… These "models" don't seem to have offered anything useful to investors for at least 14 years. I don't believe markets are nearly as over-valued as you suggest. By focusing on these models, I think you're just… wrong…

Option 2:

It's my expectation that due to [insert your reasons] corporate earnings growth is about to explode higher at a rate that has never been seen before. In other words, I believe that the market will soon "grow into" current valuations.

Option 3:

Things change… The world is always changing. The investment world included. The models are indisputable – that's been "average" for a hundred plus years. But investors are clearly willing to pay higher than historical valuations for shares. I believe that's part of the modern world and this will continue. I believe that when you look back in 50 years, that "average value" line will have shifted significantly higher. Regarding Hussman's model, I believe it will continuously under-estimate actual returns and its correlation to subsequent market returns will significantly reduce over the next 50 years.

In April of this year ("something to believe in") I said the following:

What we believe:

We believe in market cycles

We don't believe the "cycle" ended and re-set during Covid

We believe a continued unwinding of the excesses that have built up over the last 14 years of misguided zero interest rate policy will deliver more negative "surprises"

We believe that history is a reliable guide to future events

We believe in "normalisation" rather than endless extrapolation

We believe that opportunities are much easier to make up than losses

Most of all, we believe that strenuous valuations hover over the market like a giant slab of concrete suspended from a fraying rope. Not only does this cap upside potential – the rope can break at any time with little warning, doing significant damage to any unsuspecting share portfolio milling around underneath.

To repeat one of my favourite catchphrases – it's really hard for investors right now.

Yes indeed – it's really hard for investors right now. Depending on what you believe, longer-term average returns will be poor. Short-term returns are uncertain with history suggesting a significant decline in markets is very possible.

What should you do with regards to your portfolio? Anything?

Well, that depends on what *you* believe.