Andy's View

August, 2023

FOMO All the Way Down

FOMO All The Way Down

In August of 1979 Business Week famously (or infamously) proclaimed "The Death of Equities." The stock market had delivered negative real returns for more than a decade. Individual investors had fled the market in substantial numbers and new rules had just been issued to allow pension plans to invest in a broader swath of assets. In order to stay ahead of inflation, the now accepted wisdom held that portfolios needed substantial exposure to commodities, real estate, and even collectibles. It wasn't merely that equities had failed in practice as an inflation hedge, but even more, a strong fundamental explanation emerged: in an inflationary environment historic cost accounting yielded illusory inventory profits and insufficient depreciation expense. Companies were then taxed on profits that were not real.

The death of equities story turned out to be ill-timed as equities soon entered a decades long run of overperformance. Many factors contributed: compelling valuations, disinflation, increasing participation, a more favorable regulatory and tax environment, a new emphasis on shareholder value and the empowerment of "corporate raiders." By the mid-eighties there was very near universal acceptance of the idea that long term investors needed to hold substantial equity positions, and the longer the time horizon the heavier the weighting should be. Although it is manifestly and demonstrably false that equities outperform all other assets over all intermediate time periods, that proposition is often repeated and quite widely believed.

I've never really been a fan of equities. In part it's because so much that is said about them is simply false. But more critically, I've never been satisfied with the mechanisms for aligning management and shareholders' interests. In the absence of meaningful control, the common shareholder is nearly always dependent on selling his shares to a future buyer. In the modern era, with vast pools of capital available in the private markets and a myriad of disadvantages in being public, the only reason to bring a company public seems to be a hope for gross, extreme overvaluation.

In a remarkable research paper by Hendrik Bessembinder, performance of all publicly trade equities from 1926 to 2016 is analyzed. All of the return in excess of the 1-month T-bill rate that equities delivered came from 4% of the stocks, and fully half of the total wealth creation came from the top 1% of stocks by count. Stated another way, fully 96% of publicly listed stocks "collectively generate lifetime dollar gains that matched gains on one month Treasury bills." Investors believe that a diversified stock portfolio gives them broad participation in economic growth and American prosperity. That belief is wrong, or at the very least ahistorical. A stock portfolio is a collection of lottery tickets.

It is a certainty that over the next ten or twenty years a handful of businesses will do extraordinarily well, and their shareholders will reap exceptional rewards. It is much less certain whether those rewards will be sufficient to erase the underperformance of the overwhelming majority of equities. It is close to a mathematical certainty that the mega-cap tech stocks which comprise a quarter of the index are too big for extended outsized exponential growth.

The trends which became apparent in the 1980's that were so conducive to the resurrection of equities now all appear to be reversing. Add to this declining populations in the developed world and there is a strong argument that the prudent allocation to equities is zero. No mainstream investment will make this argument. I sit on the investment committee for a large Minnesota hospital system with several hundred million dollars in retirement and endowment accounts, and I don't make the argument there. I restrain myself because I know I will not prevail. The owners of Apple shares almost certainly know that the performance of the shares in the next twenty years is far, far more likely to resemble the last performance of IBM, Intel, or Cisco than Apple's own performance. They own them anyway. They know that Cisco went to 100 times earnings in 2000. No one can say that couldn't happen to Apple. Missing such a move (while all around them are celebrating) is simply an acceptable risk, whereas the stock languishing for twenty years is completely tolerable. It's not actually greed; its not naivete; its FOMO. I should add that I have made the modest suggestion that the hospital replace its S&P index exposure with an ETF of the equally weighted index.

The theoretic justification for this equity mystique is CAPM and its followers. There is a mountain evidence of the theory's failures, however. Much of what people imagine to be empirical support for the mystique collapses under careful analysis. So, I say i's FOMO all the way down. In 1987, I mistakenly thought the October crash would cause people to rethink the shibboleths fed to them by the financial industry. But shock does not kill FOMO, only exhaustion. Is anyone afraid of missing the next big rally in Japanese equities? Mark your calendars for August of 2033 and look for Bloomberg (the current owners of Business Week) to once again observe that a decade has passed and equity investors are disappointed.

In the current environment, the AAA tranches of CLOs (where there has *never* been a default) yield over 7%. With some thought and a little digging, it is possible to construct a fixed income portfolio with an expected 8% return with both less volatility and less left-tail exposure than the traditional 60/40 mix.

Andrew Redleaf