Risk is the four letter word

This is the time to trim risks. There are multiple reasons to be cautious now. However, one of the most difficult things is to look at your portfolio statements from last year. Some of you have made almost 20 percent on your year-over-year return. Why would you want to stop making 20 percent? Adjusting your portfolio by adding more bonds and alternative investments would reduce your return in the short term. There are compelling reasons to adjust for risk. For one, the investment market has been on a tear and there is practically no correction of more than 5 percent since the beginning of 2015.

When was the last recession? 10 years ago? If we look at market cycles this is the second longest up market in history. In common sense, we know we are closer to the end of the up cycle than the beginning. There is the Trump factor, the FBI probe, the firing of FBI Director Comey, the talk of impeachment and the latest ditching of the Paris accord. There is a crazy person in North Korea that is threatening our existence. We also have a Europe that is facing a split that is looking more and more like a nasty divorce.

Let us examine some of the risks we are facing.

Political Risk

During the dates of May 16 and 17 if you recall those are the days where FBI Director Comey was fired and the President was under the suspicion of "obstruction of justice." A report on Business on May 18th tells us what happened to the investment market. Tim Shufelt, one of the experienced Globe and Mail writers has this to say in his article "Markets plunge amid U.S. turmoil."

"The turmoil engulfing the White House rattled the world's financial markets on Wednesday leaving investors to question whether markets can remain resilient to U.S. political turbulence."

A textbook risk-off trading session on Wednesday saw stock benchmarks around the world suffer through their worst day in eight months, while government bonds and gold prices rose, as investors fled to safety. The sell off ended a long streak of tranquility in global equities that stood in contrast to the discord emanating from Washington.

"One has to wonder if Mr. Market is either in denial or merely clueless as to what is going on and how this is going to affect the so-called pro-growth agenda going forward." David Rosenberg, chief economist at Gluskin Sheffield + Associates, wrote in a note to clients. On Wednesday, the market tuned in. Major stock indexes in Canada, the United States and Europe fell by between 1.6 per cent and 1.8 per cent making for the worst trading session since September 2016.

The cascade of scandal surrounding U.S. President Donald Trump has the potential to hold the market's attention well beyond single trading day. Peter Carrillo, chief market economist at First Standard Financial, said in a note on Wednesday. "We think the situation is likely to change as this crisis leads to an interruption of the pro-growth White House agenda, deflating the Hope Rally," Mr. Carrillo wrote. Otherwise known as the Trump Rally, the Hope Rally is a banner that's been applied to the rise in stock prices since Mr. Trump was elected last November.

This event indicates that political risks can move the market. Protection of the possible downturn needs to set up as part of our portfolio structure."
Corporate Earnings Are Lower Than Stock Prices!

David Rosenberg chief economist for Sheff+ Gluskin associates, a regular Financial Post contributor, has written an important insight piece. Let's look at what he has to say in his article “Why the U.S. corporate earnings narrative is more than a little disingenuous” on May 26, 2016.

"So here is the conventional view on the U.S. Corporate earnings backdrop: Profits are booming. Not only have operating earnings come in far above expected, but the 14.5 percent YoY pace is strongest since the third quarter of 2011. And at $123 (the current four quarter S&P 500 earnings per share sum), we are back to a new peak!

This is just a tad disingenuous. And I'll tell you why.

First, while it is true that earnings are at a new high, since the last peak nearly three years ago, the S&P 500 has soared 22 per cent while profits have risen just 7 per cent. At the same time, one could reasonably have said the stock market was fairly valued. But since then, with price returns tripling profits, the market now is supremely overvalued. In fact, the most overvalued in 15 years, and that includes the housing and credit bubble peak of 2007.

Second, I find it amazing as well as amusing that the cheerleaders are talking about how great earnings are when they are so woefully below the estimates that the consensus analyst community was forecasting years ago.

Indeed, let's put the current $123 earnings per share (EPS) figure for the past four quarters into some much-needed perspective.

In early 2014, the consensus for 2015 was $133 for operating earnings. This was the estimate for two years ago and here we are n 2017 and earnings per share is still some $10 below that level... that we were supposed to have cleared years ago!

In early 2015, the consensus for 2016 was $136. Incredible. Today we sit $13 south of that and the shills are going wild over how superb the earnings environment is. You can't make this stuff up. Then in early 2016, a year ago, the consensus forecast for 2017 was $138. And here we are at $123.

And in January of this year, the consensus forecast for 2017 was $133, so if you notice, once-lofty expectations are receding once again. As of this month, this year's EPS estimate has dipped further to $132 even as Q1 beat expectations.

To reiterate, the current consensus for S&P 500 earnings for this year of $132 is the same estimate provided two years ago. Imagine that. We have only managed to come back to where we were in early 2015 on this year's earnings forecast. And yet, even though profit forecasts are no different now than they were back then, the stock market is up 17 per cent.

Moreover, as I said we are now at $123 EPS for the past four quarters.

Consider that this was the 2015 projection by the analyst community published three years ago, and since that time, the S&P 500 has rocked and rolled by nearly 30 per cent. A surge in prices even though today's level of earnings came two years later than the brilliant gurus had forecast would happen.”

This is truly a case of over stating the value of the overall market.

Are Low Volatility Low Risks in the Market?

Another risk we are facing is the low volatility of the market. Back in the days of 2007 and 2008 there were many 100+ point movements and we all got scared and we stayed alert. These days we are seeing 5 or 6 points movement in a day and usually the market moves in less than 50 points range per day. It is downright boring. But does boring means there's no risks? Dean Cornett has written a piece in the Globe and Mail that points out the danger of complacency in his article “Low volatility is market’s most significant danger” on May 26, 2017.

"A terrorist attack last week at a concert in the U.K. Killed more than 20 people and injured many more. North Korea continues its provocative ballistic missile tests. A huge cyber-attack affected 200,000 computers in more than
100 countries. The U.S. President fired the FBI director, leading to questions about whether he obstructed justice and even raising the spectre of impeachment.

In normal times, one would expect these turbulent events to be reflected in volatility in asset prices. But these times—when financial market outcomes are being suppressed by overriding forces of monetary policy, money flows and investor expectations— are not normal. There is a particular risk that investors construe the substantially low readings of volatility as signs that market conditions are benign, when, in fact, they are not.

Of all the dangers in the world of finance, the enduring low level of market volatility is the most significant. How quiet is quiet? Recently, the six-month realized volatility for the S&P 500 dipped to 6.7 per cent, lower than even the period leading up to the financial crisis of 2008-9. During the mid-’90s, volatility was as low as it is now, but the size, complexity and interlinkages of financial market exposure were far less significant. Now, fluctuations are severely muted, and thus send a false signal of safety to both investors and policy makers who misread the calm as an “all clear” sign, dismissing the events above as insufficiently relevant. The result is an inability to appreciate how quickly market conditions can change, especially as trading strategies that capitalize on quiet markets become vulnerable to unwind, serving to amplify a risk-off event.

Today’s risks differ meaningfully from those of a decade ago. However, the excess amount of capital chasing opportunity at increasingly aggressive terms is similar. The competition to put money to work, then, like now, results in low volatility. Investors are in danger of misinterpreting this tranquility as conveying safety when crowded positioning is resulting in more not less, risk. While spending money on hedging is especially difficult in a seemingly benign environment, investors should be actively vigilant to market risks, devoting time to an action plan that helps protect portfolio wealth against the inevitable return of volatility.”

Our decision is whether we are to maximize profits and increase the value of our portfolio as aggressively as possible or leaving some money for the brave and begin to lower our overall risks. If you are able to preserve your wealth, you will live to see another day. If you risk too much, the days of 2007-8 will repeat again. History repeats itself again and again and again.

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