Trust & Financial Services

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QUARTERLY MARKET INSIGHTS – THIRD QUARTER 2022

To the Clients and Partners of Hilltop Trust and Investments:

When you start law school, one of the first adjustments you have to make is to the Socratic method of teaching. As you might guess from the name, this method has a long, historical tradition.[1]

At its base, the method requires the student to engage in something like an oral examination with their professor. In the classic law school example, a student is randomly selected and asked to recite the facts of a case they were supposed to have read before class. If you are able to do that successfully, the professor will then ask you to explain the legal issues at hand, the reasoning the court applied, and the decision it reached. At that point (if the professor still believes you did your reading), the Socratic method really begins.

If you tell the professor that the case was properly decided, you will get a series of probing questions designed to convince you that the court was subject to some crucial error of judgment. If you tell the professor the case was wrongly decided, the questions will make you wonder why you ever thought you were smarter than the justices of the Supreme Court. This all takes place in front of the class, and is generally a pretty harrowing experience for new students. It is not, however, without purpose.

What the Socratic method does for these students is train them to "think like a lawyer". That is, to collect all the facts, see all sides of an issue, weigh the reasoning for each, and develop a view of the best possible decision. As it turns out, this is also a great way to approach thinking about investing.

First, collect all the facts you can. Whether it's economic data, historical movements of asset prices, or human behavior in market settings, it can all be helpful. Next, make sure you understand all sides of the issue. Like in a court of law, every transaction in the markets has at least two sides: A buyer and a seller. If you are going to be a buyer, make sure you understand why the other side is trying to sell. If you are going to be a seller, understand why someone else has your opposite viewpoint. Eventually, once you've got the facts, understand the issues, and applied your reasoning, the market will tell you which one of you is correct. It always renders a decision.

Facts, issue, reasoning, decision.

The Facts

As we've discussed in this newsletter before, the US economy is increasingly likely headed for a recession. As we have also discussed in the past, the reason a recession is becoming more probable is that the Federal Reserve (referred to by its shorthand "the Fed") is going to need a recession in order to rein in inflation.

In order for inflation to revert to more normal levels, there needs to be either an increase in supply, a decrease in demand, or both. The Fed has very little ability to control supply (supply is controlled at the micro-level of hundreds of thousands of business decisions made every day, the dynamics of the labor market, and our ability to move goods and services through supply chains). In contrast, the Fed can manipulate the lever of demand. It does this by raising interest rates, which generally make it more prudent to save and more expensive to purchase. By pulling this lever, and decreasing demand, the economy will eventually reach a level where fewer purchases are being made, less business is being done, and a recession occurs.

Much of the decline in prices we have seen so far this year has been the market pricing this recession in, as it begins to look more and more probable.

[1] The tradition is mostly torturing students. A second adjustment you have to make is actually reading the footnotes.

The Issue

Once we establish that a recession is coming (if not already occurring), and the market has priced it in (at least partly), the issue we have to consider is how best to invest. Our options include pulling out of the market altogether, trying to time the bottom of the market, or maintaining each of our long-term investment strategies.

The Reasoning

Since we can't all meet up in a classroom for our own Socratic lecture, the best we can do is administer it to ourselves. You may already have an idea where you fall regarding our issue, but even so, you may find the following hypothetical instructive.

Imagine a market in which we have invested at a price of $100. Over the past 100 years, that market has appreciated in value by about $6 per year. For reasons beyond any of our control, we now find that this year the market is suddenly only worth $80.

I am sure it's obvious enough that if we choose the option of pulling out now, we will lock in a $20 loss (and forego those future years of $6 returns that would have gotten us back to $100 in just 3 and 1/3rd years).

What if, instead, we pull out at $80 and decide we will buy back in at the bottom? What is the right level at which to reinvest? If the market turns around, and increases to $85 is that the signal we were looking for? Let's take the example of two investors - The Buy-and-Holder, who bought at $100 and stayed invested, and the Market-Timer, who sold at $80 and bought back in.

On the one hand, if the market declines again after that, say to $70, Buy-and-Holder has lost $30, while the Market-Timer who sold at $80 and bought again at $85, has now lost $35. The market rules in favor of the Buy-and-Holder.

On the other hand, even if the Market-Timer were correct about the turnaround, and the market goes back to $100, the Buy-and-Holder has now lost nothing, earning a $0 return. The Market-Timer who sold at $80, and bought back in at $85, maintains a negative return - they lost $20 on the ride from $100 to $80, and regained only $15 on the recovery. The market is still in favor of the Buy-and-Holder.

Finally, you might have noticed that the Market-Timer who sells at $80 and buys back in at $85 has actually invested more than $100. After taking the first $20 loss, that investor now needs to come up with $5 more than what they received from selling to buy back in. What if our Buy-and-Holder has the same $5 extra, and spreads it out over time in our volatile market? If they reinvested one third of that $5 over the whole course or our hypothetical market movements, maybe one third when the market was at $90, another third when the market drops to $80, and the final third when the market drops to $70?

It turns out that if one third of that $5 was invested at each of $90, $80, and $70, when the market recovers to $100, our investor now has actually produced a gain of almost 1%.[2]

The Decision

Just as a legal argument ought to be backed up by precedent, we can look at what's happened in the markets' past and apply it to our issue at hand to see if it supports our reasoning.

In each of the market rulings for our Buy-and-Holder above, you likely noticed that the hypothetical always includes a market recovery. That's because one thing, of which history makes us confident, is that the market will eventually recover. Five years after the 2008 financial crisis, the cumulative return of 60% stock/40% bond portfolio was +82.6%. Five years after Black Monday, in October, 1987, the cumulative return was +90.1%. After the savings and loan crisis it was +59.2%. Even after the dot-com crash in 2000, such a portfolio was worth +10.3% more after five years. Eventually markets recover.

Next, I am sure you realize that there are possible combinations of returns in which our Market-Timer nails the call, and actually does come out ahead. What precedent shows us, however, is that the Market-Timer pulling that off is extremely difficult. The margin for error is just too small. From 1928 through the end of last year, there were 23,300 trading days in the U.S. markets, which resulted in an annualized return of 6.2%. If you missed just the 10 best days in that period, your annual return would already be down to 5.0%. If you missed the 20 best days, your annual return would be only 4.1%. If you missed the 30 best days, your annual return was down to 3.3%. Mistiming the bottom of the market by just a month can cut your future returns almost in half.

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[2] For those interested, our investor earns a 10% return on the $1.667 invested at $90, 20% return on the $1.667 invested at $80, and 30% on the $1.667 invested at $70. The extra $5 invested has an ending value of about $6. The account's total ending value is about $106 vs. the total invested of $105.

Now that we have collected the facts, looked at our issue from all sides, and applied our reasoning supported by precedent, we can present the case that the best way to invest in this market is to be the Buy-and-Holder, and maybe even reinvest a little as we can. After all, a down market doesn't only give us the chance to make the mistake of locking in past losses, it's also an opportunity to lock in future gains.

Best,

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