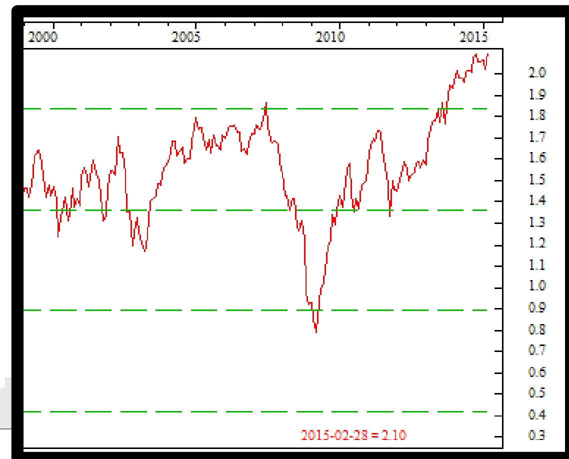
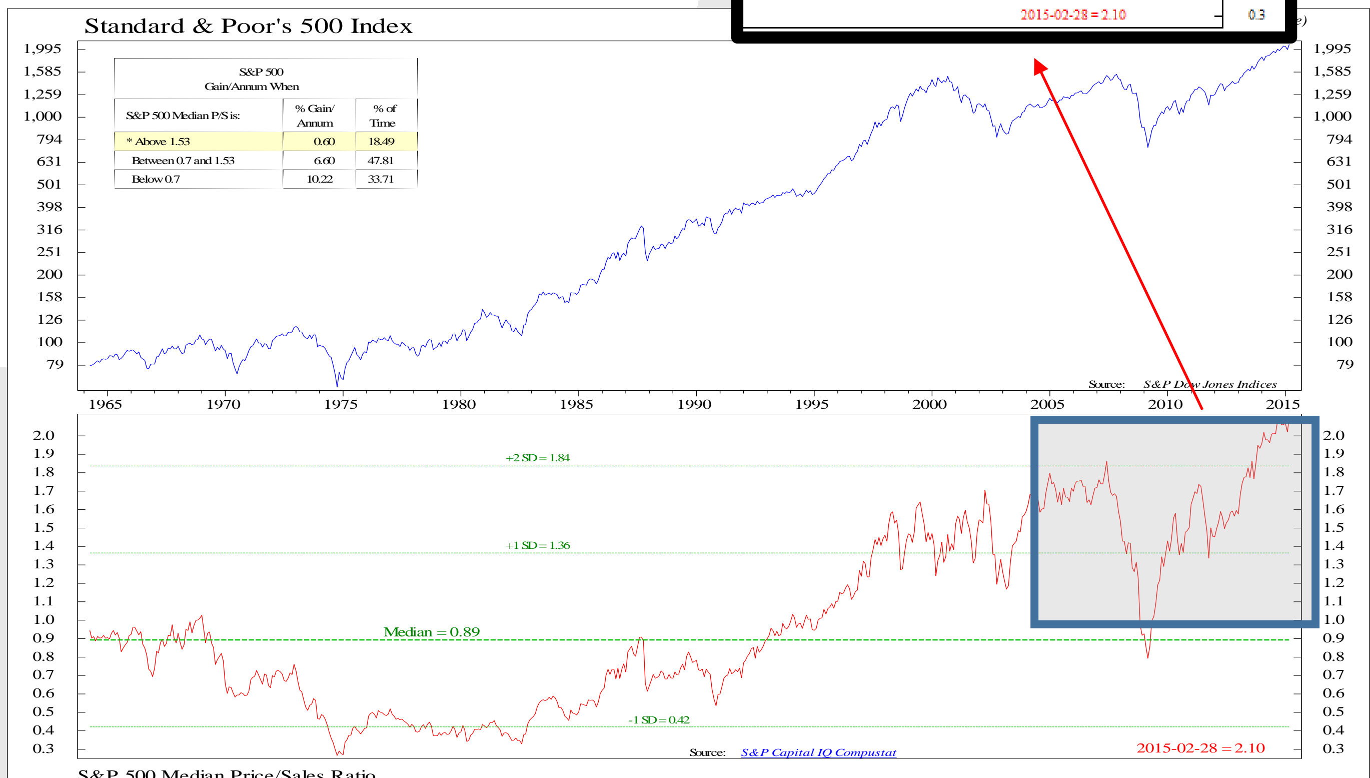
Long Only – What Could Go Wrong?

Why would an investor want a risk-averse strategy in their portfolio in these markets? Why not just buy an indexing product? In 2014 passive US equity funds saw $166.6 billion of inflows.[1] A recent news headline read: "Relax and let passive funds do the work." Unfortunately, if you look through the lens of history, the time to invest in passive funds was five years ago, not today.

Currently, what are the market fundamentals telling us? Most managers look at traditional measures of valuation including price-to-earnings, price-to-book, etc. Below is a chart of the price-to-sales ratio, which is at record levels, exceeding both the 2007 peak and the bubble peak of 2000.

Based upon price-to-sales ratio, prices have never been more expense.





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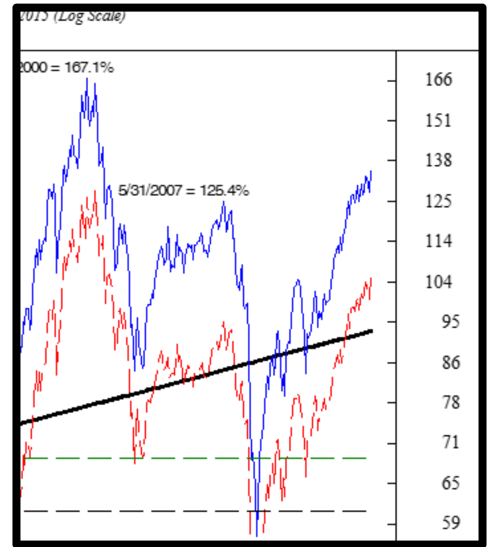
1. Morningstar direct

Chart Source: Ned Davis Research

Stock market capitalization as a percent of GDP has also exceeded levels seen at the 2007 peak and are approaching those of the 2000 bubble. This long-term valuation indicator is sometimes referred to as the "Buffett Indicator". Buffett was quoted in a Fortune magazine interview saying "it is probably the best single measure of where valuations stand at any given moment."



Monthly Data 12/31/1924 - 2/28/2015 (Log Scale)

Stock Market Capitalization as a Percentage of Nominal GDP

Source: Ned Davis Research, Inc.

NDR Estimated value of 4000 U.S. common stocks:	$23.90 trillion
U.S. Nominal Gross Domestic Product (latest figure):	$17.70 trillion
Current ratio for 2/28/2015 (blue line):	135.0 %
Value of S&P 500 Index constituents:	$18.67 trillion
U.S. Nominal Gross Domestic Product (latest figure):	$17.70 trillion
Current ratio for 2/28/2015 (red dotted line):	105.5 %

Linear regression trendline
2/28/2015 = 92.7%
(----)

8/31/1929 = 85.7%
11/30/1936 = 70.7%
6/30/1932 = 26.3%
4/30/1942 = 18.9%
Norm Since 1925 = 61.0%
11/30/1968 = 73.8%
12/31/1965 = 69.5%
1/31/1973 = 76.8%
Very Overvalued
Very Undervalued
9/30/1974 = 35.2%
7/31/1982 = 31.4%
10/31/1990 = 42.0%
3/31/2000 = 167.1%
5/31/2007 = 125.4%
2/28/2009 = 57.6%

NDR Estimated Fixed-Weighted GDP December 1924 - February 1946
Chain-Weighted GDP used after February 1946

Calculation uses NDR Estimated Common Stock Market Capitalization of U.S.-based Companies
Dow Jones Total Stock Market Capitalization used from January 1973 through September 1980
NYSE Market Capitalization used prior to January 1973

Concept Courtesy: Jim Bianco

166 151 138 125 114 104 95 86 78 71 65 59 54 49 45 41 37 34 31 28 25 23 21 19

1925 1930 1935 1940 1945 1950 1955 1960 1965 1970 1975 1980 1985 1990 1995 2000 2005 2010 2015

(S702)

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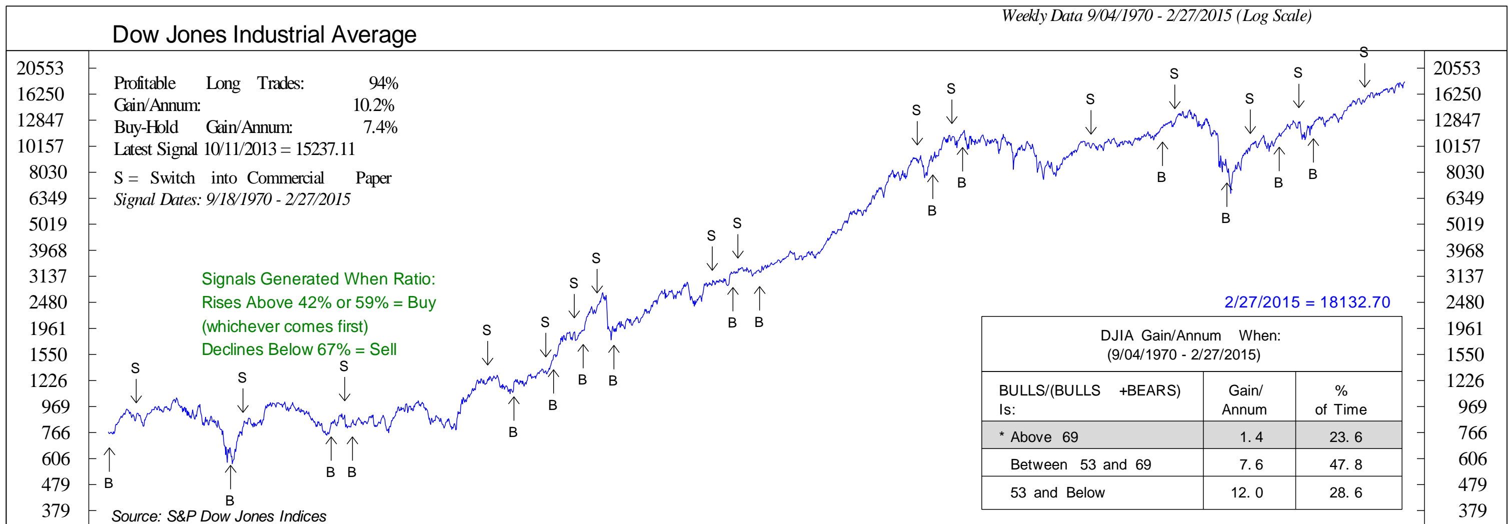
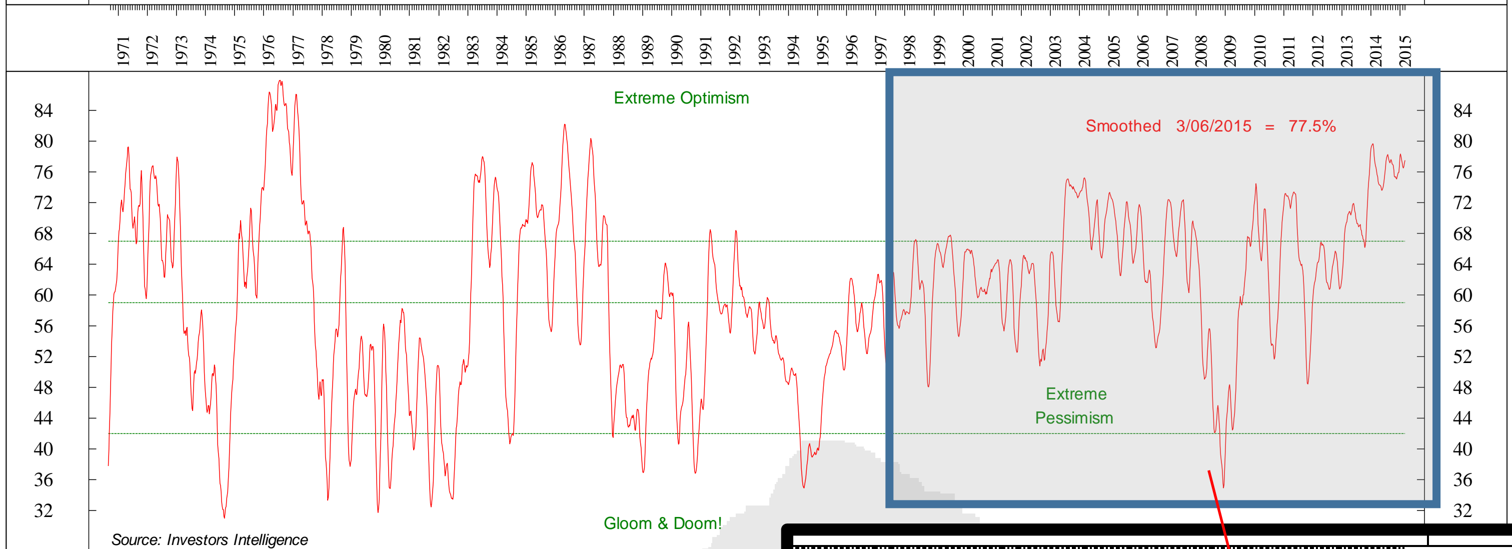
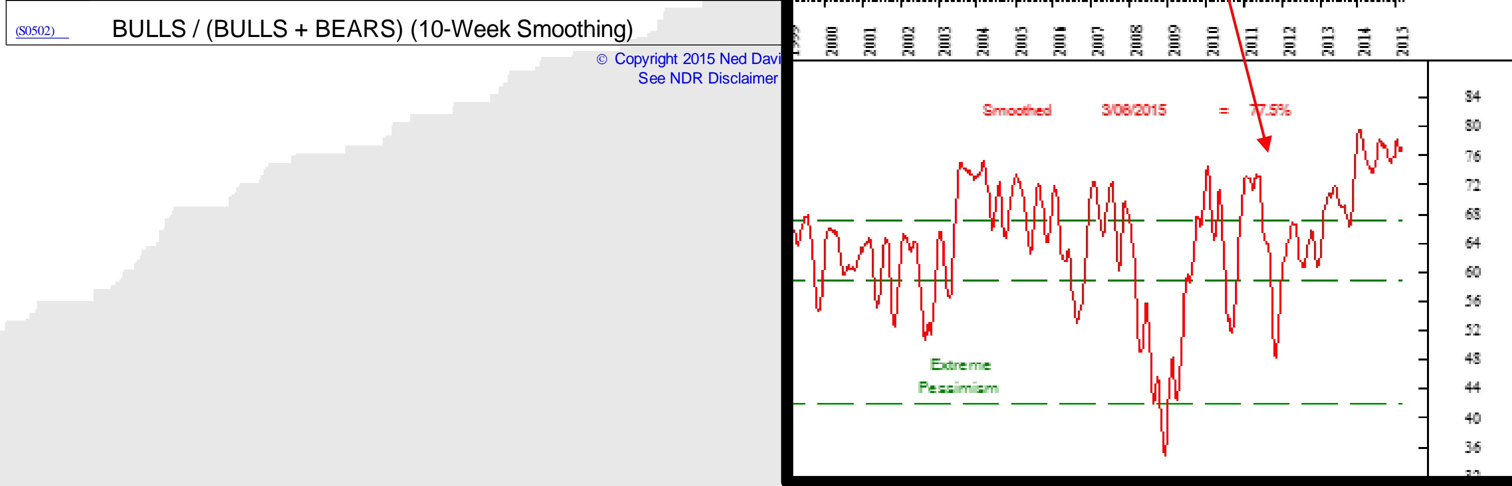


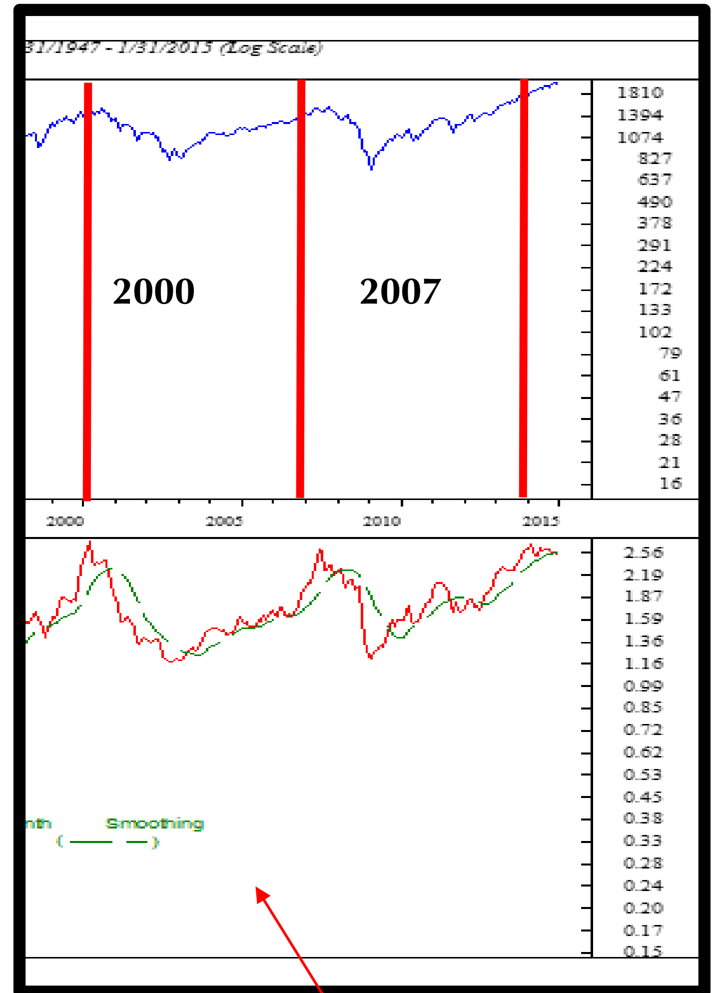


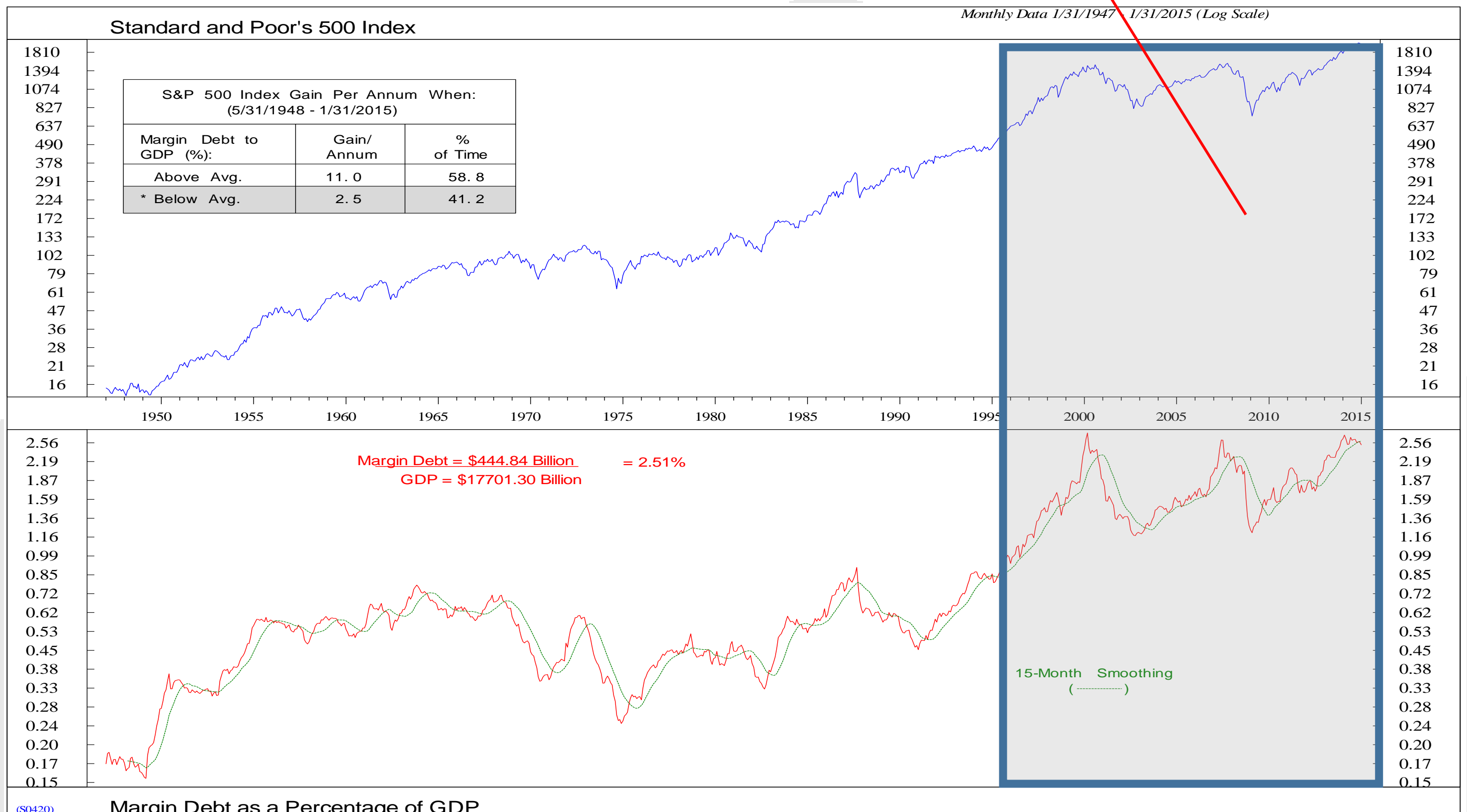


The “wrong-way crowd” consistently makes bad investment decisions, they buy high and sell low. A common longer-term measure of investor sentiment is when stocks are being well embraced by the public. Markets tend to reflect group psychology, for example, market peaks tend to coincide with extreme optimism. As seen in the above chart, currently optimism levels are exceeding the levels from the 2000 bubble and 2007 peak.

Chart Source: Ned Davis Research

Margin debt as a percent of GDP today is matching the levels seen in 2000 and 2007. Typically, in an up-trending equity market margin debt rises. However, it can be an early warning signal as it starts to turn down. Historically margin debt will roll over in front of an ultimate peak in the market.





S&P 500 Index Gain Per Annum When: (5/31/1948 - 1/31/2015)

Margin Debt to GDP (%):	Gain/ Annum	% of Time
Above Avg.	11.0	58.8
* Below Avg.	2.5	41.2

Chart Source: Ned Davis Research

Standard & Poor's 500 Stock Index

Daily Data 1/13/1994 - 3/03/2015 (Log Scale)

S&P 500 Gain/Annum When:		
Indicator in Bottom Clip:	Gain/ Annum	% of Time
* Above 82.5	-6.4	15.5
Between 50.5 & 82.5	1.8	68.1
50.5 and Below	52.2	16.3

Bear Funds = Rydex Inverse S&P 500 + Dynamic OTC + Inverse Dynamic S&P 500 + Inverse Dynamic OTC + Inverse Small Cap + Inverse Mid Cap + Inverse Dynamic Dow

Bull Funds = Rydex Nova + Dynamic S&P 500 + Dynamic OTC + OTC Assets + Russell 2000 Advantage + Mid-Cap Advantage + Long Dynamic Dow

Source: S&P Dow Jones Indices

5-Day Smoothing

Excessive Speculative Optimism

Extreme Speculative Pessimism

Source: Rydex Funds, www.rydexfunds.com, past performance is not indicative of future results.

3/03/2015 = 92.0%

(S0572A) Rydex Bull Funds Assets / Rydex Bull + Bear Funds Assets

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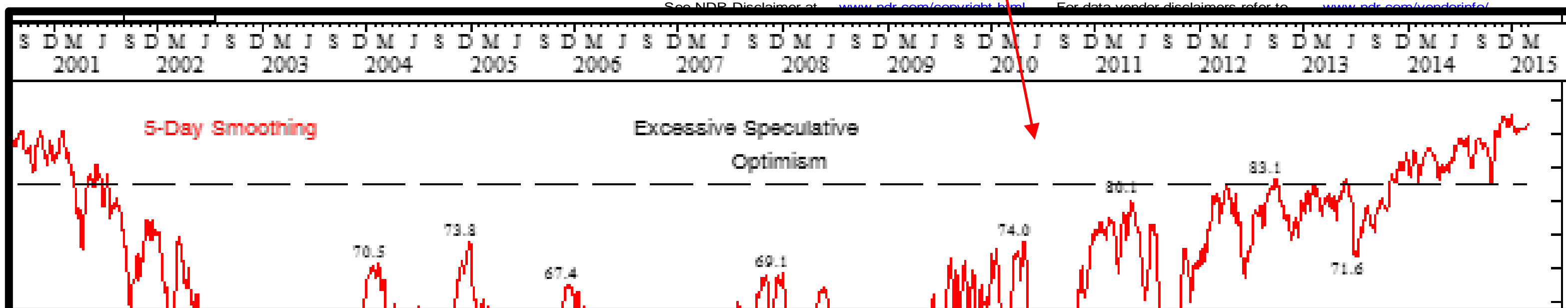
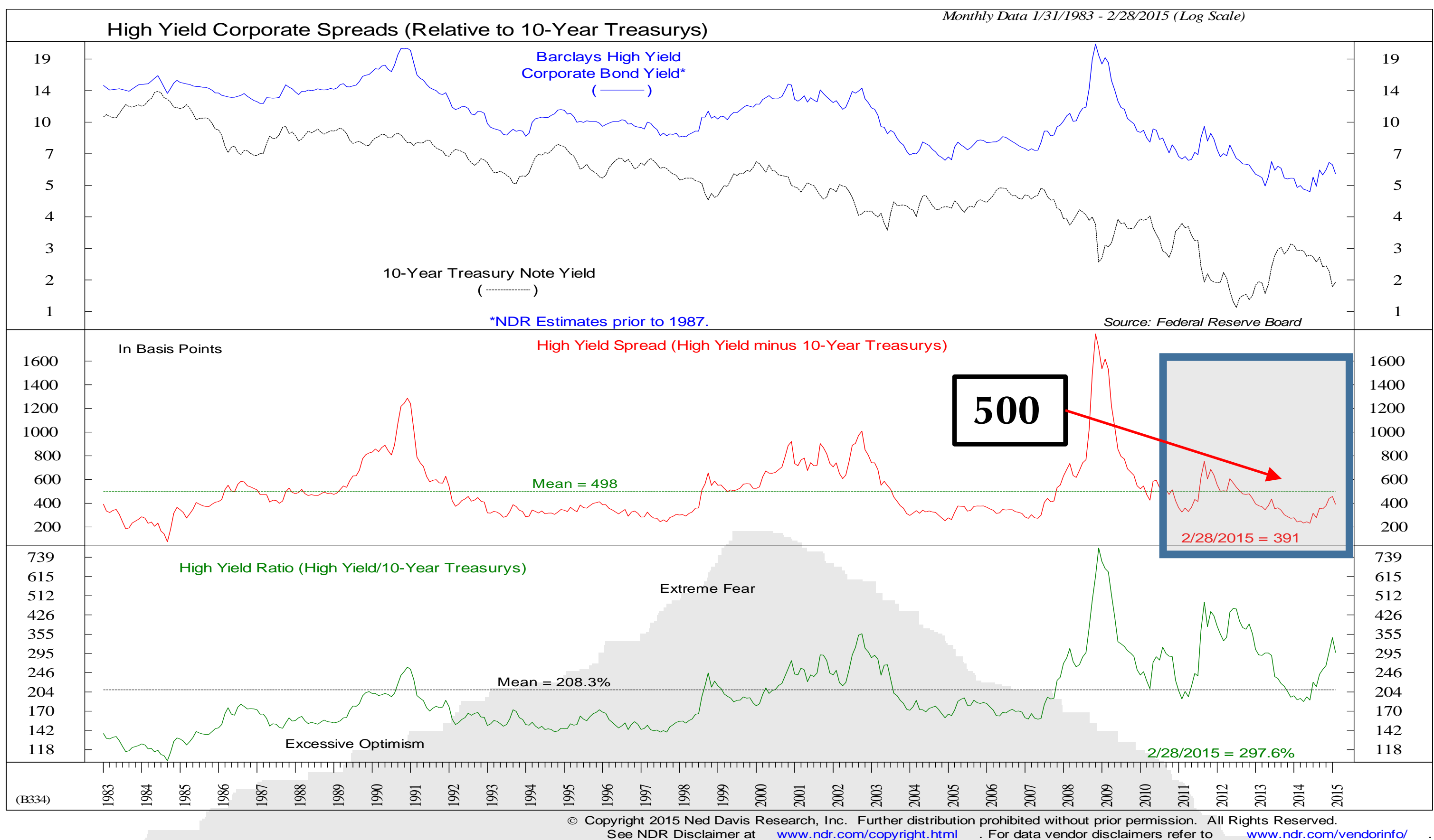


Continuing with the investor sentiment theme, Rydex Funds measures the ratio of assets invested in bullish funds to those invested in both bullish and bearish funds. Today this ratio has never been higher, indicating an extreme in bullish sentiment among mutual fund investors.

A classic example of mutual fund investors getting the timing wrong are in Q1 of 2000 when the S&P 500 had a 37 P/E multiple and the Nasdaq had a multiple of 45 and that excluded all of the companies losing money. Mutual funds saw a record inflow right at the market peak. Another example is in 2002, at the bottom of the market cycle there were record outflows. The little guy gets hammered every time.

Chart Source: Ned Davis Research

With all of that said, one may ask "What could be the trigger for the next move south?" Traditionalists would argue that monetary factors will drive the direction of the market. At this time, we are exiting a period of unprecedented monetary ease. With tightening monetary factors on the horizon we remember that typically tightening produces difficult environments for equity markets. Another useful indicator is credit conditions which help forecast a major decline or recession. In the following chart, credit spreads are widening beyond 500 basis points, which typically are levels that has produced a recession. So currently we are in the danger zone.



Now is the time to have a risk managed strategy in your portfolio. In a historical context, the time to implement a buy and hold passive index strategy would have been 5 years ago, not today. Yes, hedging looks expensive on the surface and may have seemed unnecessary in the recent past. But use history as your guide and determine if you want to hold on for the ride or think about managing the systematic risk that is rising like a king tide.

Chart Source: Ned Davis Research