Cumberland Private Wealth Management Inc.

Three principles for staying a step ahead of the market

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Introduction

The 2008 financial crisis was scary. So was the 2011 European crisis, the 2000 tech collapse, the 1987 market crash and the 1974 recession. Media pundits warned that the markets may never recover. Fearful investors ran for the exits. Yet, in each case, markets regained their equilibrium in relatively short order, producing stellar gains along the way.

The question is why do some investors sell at the bottom while others get into position for a recovery? And why do most sit on the sidelines while a select few profit from historic rebounds? We believe successful investors have sound investment principles to guide their decisions and the experience to act with confidence.

At Cumberland, we've been refining our investment principles through more than four decades, including five major economic cycles and innumerable ups and downs in the market. These principles have given us the courage to capitalize even while others are afraid and keep our clients a step or two ahead of the market for a very long time.

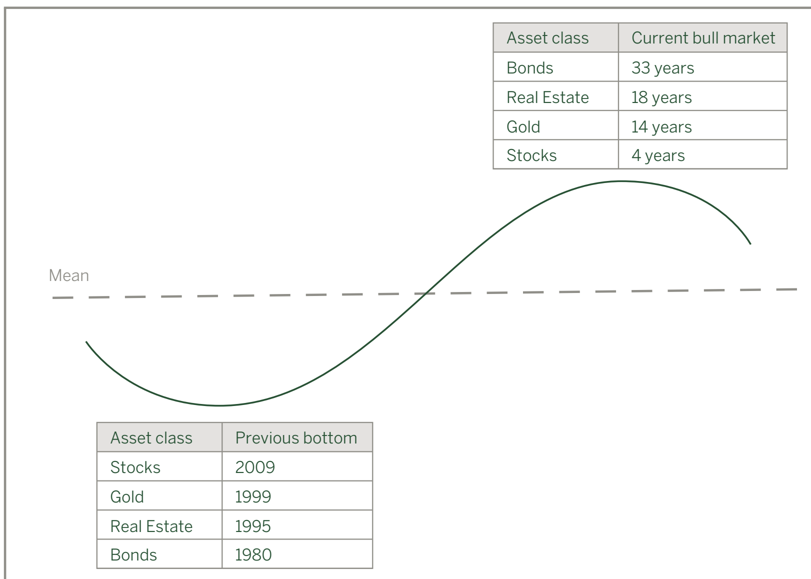
Here are three of those principles.

Principle #1

Values Revert To The Mean

Greed can push market values to record highs and fear can drive them to new lows. But eventually, these trends change direction and market values revert to their long-term average or mean.

This chart illustrates the long, arching trends of stocks, bonds, gold and real estate over the past few decades. They have all seen highs and lows at different times. Astute investors sell when prices are above the mean and buy when they are below the mean.



Asset class	Current bull market
Bonds	33 years
Real Estate	18 years
Gold	14 years
Stocks	4 years

Asset class	Previous bottom
Stocks	2009
Gold	1999
Real Estate	1995
Bonds	1980

The trend that may reverse next is risk. In the wake of the financial crisis, nobody wanted it, so investors sold stocks and bought bonds in droves. This has driven bond values so high, that the yield on a 10-year Treasury bond has dropped below 2%. Meanwhile, the earnings yield of the equity market has been in the 7%-8% range, which means that corporate earnings as a percentage of stock prices are now near the highest level since the late 1980s.

Historically, treasury bond yields and corporate earnings yields should be roughly the same. We believe this sets the stage for a significant reversion to the mean.

Key point:

A reversion to the mean would see bond prices fall and stock prices rise.

Principal #2

Negativity Reduces Risk

Investors buy or sell stocks based on how they predict the world will unfold over the next 6-12 months. The investment paradox is that when risk or opportunity is perceived to be the greatest, it is often the least.

Current market prices reflect the predictions of millions of investors and market forecasters. Some of the greatest opportunities can be seized (and disasters avoided) because a "herd mentality" leads to highly correlated beliefs that are often dead wrong.

For example, in 2009, stocks were priced as though everyone believed capitalism was over and done. With so many investors expecting bad news and the market already at rock bottom, stocks had no where to go but up. This table explains why:

	When bad news *does* come true	When bad news *does not* come true
Impact on the market	*Neutral* The market stays flat, as the bad news was already reflected in current prices	*Positive* The market can now rise, as the expectation of a negative outcome has been removed

This phenomenon explains why, when Europe did not implode and the US government did not fall off a fiscal cliff, the stock market was able to climb more than 100% from its low in March 2009 to the first quarter of 2013.

Key point:

Correlated beliefs can create risk or opportunity when they deviate from reality.

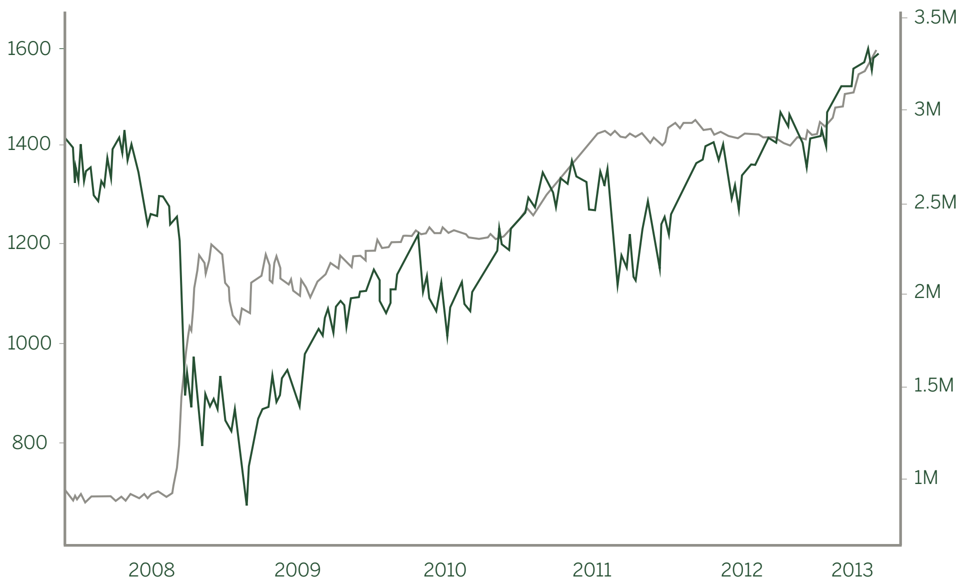
Principle #3

Liquidity Trumps Economics

The flow of money in and out of the market has a much greater impact on the direction of the market than traditional economic statistics such as GDP and manufacturing. This is why economists tend to make such poor investors.

Trying to invest based on the latest economic headlines is dangerous. In fact, there is evidence of an inverse relationship between the performance of the economy and the performance of the markets, especially at their extremes. Markets tend to hit bottom and turn higher while the economy is still in recession. Markets tend to reach a peak and go down while economic growth is at its highest.

In times of economic weakness, excess liquidity provided by central bankers tends to flow into the market, pushing up financial instruments such as stocks and bonds. When the economy strengthens, those funds tend to flow out of the market as businesses use them to buy inventory, plants and equipment.



The S&P 500 (green) rises along with the US Federal Reserve balance sheet (grey)

Bloomberg L.P., January 1, 2008 to May 1, 2013

Key point:

The direction of the market is driven more by central bank monetary policy than by economic growth.

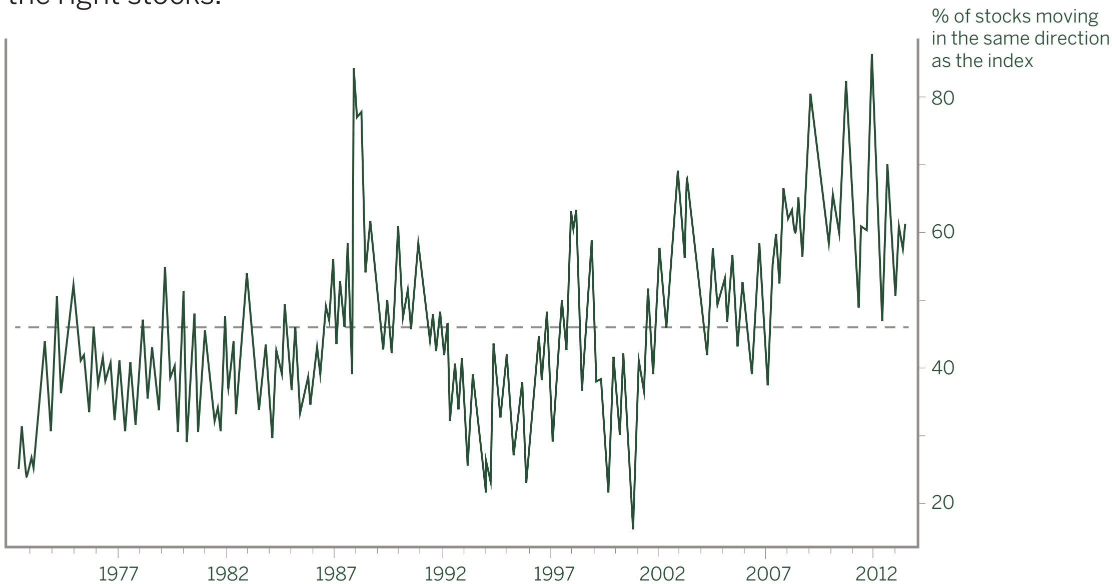
Principles in action

Experience Cumberland For Yourself

Our investment principles have allowed us to anticipate some of the most crucial market cycles of the past four decades, and have helped our clients consistently protect and grow their capital.

As active portfolio managers, our first priority is to recognize and respond to changing market cycles. For example, we made a critical asset allocation decision when we traded out of stocks and into real estate in the late 1990s, and we are reversing that trade today.

Our next priority is to select the right securities within each asset class. This chart shows that less than half of the stocks in the S&P 500 move in the same direction as the overall index on any given day. This highlights how easy it is to underperform the market if you don't select the right stocks.



Median 63-day correction of S&P 500 stocks to the S&P 500 Index.
Source: Ned Davis Research Inc.

When investors follow a pre-set asset allocation strategy, they cannot react to major market shifts. And when they diversify very broadly or choose passive investment vehicles, they tend to get mediocre results. We believe truly hands-on portfolio management guided by experience is essential for investment success.

Investors with portfolios of $1 million or more are invited to meet our senior team and learn more about the investment principles that have helped our clients beat the market since 1998.

For more information, call us at 416-413-4057 or 1-800-929-8296

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