CUMBERLAND
Private Wealth

Three Principles for staying a step ahead of the market.

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The stock market volatility last fall was scary.

So was the 2011 European crisis, the 2008 financial crisis, the 2000 tech collapse, the 1987 market crash and the 1974 recession. Each time, media pundits warned that the markets may not recover any time soon. Fearful investors ran for the exits. Yet, in each case, markets eventually 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 Private Wealth, we've been refining our investment principles through more than two decades, five major economic cycles and countless 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.

Eventually, trends change direction and market values revert to their long-term average.

Asset class	Current bull market
Bonds	39 years
Real Estate	24 years
Gold	4 years
Stocks	10 years

Asset class	Previous bottom
Stocks	2009
Gold	2015
Real Estate	1995
Bonds	1980

Let's look at a good example of this. In 2009, in the wake of the financial crisis, nobody wanted to take any risk, so investors sold stocks and bought bonds in droves. This pushed bond values so high that the yield on a 10-year Treasury bond dropped below 2%. Meanwhile, the earnings yield of the equity market was in the 7%-8% range, which meant that corporate earnings as a percentage of stock prices were near the highest level since the late 1980s.

Historically, we knew that treasury bond yields and corporate earnings yields should be roughly the same. At the time, we saw that this set the stage for a significant reversion to the mean.

We continue to watch for the trend that will reverse next.

A reversion to the mean would see one asset class fall in value while others rise.

Principle #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, going back to 2009 again, stocks were priced as though everyone believed capitalism was over and done. With so much negative sentiment and investors expecting bad news, the market was already at rock bottom, so stocks had nowhere 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 the US government did not fall off a fiscal cliff after 2009, Europe did not implode in 2012, and the US economy gradually came into line with the support of the Federal Reserve, and world economies recovered, the US stock market was able to climb more than 350% from its low in March 2009 to the end of 2018.

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

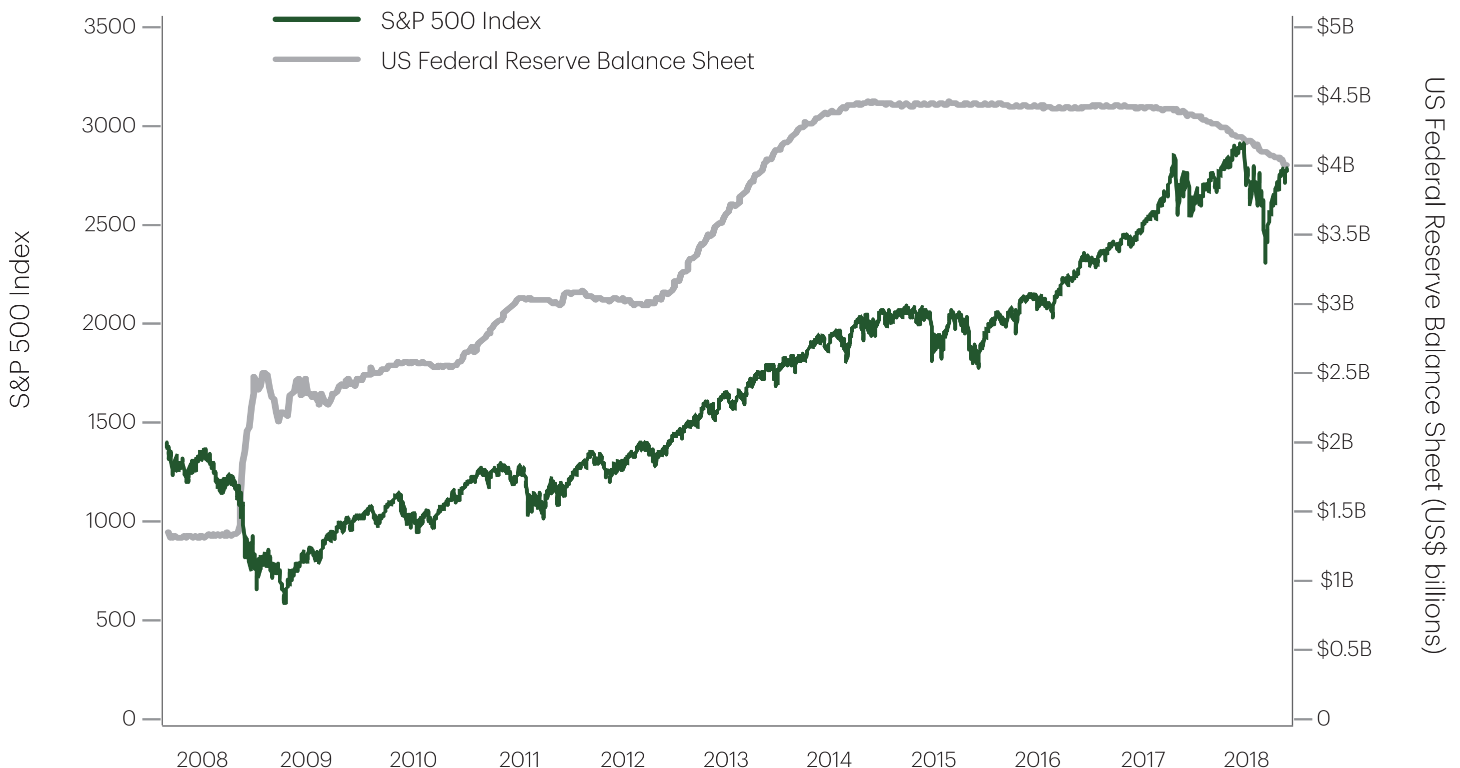
Principle #3
Liquidity trumps economics.

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, as we have already seen.

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.

Central bank monetary policy is a strong driver of S&P 500 growth.



The S&P 500 (green) rises along with the US Federal Reserve balance sheet (grey) Bloomberg L.P., January 1, 2008 to March 1, 2019

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

See our principles in action. Experience Cumberland for yourself.

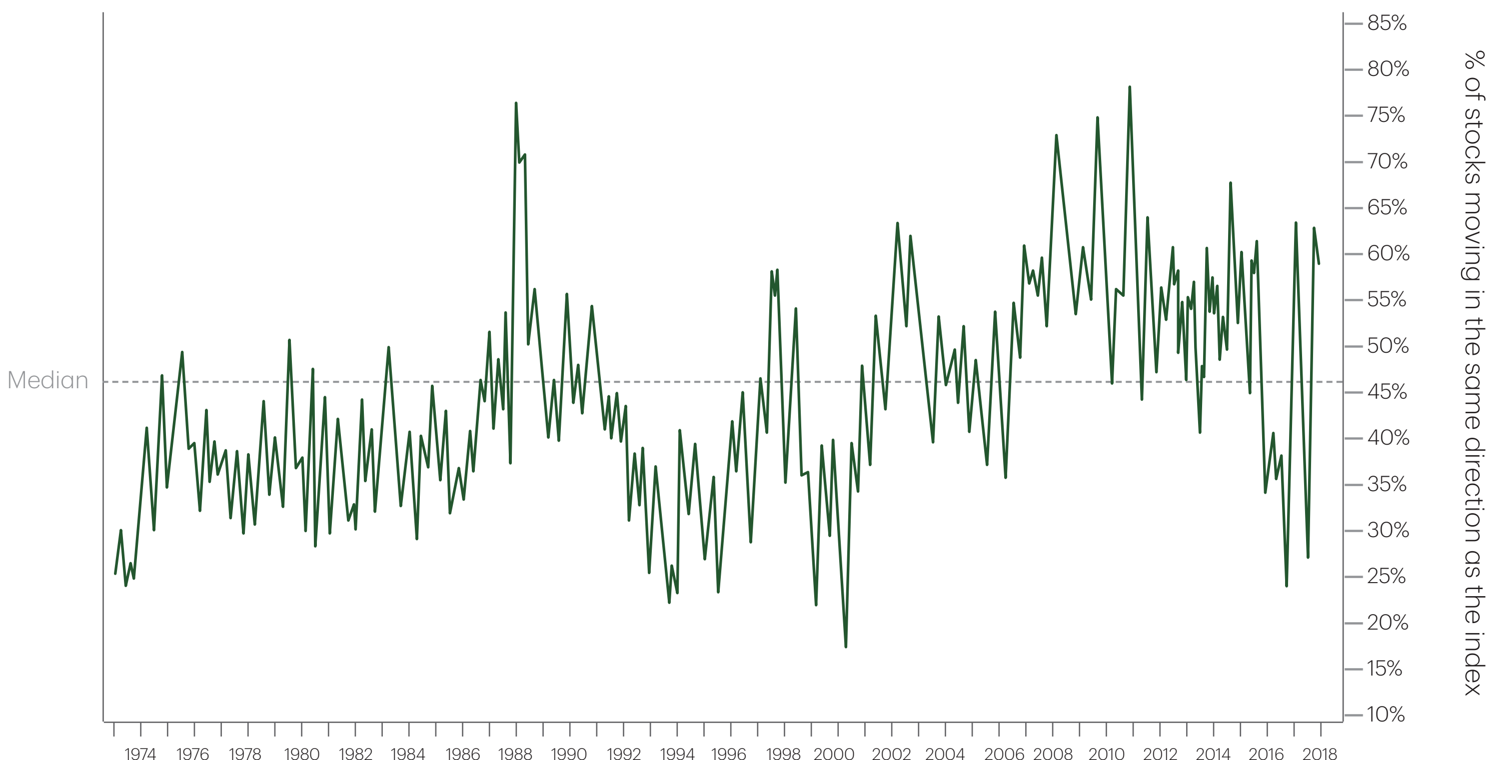
Our investment principles have allowed us to anticipate some of the most crucial market cycles of the past two decades and have helped our clients successfully protect and grow their capital.

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. In 1999, we traded down our U.S. equities ahead of the Tech Bubble bursting, allocating significant capital to Canadian equities, which were deeply out of favour at that time and subsequently surged.

After asset class decisions, our next priority is to select the right securities within each asset class.

The chart below 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.

Stock selection is key: On an average day, less than 50% of S&P stocks move in the same direction as the Index.



Median 63-day correlation 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 2000.

*Cumberland Private Wealth refers to Cumberland Private Wealth Management Inc. & Cumberland Investment Counsel Inc.

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