DIVIDENDCAFE | PODCAST TRANSCRIPTION

FRIDAY, JULY 27, 2024

Due to the publishing time constraints for us to produce our daily missive, podcast, and video, the best we can offer at this time is a machine-generated transcription which contains errors. We will continue to work to improve this service and appreciate your patience with us.

Well, hello and welcome to this week's Dividend Cafe. It is so nice to be recording from the studio here in the Newport Beach office back in this saddle and ready to talk to you a little bit today about logic, emotion and the market. And there are a few other things that need to dovetail with the overall conversation.

Let me just get the fun stuff out of the way. I want to go to a couple of different topics here in the sort of second half of our time together. But off the top, I want to talk about the concept of a balanced portfolio and what that means in terms of our human nature, what, where our human nature can get in the way.

And I am reminded. In preparing what I wrote this week, that human nature is at the heart of what we do in managing investors that human beings naturally have a logical and rational side. What we refer to as the logos and human beings have emotions and they, and we refer to the pathos from where, the same prefix where we get the pathology, the way in which we're wired.

And this goes outside of our reason and into some of the emotional elements of the human being. And a person who is all logos and no pathos is called a psychopath. And a person who is all pathos and no logos is called insufferable. But at the end of the day nobody is all one. We all have both components and I'm not here to talk about human psychology directly.

It's more as it pertains to habits and behaviors. as investors, that this is a tricky element because people have a tendency to let one get in the way of the other. And unfortunately in this case, it's very rare that somebody's logic or reason is getting in the way of their emotions for the most part.

It's the opposite. And so we have to start here with just making sure we understand what the basic premises are. I don't mind. First of all, as a human being, that there are all kinds of things in life that we have to hold intention, and I don't mind as an investor or as an investment manager.

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In a wealth advisory profession, I don't mind that human beings have these different components that need to be held in tension. I, it's, what we're paid to do in a lot of ways is to reconcile some things that are not easily Reconcilable all the time. However there's a very easy tendency to allow this to go to a place that can create mistakes and sometimes fatal ones and other times maybe not fatal, but they can impair the success of an investor, the ability of their portfolio to help bring about a successful ends.

Do, we talk about diversified portfolios for two reasons. One is called systematic risk and this is different than what you mostly think of with diversification. Okay. So with systematic risk, we are used to thinking of you can't diversify out of it. In other words, you say, Oh, I'm diversified because I own a consumer staples company and energy company and a tech company.

But if the whole market drops because there's a systematic reason, A war breaks out or interest rates spike higher or some geopolitical event. You can't diversify away necessarily because everything within that asset class kind of is subject to going down. And yet we use multiple asset classes that don't always necessarily correlate with one another.

And so one of the ways you deal with systematic risk is asset classes that might zig when others zag. We traditionally talk about it in modern portfolio theory of stocks and bonds, but we at the bonds group are heavy users of alternatives and try to lean in to very specifically non correlated asset classes.

And that is for the purpose of diversifying from the impact of systematic risk, but then the more traditional form of jurisdiction is non systematic risk, which is not necessarily the whole system that is going to go down. But there is a execution error or a manager error at a particular company.

And so you diversify because One company failed, but another one didn't. And so that diversification provides a certain benefit. I definitely believe that it is a significant problem in portfolio management of over diversification. I wrote a dividend cafe recently about diversification where people make a portfolio worse by overly diversifying.

But the basic concept of not putting all the eggs in one basket and not and allowing for human error and execution error and various systematic events, both at a high level with asset allocation at the Bonson group, we refer to it as our magnify. We have different sleeves that we utilize depending on different objectives and whatnot.

And then the non systematic risk of where you want to achieve diversification and so forth. Okay. So this is not really upper debate. Generally everybody understands it's a good thing.

Unless someone wants to say. No, I'm willing to have a single event wipe me out. And or I'm so good at this that no bad event can ever happen, okay?

There might be people who say that. It's just not necessarily the type of person we would work with or listen to or avoid saying things about behind their back. But here's what I would tell you. It is one thing to acknowledge the need or the benefits of a balanced portfolio. It's another thing to when the repercussions of that play out not feel some sense of regret.

What are the repercussions? Something is always going to be outperforming something else, which means something is always going to be underperforming something else. And so you get a statement or you look at a portfolio review and you go, Oh, Such and such was down 2%. This other thing was up 14. Why didn't I just own less of this thing and more of this thing?

It's totally human, but that would be a great example. working outside of the logic and playing into the emotion because nobody logically believes they have a rear view mirror and everybody logically knows why there was a sense of balance diversification in the portfolio. And yet, of course, you could either wish that you only owned all the winners and illogically presume that they will then be the next winners as well.

You also could start to make the mistake of saying, okay, well, I certainly realized that some things are going to go up when everything's going down. And yet what I want to do is I want to pay an investment manager who will know those things. So they'll have me in the good stuff when it's going up, but then we're still going to be diversified because we're going to change our portfolio from this to that before those things, before the seasons change and therefore benefit it as all these different events are taking place and some stuff's going up since I was going down and we're shifting with the times there.

And again, that requires a certain resignation of logic, a suspension of reason in order to come up with a, an absurd idea, but it's only absurd if you're holding it to a intellectual standard. It is not absurd emotionally. And yet this is an example where our emotions are not the best guide for investment decisions.

In my opinion, the the very purpose of Balancing a portfolio, diversifying it, leads to a time in which you may be frustrated with the portfolio, and that would require us to constantly be remembering why we did it. Otherwise, we are constantly feeling a regret. Why didn't I own more of the winners, less of the losers, etc.

That's difficult for human pathology. But the balanced idea that diversifies from systematic and unsystematic risks is brilliant. It's just that math is unavoidable here. And other than making a tremendous and colossal mistake, it requires you to go into a mindset that takes discipline, I think takes advice and whatnot, but it also takes the ability to harmonize your logos and your pathos together.

So that rational decisions can be made despite some of the human emotion and tendency that takes place. Okay, I hope that was helpful. Let me talk to you a little bit about the market we're in right now. It's getting a little crazy and it's interesting because if you think about the last few weeks, we have had a president now he has not technically resigned, but he has just at the very last minute announced he's not going to be rerunning after securing the delegates for the nomination.

First time it's happened since Lyndon Johnson in 1968. We had an assassination attempt on a former president who is a current presidential candidate that came within half an inch from succeeding. We have had one of the conventions, you've had polls go up and down the last several weeks have been crazy in the American political cycle.

The current vice president of the United States is now running for president and is essentially representing the incumbent party. A sort of re election endeavor. There, there is globally no signs right now of the Ukraine Russia war ending. Constant tensions with the Hamas war against Israel and their efforts to defend themselves.

We had this week the prime, the president of Israel in America's capital. And protesters take down the American flag across the street from the Capitol building and put up a Palestinian flag. And you've had drone attacks in Yemen that would have been a huge news story and they barely make the top ten these days.

And so then you say, okay, well the NASDAQ is down about 7 or 8 percent in the last couple weeks. And the S& P is down 4 or 5 percent in the last couple weeks. This geopolitical tension may be getting to markets a little. And that's prima facie a reasonable statement, but it's only reasonable for one second.

Because, immediately you look at it and you go, wait a second. Actually, the bond market hasn't moved at all. The 10 year has stayed between 420 and 430 for a month. The dollar is really hung in there. It's weakened a little against the yen, but flat against a lot of other currencies.

And the yen was down. deeply under, undervalued a few weeks back. Oil is actually lower. I think it was about 81 a barrel a few weeks ago. It's 77 as I'm sitting here recording. It's gone

lower. During these times of intense geopolitical stress, if you think they're going to be putting downward pressure on equities, it would be putting upward pressure on commodities.

It would have some disruption in the bond market and currency markets. It hasn't. And in fact, it hasn't really. had a big impact with equities themselves. You go, you just said the S& P is down 4 percent now it's down 8%, but a risk off rally would mean everything has gone down and very candidly, small cap.

It's not down. Financials are not down. The bank stocks are not down. Consumer staples are not down. Energy is not down. So you've had a rotation, but not a risk off decline. That, by definition, helps us eliminate geopolitical stress as the cause of this. Not only is there the lack of stress evidenced in other financial markets, But even within the most risky of risk markets, that is equities, the epicenter of risk, it's been very selective.

My friends, this is so obvious. It's not geopolitics. It's valuation. The valuations were too high. And overvalued assets revert to the mean. And right now it's my opinion that we're in innings of that playing out. It will zig and zag a bit along the way, but the last few weeks has been substantial.

And to get back to more mean value to revert to average valuations, it would take a long time. There's a long way to go if that were to really fully play out. But no, I don't think that that explaining the Dow, excuse me the NASDAQ and S& P pressures any other way than valuation excess was is really possible in the last several weeks.

Things could change, by the way. Geopolitical stressors could come in and exacerbate the valuation problems because there isn't a buffer there. And so if you're going to get downward pressure in a risk off scenario, a high valuation could just make everything worse. But thus far, you just simply have a very divergent set of circumstances.

And the areas that have gotten hurt were overvalued, the areas that have not were not. And fundamentally, the geopolitical environment has not yet taken a toll on markets. And that is very evident in bond markets and so forth. The other thing I want to bring up before I let you go here on the podcast and the video is just a thought I had as I was flying back from New York about Ukraine.

I don't say what I'm about to say for any kind of prescriptive reason at all. What I mean by that is I am not. stating, I hope something like this happens per se. My own personal opinions here or wishes are first of all, totally irrelevant. I can't even imagine anyone cares what I would have to say about it.

But second of all, they would have nothing to do with the way I think about the kind of investment landscape or the descriptive environment of the economy and economic implications. I happen to hope that an eventual solution is Entirely Ukraine friendly and not at all Russia friendly.

They were invaded in an act of aggression by a hostile enemy. And I don't do this sort of ambiguity that sometimes even some of my friends on the right have been guilty of lately about Putin, Russia, any of that. So I am unequivocally opposed to what has happened to Ukraine and unequivocally supportive.

Even if there's nuances about how they get supported and what accountability goes with it, I'm fine with that conversation too. But I just am putting my cards on the table. But look, I think there is a very likely scenario by which There ends up having to be an agreement, and that agreement may come sooner than later.

There are potential election outcomes a fatigue I don't know that the situation and its status quo can last forever. And if there is a scenario in which Ukraine, as an attacked country, ends up giving concessions to make this thing go away concessions that they don't want to give up and that they didn't give up a couple years ago and could have avoided a whole lot of hassle if they had done it sooner, I think it is absolutely inevitable that for them to do that, they're going to be asking for money.

Lots of money for a rebuild, for a reconstruction. There's been hundreds of billions of dollars of damages. And so when I think about our CapEx theme here in America, and the potential for re regionalization, re industrialization certain innovations that could allow for a CapEx renaissance, and I apply that type of thinking in commodities, in industrial, in, in materials, it seems to me very possible, if you game theory this out, That Ukraine will end up making concessions that leads to some sort of settlement.

And in order to get that, the pound of flesh they would want would be an awful lot of financial support. And that there would end up being an investment theme around that, well, what companies, who's going to be involved? What do we do? No. I have no idea. No idea. Don't know who don't know when I'm referring at a high level.

to the thematic issue of CapEx and industrial investment, rebuilding, that there is that category of opportunity very likely coming in much of Europe, particularly Ukraine and that's very compatible with the theory thesis we have here in the United States. Just something to think through that we're thinking through thematically at the Monson Group.

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If you read the Dividend Cafe this week, beyond the things I've gone through on the podcast first of all, there's two charts you have to look at, just nothing else worth the price of admission. And then also I, a couple of anecdotal things, the S& P this week breaking a streak that lasted 17, it had been 17 years since we had gone this long, I think it ended up being 356 trading days without a down day of 2% and this week on Wednesday, the market, the S& P was down over 2 percent in a single day for the first time in 356 trading days, which was a record that had stood for 17 years.

Yeah. You have to go back 17 years since it had been that long. Some other little tidbits there in dividend cafe, I'll encourage you to check out anyways, please reach out with any questions. We certainly appreciate you forwarding this or rating us subscribing if you're listening to the podcast.

Just put it in your regular feed. And in the meantime, I'll look forward to come back to you next week. Where on planet earth am I next week? I believe I'm back east by the end of next week, but here in California through the middle of next week. So in the meantime, thanks for listening. Thank you for watching and thank you for reading the Dividend Cafe.