SAXUM
REAL ESTATE

# SAXUM INSIGHTS

*Fool Me Three Times,*
*Shame on Us*

*June 2020*

**Different Catalyst with a Similar Outcome**

During my Wall Street trading days, a common wish uttered by traders in one form or another involved demands for the market gods to deliver more volatility to the market. Increased volatility, combined with a multitude of factors, generally led to greater money-making opportunities for traders. Those demands would, at times, take a different tone when the market gods complied, but with a magnitude of volatility that was unprecedented and unexpected, that led to chaos, paralysis and irrational price behavior when unleashed on the market. Such was my experience during the Global Financial Crisis (GFC) a decade ago, when the market was brought to its knees by a combination of excess leverage, deteriorating credit and the most creatively destructive financial engineering ever seen in modern finance. Only a coordinated global government bailout could stop the bleeding, with monetary policy injecting trillions of liquidity into the system. Sound familiar, but with a different catalyst at play?

**Volatility is Here to Stay**

Extreme volatility in equity markets is becoming more commonplace for numerous reasons that typically run in parallel, including monetary and fiscal policies, economic risks, decreased broker-dealer risk appetite, algorithmic trading, geopolitical risks (trade wars, etc.) and now pandemic tail risks. For example, not including the S&P 500 bear market moves during the Great Depression (1930s), we have recently witnessed the first (2009), second (2000) and fifth (2020) largest percentage loss bear markets over the last 80 years clocking in at -57%, -49% and -34%, respectively. When describing the speed of the move from the peak to the trough as measured by days, using the same sample set over the last 80 years, the average move greater than -25% registered 412 days over nine occurrences. For perspective, the most recent bear market in response to the coronavirus pandemic registered just 33 days or over 12 times faster than the average of the previous nine fastest -25%+ bear moves[1]. Alternatively, in defense of the bull case, the S&P 500 recently exploded off the March 23rd intraday lows and, by definition, would have entered a new bull market up 20% in just three days' time. The velocity of bull move was even more impressive than the bear price action. If we pay attention, the market is providing valuable investment insights highlighting extreme internal stresses at play for both the bull and bear cases.

**Don't be a Fool**

Stephen King  once said, "Fool me once, shame on you. Fool me twice, shame on me. Fool me three times, shame on both of us." I am not a fan of horror films, but I think equity investors might agree that investing over the last decade has, at times, felt like playing a lead role in horror film given the unprecedented market volatility. If even pro traders find themselves over their skis in extreme market moves, what does that suggest for the average retail investor? Retail investors have a shot if they buy into long-term hold strategies that eliminate the desire to time the markets but, unfortunately, that is not commonplace. Retail investor strategies can turn devastating when they devolve into buying high and selling low as market moves amplify human emotion, which typically drives irrational decisions at the worst times.

Many investors who did not survive the GFC likely sold positions with the S&P 500 below 1000 in 2009. Out of fear, they then likely sat out most of the rally as the market doubled over the next five years to reach 2000. At that point, the bad memories started to fade and the fear of missing out on a never-ending rally sucked them back in as the market appreciated another 70% over the next five years to the all-time high of 3386 on Feb 19, 2020. The next financial jolt came in the form of an unexpected global pandemic, the likes of which hasn't been seen in 100 years, likely wiping out a majority of the gains earned by investors who cautiously re-entered the market post-GFC, as the S&P 500 fell back to 2191 on March 23rd. Retail investors have been dramatically scarred twice over the last decade due to a combination of heightened equity volatility across portfolios, which are generally over-allocated to equities due to oversimplified and elementary investment strategies recommending equity allocations of +60%. Who is to say what will be the next event to cause unrestrained, heightened market volatility, but the third time will likely not be a charm.

**Diversify with Discipline**

In May 2019, I authored a *Saxum Insights* entitled *Opportunity Zones: Think Long-Term, Diversify and Sell the Bounce*[2]. I will not reiterate the merits of that Insights in its entirety, but in summary, I urged investors to take profits on the impressive equity rally from the December 2018 year-end lows, which saw stocks reach an all-time high of 3000 in May 2019. I suggested that risk-reward was skewed to the downside and that investors should take chips off the table by harvesting gains from stocks and diversifying into real estate through

the historic tax incentive Opportunity Zone Program. To be clear, I did not recommend selling all stock positions outright, but merely to realize and reallocate gains, in a tax-efficient manner, into alternative assets to enhance the diversity of the portfolio. Taking that advice at first would have looked like a mistake as the market climbed another 10% higher to approximately 3400 over the ensuing eight months. However, those same investors would have appreciated a significantly lower downside loss in the recent equity whipsaw due to less equity exposure with a 30% allocation to alternatives.

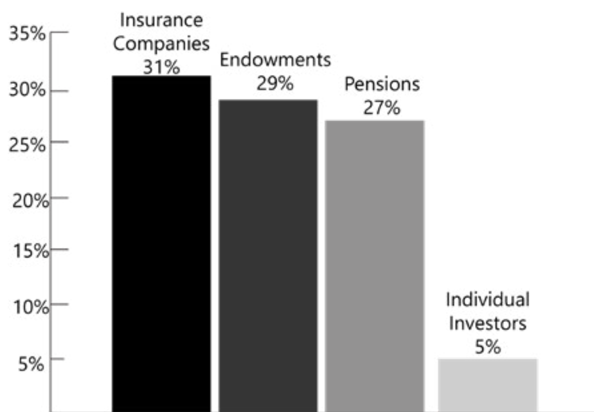

Figure 1

We believe that average retail investors who truly desire to achieve a long-term, value-based portfolio should mirror the professionally managed portfolios of insurance companies, endowments and pension funds when strategizing on long-term allocations. These institutional investors fit the textbook definition of long-term value players, and the percentage of their portfolio allocated to alternative investments (real estate, private equity, etc.) is approximately 30% (Figure 1). We recommend that retail investors should strive to match the alternative asset allocation of 30%, with approximately 50% of that alternative investment allocated to real estate.

**Call to Action**

For those investors with the stomach to hold onto positions, the market has indeed rallied off the March 23rd coronavirus low, and it's currently chopping around the similar S&P 500 level of 3000 where I recommended in May 2019 that investors lighten up on equities. The difference now is that the market is weighing the uncertainty of an ongoing pandemic with over 42 million workers unemployed nationwide and equity valuations close to multi-decade highs as measured by the Shiller PE ratio. Simply put, most sophisticated investors agree that, but for historic monetary policy intervention, equites are significantly overvalued. Unemployment numbers are generally a lagging indicator, but the damage to small businesses and their ability to rebound and survive as PPP programs wear off is uncertain and a critical factor for future growth. Add in a challenged social-economic environment and an explosive election season, and there are additional reasons for caution. Alternatively, "Don't Fight the Fed" rhetoric is back as the market is digesting the most significant monetary and fiscal stimulus in history, with rates likely to stay pegged at historical lows over multiple years per the Fed's guidance. Notable cases can be made for both bear and bull markets at this juncture.

Our view is that the technicals driving the recent blistering equity rally off the March lows have turned negative. In response, the market has come under pressure over the last week, and the S&P 500 at 3000 also represents the 200-day moving average, which is a key technical level followed by the market. Strength is to be sold above the 200-day moving average going forward with a recommendation of reallocating proceeds into alternatives with a preference towards real estate, as rates are likely to remain historically low for an unprecedented period. Also, historically low for long rates will positively affect long term real estate values, which is currently not being fully priced into the market. If you are an investor with a traditional stocks/bonds only allocation and an outsized exposure to equities, now is the time to consider selling stock strength and repositioning gains into a safe haven asset with equity upside like real estate, especially if you have managed to hold strong to this point and produced a 100-200% return over the past ten years. The next decade is not likely to be as friendly to the broader equity indexes, and we expect a diversified real estate portfolio will substantially outperform on a risk-adjusted basis. Don't risk being fooled a third time.

*Saxum was voted a Top 25 Fund Manager/Developer by OpportunityZone.com for 2019 & 2020 and currently is executing on its seventh Opportunity Zone Fund, securing its position as one of the premier Opportunity Zone sponsors in the nation.*

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***Sources***

[1] Yardeni Research Inc. SPX Historical Moves
[2] Opportunity Zones: Think Long-Term, Diversify and Sell the Bounce