

All Time Highs

A Good Time To Invest?
No. A Great Time.

by Meb Faber

If there was a hall of fame for “horrible ideas,” you could make a strong case that Dick Rowe’s fateful decision in 1962 should be at the top.

Rowe was the Decca Records executive who turned down a chance to sign The Beatles.

Why, exactly?

As the story goes, he said “the Beatles have no future in Showbusiness... Groups are out; four-piece groups with guitars, particularly, are finished.”

So, who did Decca sign instead?

“The Tremeloes.”

Horrible idea.

In the investment world, is there such a “horrible idea” equivalent?

Maybe doubling down on a stock in freefall that’s already slashed your investment capital by 75%? (But hey, it looks ready to bounce!)

Perhaps mortgaging your house to go all-in on that microcap biotech which your golfing buddy swears by?

Or how about following the lead of your neighbor, Jim, who is finally interested in going all-in on stocks today, now that we’re back to all-time highs.

Horrible idea, right?

I mean, let’s get real. For a stock you bought back in 2009, in the aftermath of the Global Financial Crisis, and held for a decade, “all-time high” means you’re up big – congrats.

But purchasing today at “all-time highs”? Well, that just means you’re paying the highest price-tag ever.

Nevertheless, Jim is all-in. In fact, if stocks aren’t setting new all-time highs, he’s out of the market. In that case, he parks his money in bonds. It’s like he wants to overpay.

Horrible idea, right? You can almost hear The Tremeloes tuning up...

It turns out, no...

It’s a GREAT idea.

Confused?

Let’s jump into the details because today, you have the chance to sign The Beatles.

How Mimicking Jim Can Best Your Current Portfolio

One day, you decide you can't take listening to Jim anymore. So, you decide to test his theory on your own.

As a numbers-based investor, you set up a simple rule...

Each month, you check to see if an asset (in this case, stocks) is within 5% of its all-time high. If it is, you either buy the asset (if you didn't already own the asset based on the prior month), or you continue owning the asset. You'll reevaluate at the end of the upcoming month.

If the asset class doesn't meet this "all-time high" hurdle, you invest your capital in the relative safety of 10-year US government bonds. You ignore all intramonth action, so this strategy requires about five minutes to implement...a year.

You begin your historical test back in 1926, starting by evaluating how a buy and hold allocation to stocks returned so you have a baseline.

10.07% per annum.

Using Jim's modified system, you crunch the numbers and find...

Underperformance!

This "switching" method produces slightly lower returns of 9.61%.

HA! You knew Jim was a foolish. This ill-conceived attempt at market timing just proves buy and hold is dominant.

But as you evaluate related data coming out of your study, you notice something...

Since Jim's method had you invested in stocks only about half the time, the volatility of this portfolio was vastly lower (nearly half as volatile). Even more glaring, the largest drawdown was reduced from a gut wrenching -83.66% with just-stocks, to only -29.13% with the switch approach.

After the terror you experienced in 2009, you realize that a portfolio which severely reduces your prospective drawdown offers a huge benefit – namely, it keeps you from panicking and thus stay invested so that long-term average market returns can compound your wealth over the years.

You saw friends unable to handle the pain back around 2009 and sell...some of which missed out on half of the market's rally over the last decade...some who still haven't gotten back in.

Either way, a slashed drawdown number is a real bonus. Maybe Jim isn't a total moron.

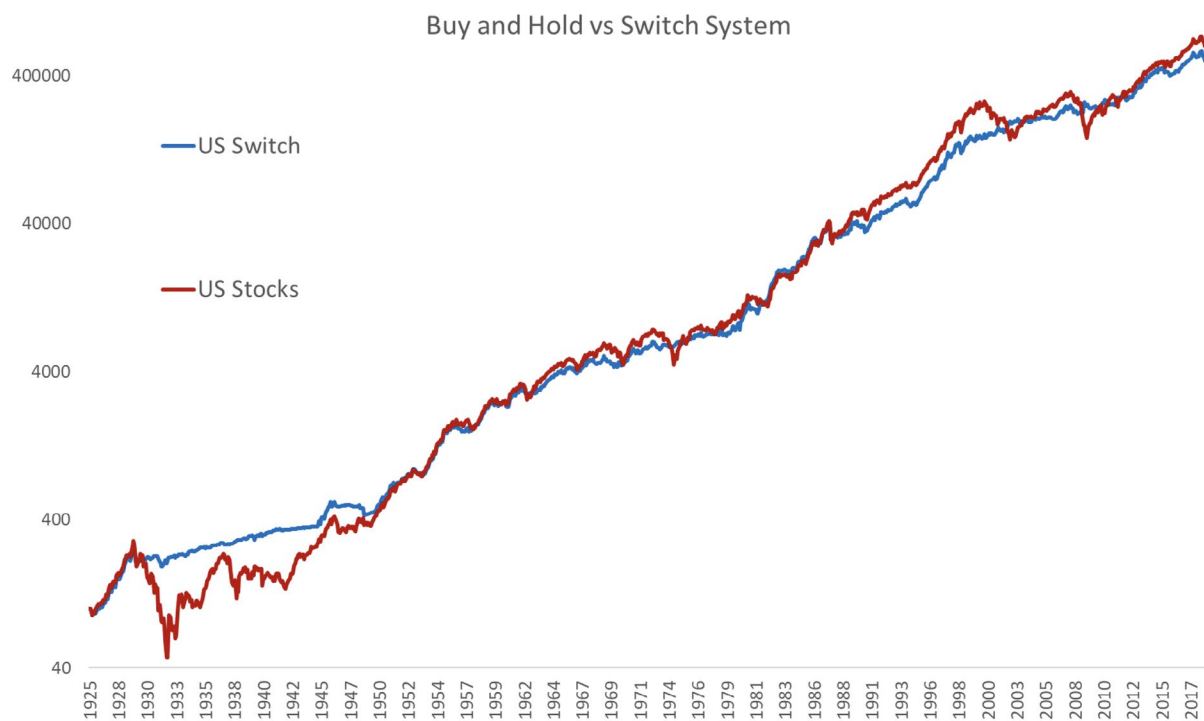
Below are the simulated results of the switch model compared to long-term stock returns alone.

Table 1: US Stocks and the All Time High Switch Model

| 1926-2019 | US Stocks | Switch |
|------------|-----------|---------|
| Returns | 10.07% | 9.61% |
| Volatility | 18.65% | 10.84% |
| Sharpe | 0.36 | 0.57 |
| Max DD | -83.66% | -29.13% |

Source: Meb Faber, Global Financial Data, Inc.

Figure 1: US Stocks and the All Time High Switch Model Equity Curve



Source: Meb Faber, Global Financial Data, Inc.

But perhaps Jim got lucky.

You realize that models need to work most of the time, and in most geographies, so you test the switch method on foreign stocks.

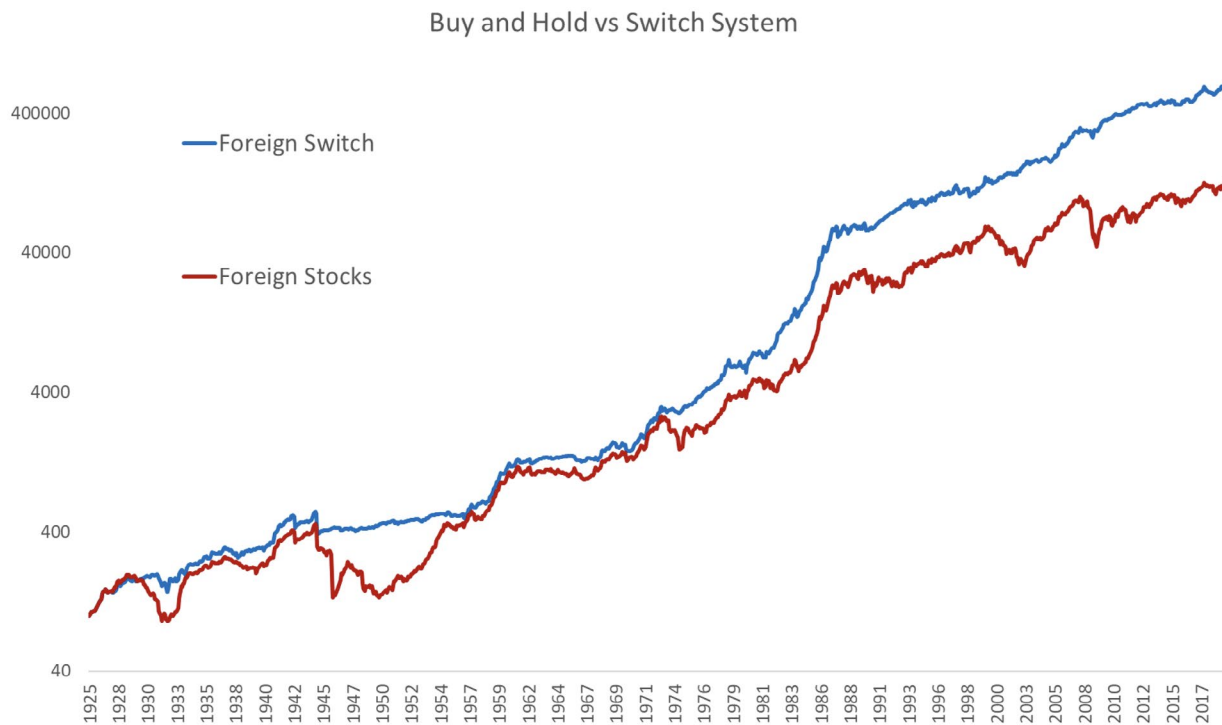
In this case, you're surprised to find that, not only did volatility and maximum drawdowns reduce again, this time returns increased. In other words, investors had their cake and ate it too.

Table 2: Foreign Stocks and the All Time High Switch Model

| 1926-2019 | Foreign Stocks | Switch |
|------------|----------------|---------|
| Returns | 7.91% | 9.81% |
| Volatility | 15.83% | 10.27% |
| Sharpe | 0.28 | 0.62 |
| Max DD | -70.35% | -30.82% |

Source: Meb Faber, Global Financial Data, Inc.

Figure 2: Foreign Stocks and the All Time High Switch Model Equity Curve



Source: Meb Faber, Global Financial Data, Inc.

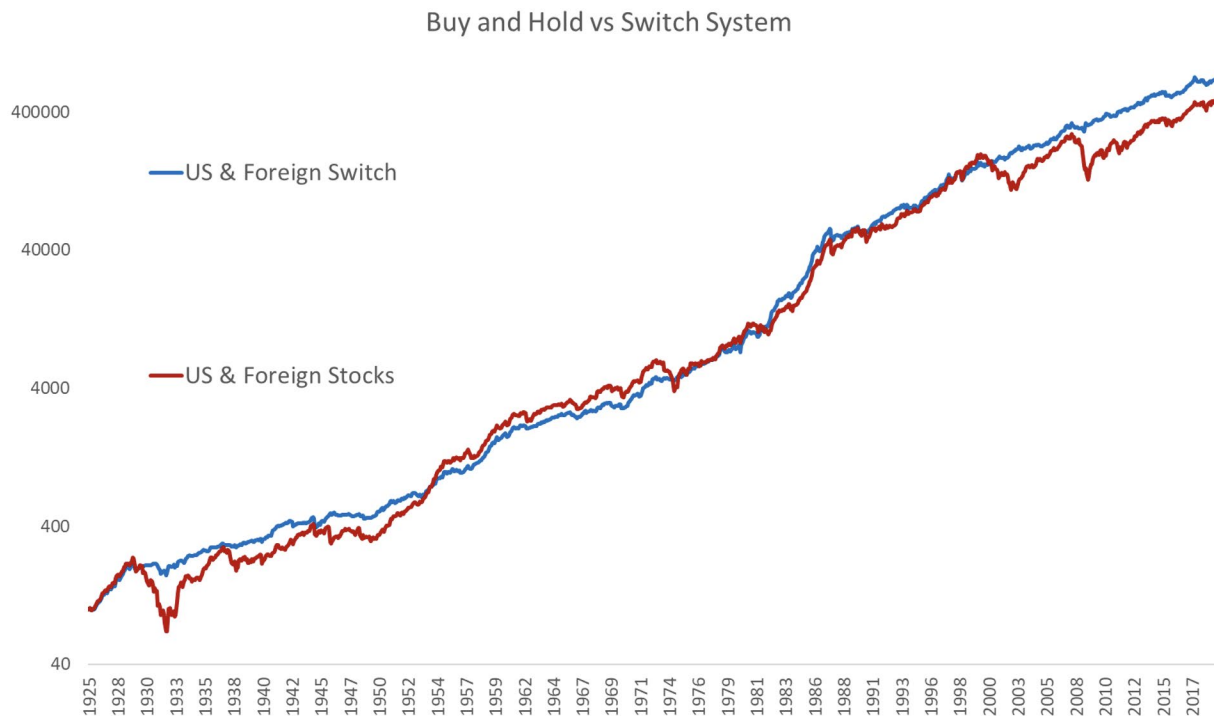
You tested a third portfolio, one that's half US and half foreign. The results are equally impressive.

Table 3: US and Foreign Stocks and the All Time High Switch Model

| 1926-2019 | Average | Switch |
|------------|---------|---------|
| Returns | 9.52% | 9.92% |
| Volatility | 14.37% | 8.61% |
| Sharpe | 0.43 | 0.76 |
| Max DD | -71.06% | -21.07% |

Source: Meb Faber, Global Financial Data, Inc.

Figure 3: US and Foreign Stocks and the All Time High Switch Model Equity Curve



Source: Meb Faber, Global Financial Data, Inc.

Wow.

Tweaking the System Away from “All-Time” Highs

Now, many investors are not willing to wait around for all-time highs, and some markets can go decades in a drawdown. So, you also test a similar variant where you invest in stocks when a market is within 5% of a 12-month high, rather than within 5% of an all-time high.

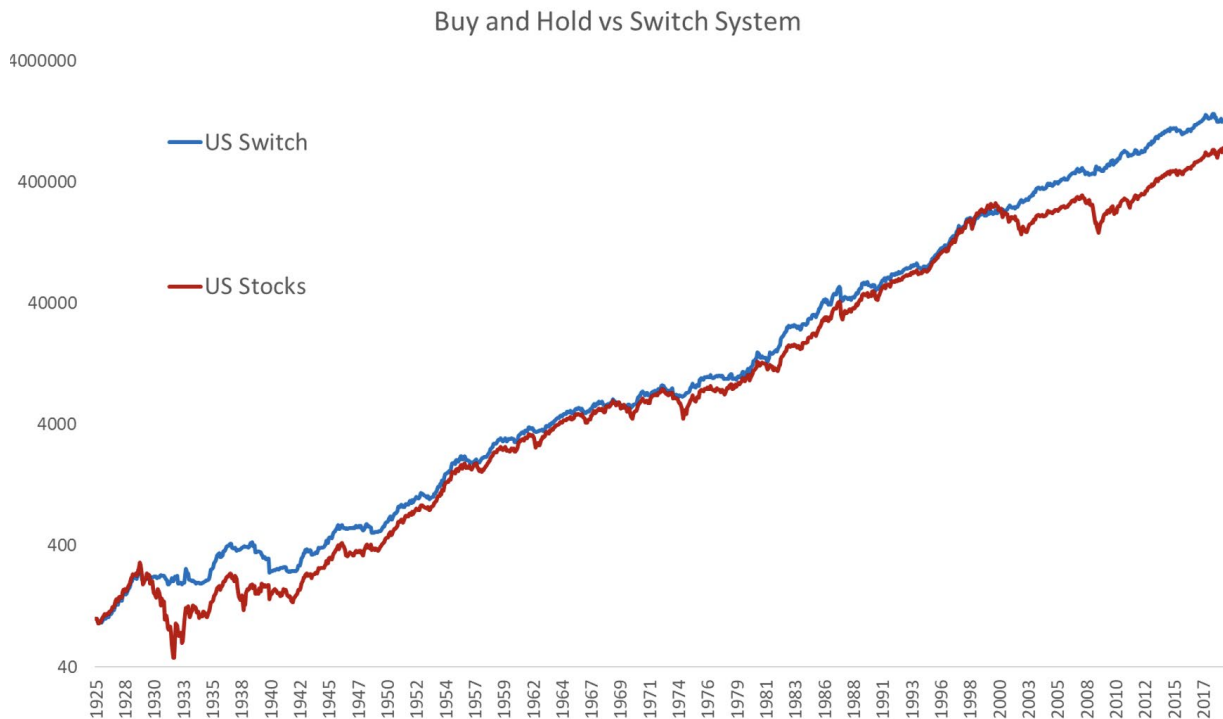
Again, strong results. In this case, lower volatility, basically half the drawdown, and greater returns.

Table 4: US Stocks and the 12-Month High Switch Model

| 1926-2019 | US Stocks | Switch |
|------------|-----------|---------|
| Returns | 10.07% | 10.68% |
| Volatility | 18.65% | 12.43% |
| Sharpe | 0.36 | 0.58 |
| Max DD | -83.66% | -43.98% |

Source: Meb Faber, Global Financial Data, Inc.

Figure 4: US Stocks and the 12-Month High Switch Model Equity Curve



Source: Meb Faber, Global Financial Data, Inc.

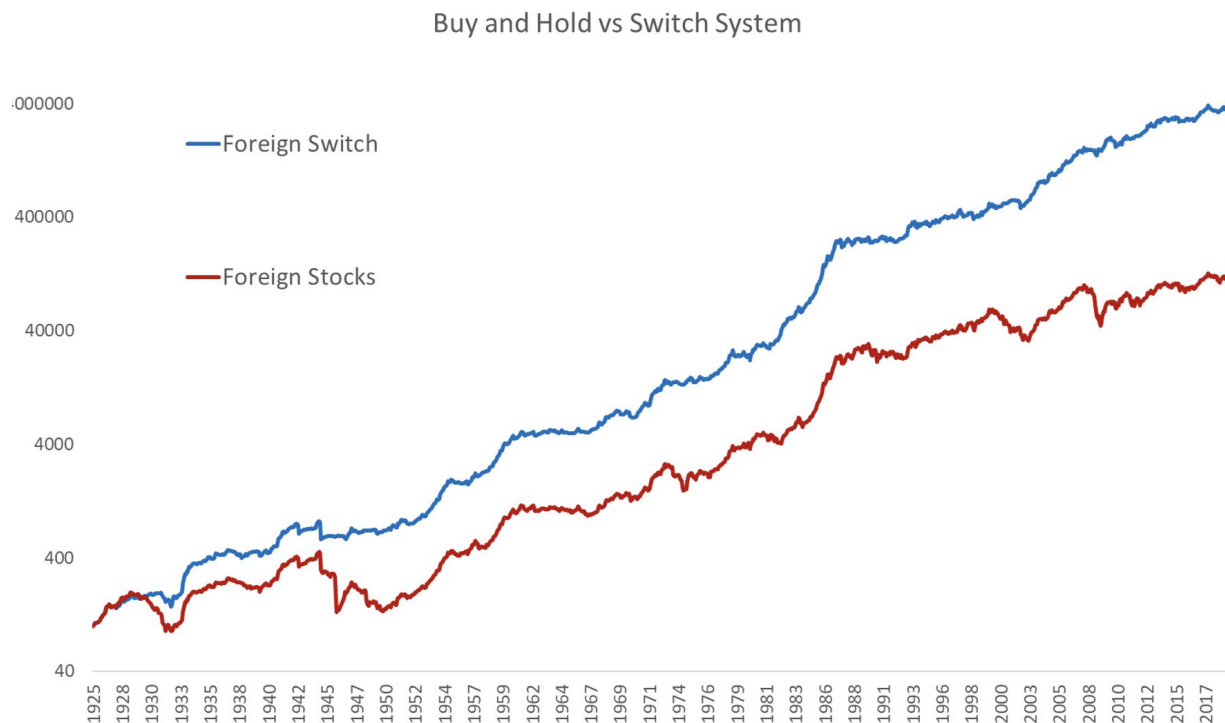
With the foreign 12-month-high switch, the results are even better, as you can see below.

Table 5: Foreign Stocks and the 12-Month High Switch Model

| 1926-2019 | Foreign Stocks | Switch |
|------------|----------------|---------|
| Returns | 7.91% | 11.89% |
| Volatility | 15.83% | 11.46% |
| Sharpe | 0.28 | 0.74 |
| Max DD | -70.35% | -30.82% |

Source: Meb Faber, Global Financial Data, Inc.

Figure 5: Foreign Stocks and the 12-Month High Switch Model Equity Curve



Source: Meb Faber, Global Financial Data, Inc.

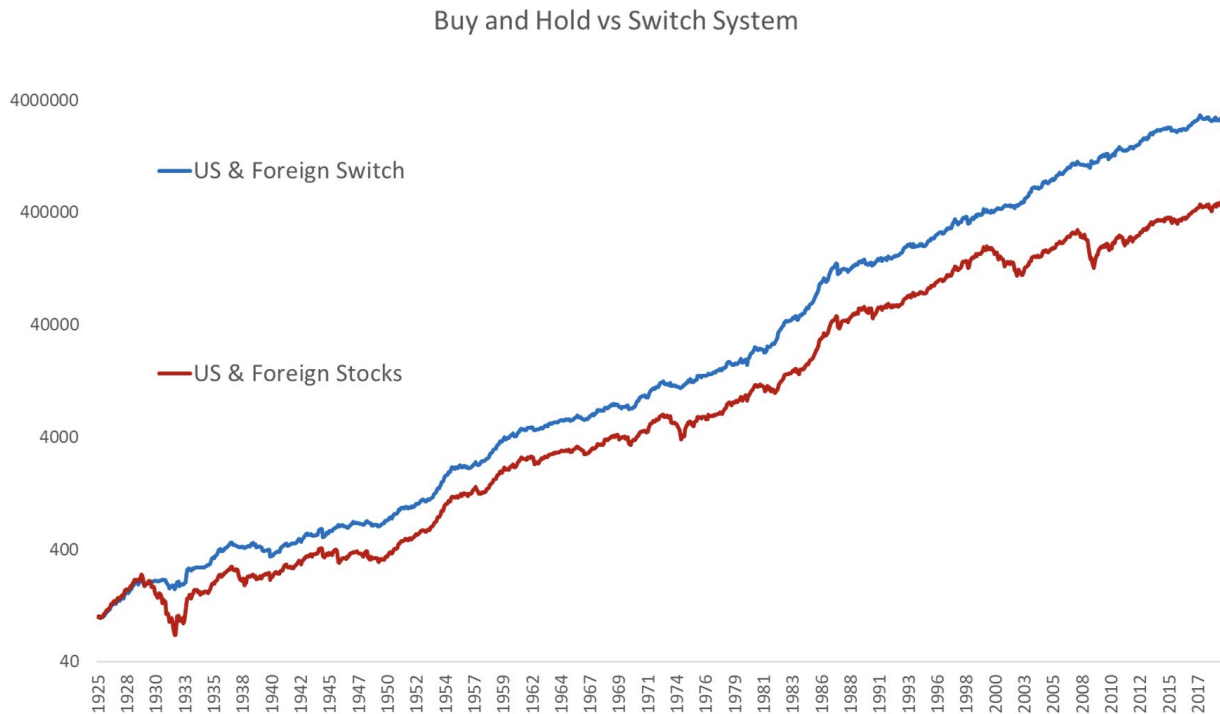
And below is the half U.S., half foreign model.

Table 6: US and Foreign Stocks and the 12-Month High Switch Model

| 1926-2019 | Average | Switch |
|------------|---------|---------|
| Returns | 9.52% | 11.55% |
| Volatility | 14.37% | 9.79% |
| Sharpe | 0.43 | 0.83 |
| Max DD | -71.06% | -25.58% |

Source: Meb Faber, Global Financial Data, Inc.

Figure 6: US and Foreign Stocks and the 12-Month High Switch Model Equity Curve



Source: Meb Faber, Global Financial Data, Inc.

While these results are impressive, you're not willing to concede that Jim has come up with a great market approach. Would the extra trading be worth the headache?

You only stand to be convinced after testing more assets in the modern era.

How the Switch System Holds Up with Other Asset Classes

You decide to pick out what you consider to be the major asset classes: US stocks, foreign stocks, real estate, gold, and commodities.

Here are the results on our assets from 1972-2019. We present the 12-month-high system (FYI, the all-time-high system is similar in performance).

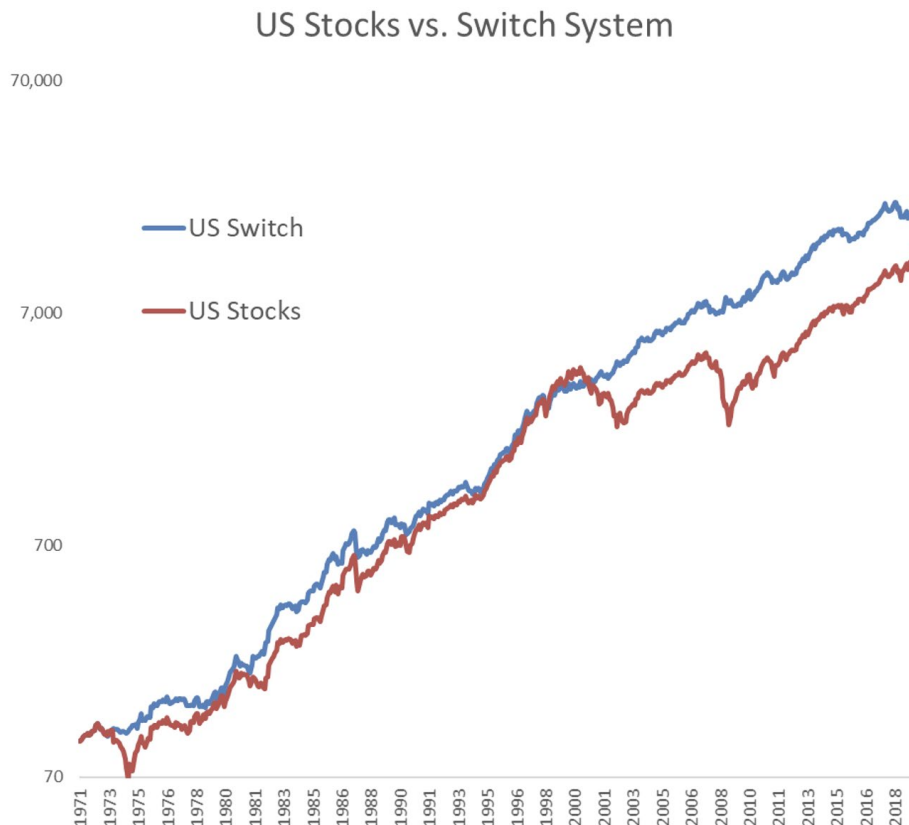
Spoiler alert – the switch system improves the numbers of every asset class – and in some case, quite significantly.

Table 7: US Stocks and the 12-Month High Switch Model

| 1972-2019 | US Stocks | Switch |
|------------|-----------|---------|
| Returns | 10.61% | 11.68% |
| Volatility | 14.98% | 11.88% |
| Sharpe | 0.39 | 0.59 |
| Max DD | -50.95% | -23.26% |

Source: Meb Faber, Global Financial Data, Inc.

Figure 7: US Stocks and the 12-Month High Switch Model Equity Curve



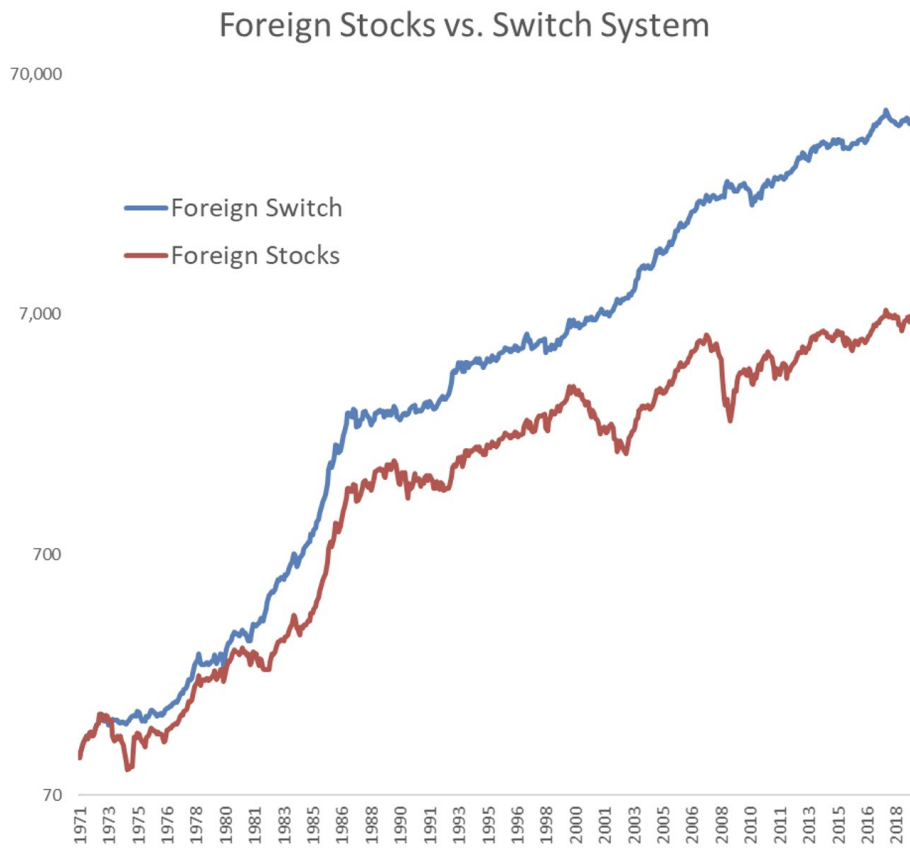
Source: Meb Faber, Global Financial Data, Inc.

Table 8: Foreign Stocks and the 12-Month High Switch Model

| 1972-2019 | Foreign Stocks | Switch |
|------------|----------------|---------|
| Returns | 9.35% | 13.67% |
| Volatility | 16.80% | 12.16% |
| Sharpe | 0.28 | 0.74 |
| Max DD | -56.40% | -19.93% |

Source: Meb Faber, Global Financial Data, Inc.

Figure 8: Foreign Stocks and the 12-Month High Switch Model Equity Curve



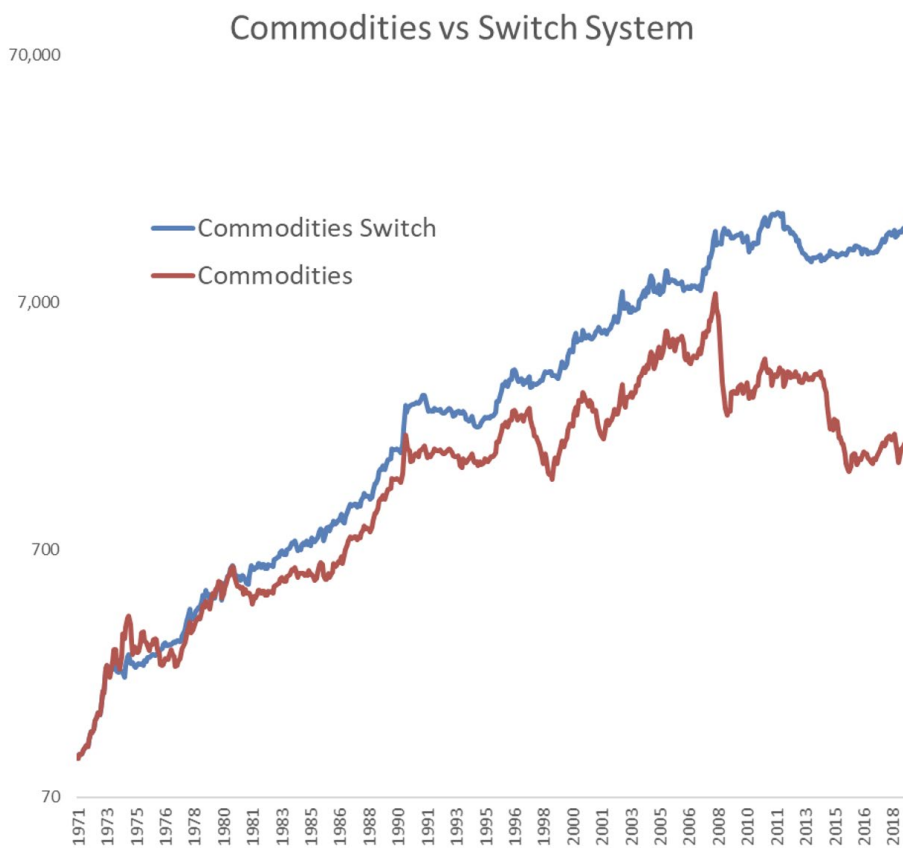
Source: Meb Faber, Global Financial Data, Inc.

Table 9: Commodities and the 12-Month High Switch Model

| 1972-2019 | Commodities | Switch |
|------------|-------------|---------|
| Returns | 6.27% | 10.94% |
| Volatility | 20.09% | 14.87% |
| Sharpe | 0.08 | 0.42 |
| Max DD | -80.90% | -37.01% |

Source: Meb Faber, Global Financial Data, Inc.

Figure 9: Commodities and the 12-Month High Switch Model Equity Curve



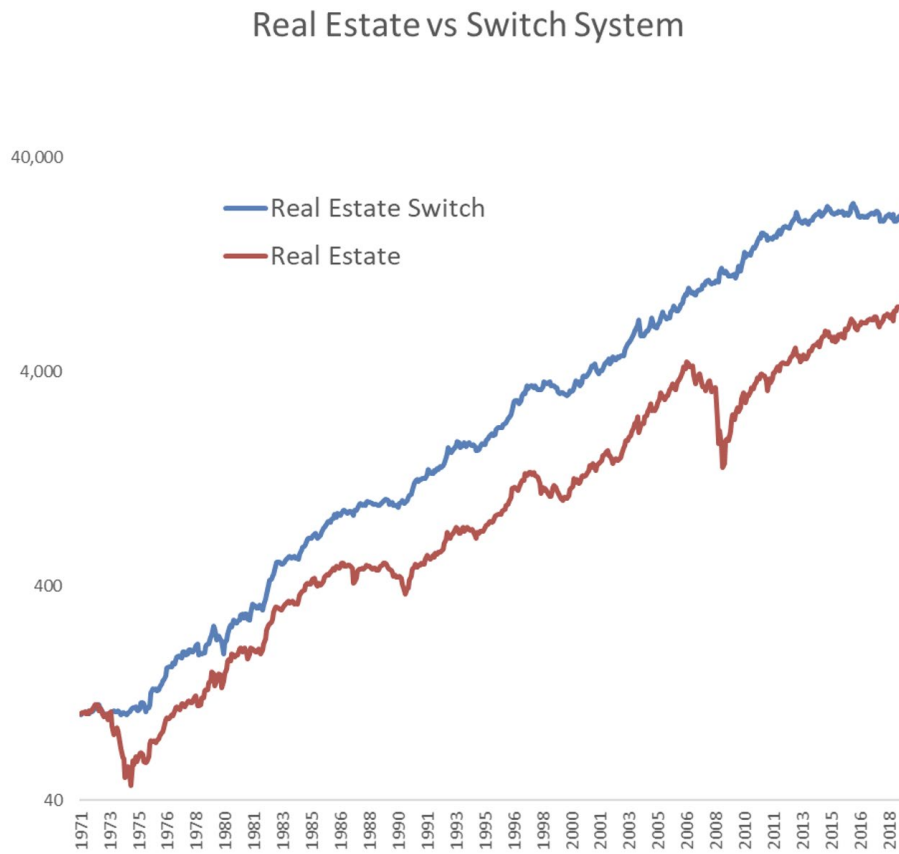
Source: Meb Faber, Global Financial Data, Inc.

Table 10: Real Estate and the 12-Month High Switch Model

| 1972-2019 | REITs | Switch |
|------------|---------|---------|
| Returns | 9.75% | 11.99% |
| Volatility | 17.27% | 11.41% |
| Sharpe | 0.29 | 0.64 |
| Max DD | -67.88% | -26.19% |

Source: Meb Faber, Global Financial Data, Inc.

Figure 10: Real Estate and the 12-Month High Switch Model Equity Curve



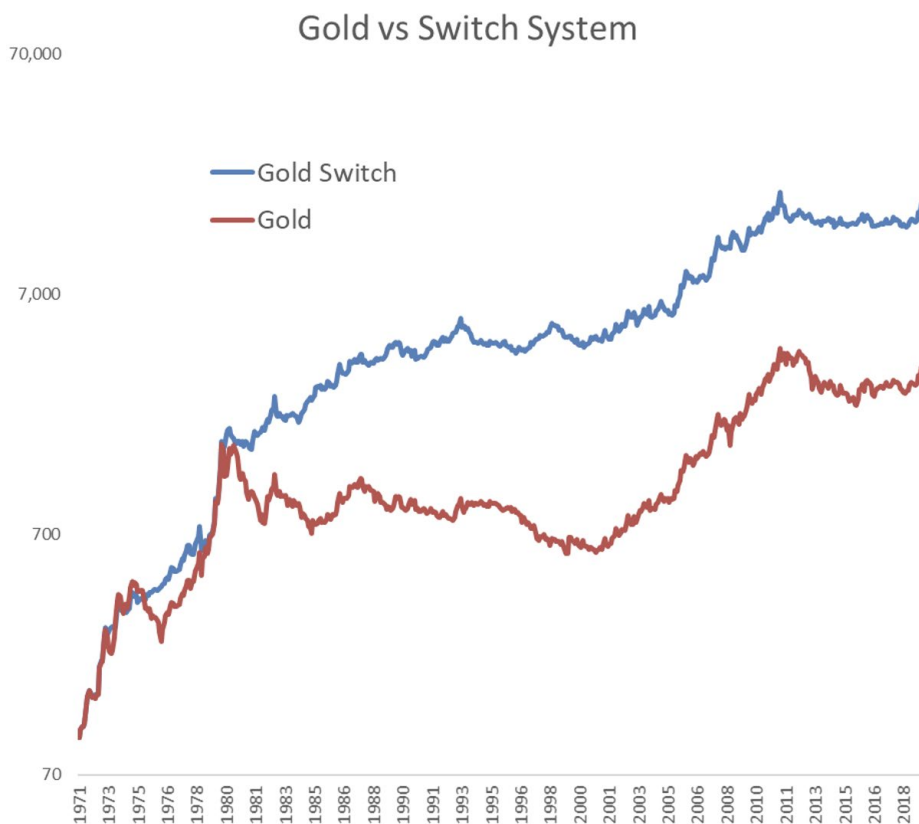
Source: Meb Faber, Global Financial Data, Inc.

Table 11: Gold and the 12-Month High Switch Model

| 1972-2019 | Gold | Switch |
|------------|---------|---------|
| Returns | 7.65% | 11.21% |
| Volatility | 20.16% | 16.13% |
| Sharpe | 0.15 | 0.40 |
| Max DD | -64.97% | -28.54% |

Source: Meb Faber, Global Financial Data, Inc.

Figure 11: Gold and the 12-Month High Switch Model Equity Curve



Source: Meb Faber, Global Financial Data, Inc.

Below is an equal-weighted portfolio of the asset classes.

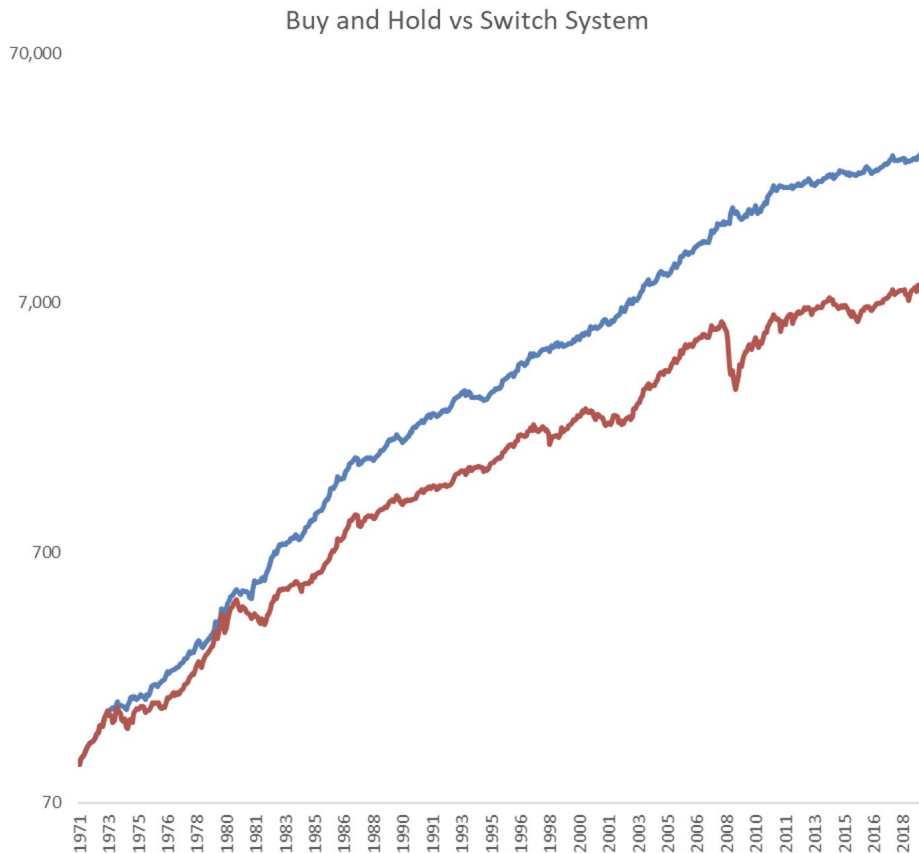
Look at that drawdown falling to just 11% while returns added over two percentage points.

Table 12: Aggregate Portfolio and the 12-Month High Switch Model

| 1972-2019 | Average | Switch |
|------------|---------|---------|
| Returns | 9.78% | 12.51% |
| Volatility | 11.14% | 8.18% |
| Sharpe | 0.46 | 0.96 |
| Max DD | -46.49% | -10.79% |

Source: Meb Faber, Global Financial Data, Inc.

Figure 12: Aggregate Portfolio and the 12-Month High Switch Model Equity Curve



Source: Meb Faber, Global Financial Data, Inc.

Some investors will notice that this basic system is a channel breakout style system. Furthermore, you market historians will realize it's not new – it's been around since the time of Donchian and likely much longer. (For a fun read on this topic check out the book “How I made \$2,000,000 in the Stock Market” by Nicolas Darvas. And before you snicker at the amount in the title, realize the book is from 1960!)

If you've been following Cambria for some time, you may also notice how this system looks like a cousin of our old trend following market approach that incorporated moving averages, which we introduced over a decade ago in our white paper and our book, The Ivy Portfolio.

So, Why Aren't More Investors Following Similar Strategies?

Many investors fear buying at recent or all-time highs.

This is understandable. It can feel like you're chasing performance or showing up at the party just a few minutes before the hosts kick everyone out.

But if we go strictly by the numbers, they paint a different picture. Buying at highs is often aligning your capital with strength, rather than exposing it to weakness.

You're following a trend. In this case, the trend of climbing stock prices. (And the alternative is equally as important – you're NOT following the downtrend of falling stock prices.)

But as we pointed out earlier, trend following doesn't just offer strong returns. No matter how you measure it, regardless of the specific parameters of your preferred model, trend can potentially help reduce volatility and drawdowns.

So, why isn't everyone a trend follower?

Because it's hard.

It turns out, maybe Jim isn't an idiot. Perhaps he's incredibly disciplined.

You see, just like any investment strategy, a trend approach can suffer a long period of underperformance.

In fact, since 2009, both trend strategies highlighted in this post have underperformed a basic buy-and-hold approach.

How long would you have accepted such underperformance? Three years? Five years? What about 10?

Sometimes distinguishing between The Beatles and the Tremeloes isn't so easy. But the numbers are what they are – and it turns out, being patient and waiting to buy at highs isn't such a horrible idea after all.

PS The benefits of combining both strategies, buy and hold and trend following, is the basis for the Trinity Portfolio family of strategies.

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