The Investment Process Magnified to the Tenth Degree

Investors in markets of all types continue to try and assess the damage to corporate earnings that will be seen over the next few months as a result of the coronavirus. This analysis leads to repricing of *all* assets, not merely stocks. It is very important to understand that investments across all major asset classes are related. This is due to the constant search for yield (or return) relative to risk. As the potential for return in one asset class becomes outweighed by risk, investors necessarily turn their attention (and capital) to another asset class. The past six weeks provide a perfect example of this. The volatility that has occurred has given us a once in a lifetime opportunity to see the investment process magnified to the tenth degree. We have seen huge moves in both directions in all major asset classes. This is the result of investors worldwide sorting through probabilities of return in the face of rapidly changing perceptions. What we are witnessing is an extreme version of the day in and day out work that is investing. At its very essence, investing is all about looking at opportunities to deploy capital and picking the opportunity that will likely grow that capital the most, without losing it if things turn out differently than we believe.

So, what is the better investment right now? Is it a stock that is undervalued and whose earnings may rebound quickly? Is it a bond issued by a large, well-capitalized company that pays interest at a rate higher than that of a risk-free Treasury bond? Is it gold which may hold its value if the economy worsens and our central bankers are forced to inject more and more capital into the economy, thereby reducing the value of a dollar? Is it real estate or other hard commodities that fulfill an omnipresent need by humans, irrespective of economic condition? Is it the U.S. dollar that represents the reserve currency of the world and is reflected in the trillions that flows into money market funds when investors are truly scared and waiting for the smoke to clear? Or perhaps it is U.S Treasury bonds that represents the safest investment of all and even pay a little bit of interest? Fortunately, the repeating economic cycle gives us a very good idea of what is likely to be attractive. This “cycle” is made up of changes in interest rates, which are responsive to supply and demand, and drive access to capital and ultimately corporate earnings. Earnings of course drive the price of stocks. Tied up in the middle of all this is inflation, which reflects commodity prices, and is also very much related to supply and demand, as well as interest rates.

If this all seems confusing and makes your head hurt, fear not, for that means that you are a relatively sane person who has chosen to do something else for a living. It is not important to know how all this works, only that it does work, and it is going on around us all the time. An investor who can capture a snapshot of the current conditions set out above has a better than fair chance of determining what assets have the best chance of return, relative to their inherent risk. The problem today is that we have never seen such a sudden and severe disruption to our trusty economic cycle. Within a matter of days, we saw both supply and demand within the world economy fall off a cliff. There was no time or even historical precedent for what interest rates would or should do. Would liquidity ultimately increase or decrease thereby causing even further disruption to companies’ ability to generate earnings? Would the drop in demand be so severe that commodity prices would fall, and the economy would enter a deflation, or would the extraordinary action of our Federal Reserve to flood the bond markets with liquidity override the deflationary pressures and result in inflation? Would inflation devalue our dollar, and would that be supportive of stock prices or simply result in a flight to gold or other hard assets as a store of value? All of these questions and more have been thrust upon the collective wisdom of millions and millions of really smart investors worldwide, with the ultimate outcome hinging in large part on a viral pandemic outside of normal human control.

As I ponder an answer to the question of what the better investment in times like this is, I can make the case for most if not all the assets set out above. That fact alone is unusual and should cause an investor of my admittedly limited intellect to step back and remember the first rule of investing. A rule that comes before all else. So much so that Warren Buffet has identified that it is also the second rule. When in doubt – try not to lose money! The world around me appears very much in doubt.

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