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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

Gambling is a word with a lot with a lot of connotations, but only one real meaning: taking some measure of risk in order to achieve some sort of return. You can define risk and return any number of different ways, and at many different levels. Obviously, you want to make sure the risk you take is less than the reward you expect. This is called playing the odds, and we do just that in virtually everything we do.

However, no one really considers crossing the street as gambling, although it technically is. Gambling is what you do at the track, when you buy a lottery ticket, with a bookie, or in a casino. Right? However, that isn't gambling as much as losing. Why? Because there wouldn't be tracks, lotteries, bookies, or casinos if the odds were in the your favor. To that end, there isn't a single game in a casino where the house won't eventually take all of your money if only you play long enough.

I mean, why do you think they give you free booze? To make sure you have a good time **or** to make sure it dulls your senses enough you sit at the table longer? Further, why do you think the server visits the high dollar tables far more frequently than the penny slots? After all, the house doesn't make anywhere near as much money on the penny slots over a 15-30 minute time frame as it does at the blackjack table. It is all math, and the math says you will lose.

The same can be said of the/a lottery. These are complete suckers' bets. You probably have a better chance of being gored by an elephant in downtown New York than winning the Powerball. I mean, you might as well just hand your money to the clerk in the convenience store, and walk away. That is what the math says. However, when the lottery gets over $500 million, well, someone has to win it, right? And you know what your chances are if you DON'T buy a ticket, right? So, what is the harm in a couple of bucks, huh?

The truth is: there is probably is very little harm, financially, for the average person who wants to occasionally blow $20 on lottery tickets or on the slots at a casino. The issue is whether they can appreciate it for what it is: entertainment, as opposed to a sound way of shoring up the asset side of the balance sheet.

Investing is gambling of another sort. The reason is pretty simple: the odds are actually in your favor over the long-term. Period, and end of discussion. To that end, investing is more gambling than what we typically think of as gambling.

Now, assume an alien from KIC 8462852, Tabby's Star, asked your opinion on the best way to make money in the markets. What would tell them? Stocks, bonds, or cash? If said anything other than stocks, you would be incorrect., and not even close. Yes, you might lose more investing in stocks over a particular short-term period, but if you want to increase your wealth over years and decades, stocks are the best bet over the other primary "paper asset" classes.

Again, it is just math.

From 1928 to 2015, a span of 88 years (including 1928), stocks (as defined by the S&P 500) were positive 64 years. That is 72.7% of the time. What's more, starting with the first observation in

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1937, there have only been 4 calendar year trailing 10-year returns less than 0%. Four. The first two included years during the Great Depression, and the last two came as a result of the recent Great Recession. So, a negative trailing 10-year return is virtually a unicorn outside of a significant, major financial crisis. By financial crisis, I mean a US banking system collapse or about as close to collapse as you can get.

So, what are the odds you will make money in stocks if you simply hold onto them long enough? While past performance is not indicative of future results, the answer is about 99%, absent a once in a generation (or two) financial panic.

By comparison, bond returns (as defined by the 10-year US Treasury) have been positive 72 out of the 88 years of that time span. That equates into 81.8%. What's more there has never been a trailing 10-year calendar period when the return has been less than 0%. Finally, almost by definition, unless you currently live in Europe or Japan, cash has never been negative.

So, if the goal is to not LOSE money, you should have a portfolio of bonds & cash. However, you won't make a lot either.

But, what if you want to make a little money, but not take the short-term risks associated with the stock market? What should you do then? Well, clearly, some combination of stocks, bonds, and cash should/would fit the ball. With this in mind, how would have a portfolio of 60% stocks, 35% bonds, and 5% cash performed between 1928-2015?

Well, this mixture would have been positive 69 calendar years out of 88, or 78.4% of the time. This is only a few percentage points lower than bonds alone. Further, and I had to double check my formulas, it appears as though there hasn't been a negative trailing 10-year period (calendar year) over that time frame where this portfolio mix would have been negative. What's more, as bad as 2008 was, and it was awful, an investor in a 60/35/5 allocation would have been no worse for the wear in around 24 months….with the exception of stressed induced hair loss and a nervous tick.

Now, all of these calculations are of the proverbial "back of the envelope" variety, but I present them in good faith, and believe them to be accurate.

I have gone through this exercise for a reason. This week, I met with a client who has a portfolio with an indefinite time horizon, for all intents and purposes. They are understandably worried about short-term market conditions, as well they should be. What happens if X, Y, and Z? Truly, we are sailing in somewhat unchartered territory with some of what's going on in the world today. Negative interest rates? Bloated levels of global debt? Compressed GDP potential in developed economies? You name it.

So, I had to pull out the old "what are the odds" talk. While no one can predict the future with crystal clarity, the odds are you will make a lot of money in stocks over time. The odds are you won't lose your money with bonds and cash. The odds are you will make some money, and, importantly, not lose much in bad years in a diversified portfolio. This is important, because what do you do?

Frankly, it depends on your time horizon, and personal understanding of the odds. In this way, everyone is unique,

Disclosure

even if there aren't as many truly unique ways to manage money as the industry would like for you to believe. I have met people in their 30's who can't think past 12 months, and are paralyzed with fear. On the flipside, I know plenty of folks well into their 80's who want to roll the dice. After all, they have been there and done that; they understand the odds.

Although I thought I was quite eloquent, they pressed me on the here and now. All that talk about 10 years out, and the like, was so much noise. What in the heck is going to happen over the next several months? Whew. Folks that do what I do for a living hate such questions, because the odds aren't as firmly set.

So, I told them: "we will likely have some "chop" over the next two months, and am kind of surprised we haven't had more of it in August. That doesn't things are going to fall apart, because the financial system currently looks pretty healthy...or at least healthy enough to get out of 2016. The markets generally tend to rally during November and a decent part of December. When you add it all up, we probably won't be too much higher than where we currently are, probably, and might even be able to squeeze another point or two out of it."

But what about the election? Oooh. I just love talking politics in client settings….not.

My response was: "currently, the odds are Clinton will win the White House; the GOP will keep the House, and the Senate will be split down the middle, with neither party having a workable majority. In other words, we should have political gridlock for the next two years, and, you know, that isn't so bad. It doesn't matter what the rules are, as long investors know what they are...and they don't change midstream."

Still, he wanted to know what would happen if either party got complete control in Washington.

Here went nothing: "Frankly, the odds of that are pretty small. The Democrats have the best chance, and if that comes to pass the markets will sell off in November and the first part of December, before rallying back the last week of the year. This has everything to do with Clinton's capital tax plan, and little to do with anything else. The end result should be not too far off from where we are currently….just a lot more volatile."

But Trump?

"The odds are such I haven't come up with a scenario on that yet. If the odds improve, I will certainly get back to you on it."

He responded: "Fair enough. But what do we do in the meantime?"

What I said didn't fire him up too much: "We have been running with a slightly higher liquidity position than normal due to all of this uncertainty. If the markets sell off at the end of the year, 2017 valuations just got a little better, and we will take it as a buying opportunity. If they don't, we will enter 2017 with relatively high valuations relative to our expectations for economic and earnings growth, so a little extra cash will be a good thing."

"In other words, the odds are whatever we end up getting between now and the end of the year will either steal from or give to our return in 2017. There isn't an immediate reason to sell or buy, and nothing looks all that cheap."

I laughed, and said: "well, when you put it that way….however, longer-term your portfolio is well positioned, and you won't be upset owning the positions you currently own 5 years from now. After all, those are the odds."

In summation, life is, well, a gamble. We take risks we don't even realize to achieve some end with just about everything we do. However, what we commonly think of as gambling really isn't, for all practical purposes, because the odds are you will not get any return in the end. It is nothing more than institutionalized losing, with the government taking its cut on the backend. On the other hand, investing is a form of gambling where the odds are ultimately in your favor. If you invest long enough, it is nothing more than institutionalized winning, with (again) the government taking its cut on the backend.

If you had to choose, which will it be?