MCLEAN ASSET MANAGEMENT CORPORATION

# Occam's Razor

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**WHAT IS OCCAM'S RAZOR?**

Occam's Razor is a principle attributed to William Occam, a 14th century philosopher. He stressed that explanations must not be multiplied beyond what is necessary. Thus, Occam's Razor is a term used to "shave off" or dismiss superfluous explanations for a given event. This concept is largely ignored within the investment management landscape. This newsletter will "shave off " popular investment misinformation and present what is important for achieving long-term investment success.

## Wine and Ambien, Macroeconomics and your Portfolio

Occam's was recently woken from a self-induced hibernation with all this talk of the "cliff." Last month we sent out a newsletter discussing the "cliff" and planning opportunities. This month it's time for Occam's to stretch his muscles and discuss the question behind the question: "How does the fiscal mess staring us in the face affect my portfolio and retirement prospects?" We understand many of our readers are worried, and many of you look to us to allay your concerns. Let's see if we can end the year with an appropriately timed and reasonable explanation of why you shouldn't pay attention to the media and financial press, and should instead focus on your family and loved ones this holiday season.

CUMMINGS, Winnipeg Free Press/NYTS

We'll start with a pop quiz. What do these pairs have in common? Bleach and Ammonia; Business and Pleasure; Wine and Ambien; and Macroeconomic Forecasts and Portfolio Returns? Answer: none of these mix well, and you don't need a call from HR to tell you that.

The majority of questions we have received in the last couple of years have all been related to macroeconomics. We have all been listening to the talking heads discuss government debt, QE3, taxes, inflation, regulation, global recessions, and many other topics. And listeners naturally are thinking about their own retirement, medical care, income, purchasing power, and heirs. The intersection of what is said and what the listeners hear and care about is what causes anxiety.

We can separate the two and all sleep a bit easier by remembering that markets are forward looking; that is, expectations about the future are included in today's price. And current prices reflect these assumptions. Remember the intense coverage of Greece earlier this year? The market efficiently priced Greece's securities in advance of future expectations. Despite being the epicenter of the European Debt Crisis, Greece led the way posting a 21.05% return, the highest amongst all developed markets in the 3rd quarter.

The prevailing concern about the "cliff" is whether or not we are going to be pushed into another recessionary period, causing the value of your portfolio to decrease, and your retirement prospects to diminish. Looking at historical data, it isn't exactly clear what your timing strategy should be if you believe you can adjust your allocation at precisely the right time to benefit your return.

Making investment decisions based upon macroeconomic forecasts is very difficult. Why is that? Market returns are not strongly correlated with macroeconomic variables such as Gross Domestic Product (GDP), and markets can provide positive returns during periods of poor economic performance.

Quick programming interruption: According to Investope-

dia, "GDP is defined as the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory."

At this point I'm going to focus this discussion on the GDP and the widely held belief that GDP growth rates are directly correlated to equity (stock) returns. Ultimately, every macroeconomic question is going to boil down to shrinking GDP expectations, so let's just go there.

What if we were able to perfectly predict when we would be in a shrinking GDP environment (i.e., a recession) and adjust our allocation from stocks to government bills during each period? Think about the current "cliff" situation as an example. In the U.S. from 1900-2010, there have been 21 years when we've had a negative GDP. In those 21 years the average GDP shrunk 4.37% and real equity returns were up 11.27%. In other words, the economy shrunk but the stock market grew, significantly.

In contrast, over the entire 111 year period, GDP growth was 3.31% and real equity returns were 8.07%[1]. Having higher equity returns while the economy is shrinking versus all periods does not match common perception.

Surely if GDP growth and equity returns don't correlate in the U.S. it must work internationally. Comparing similar data from 18 additional developed economies, deploying the same strategy of adjusting your allocation from stocks to government bills over the same 21 year period, you would have been worse off in 16 out of 18 countries than if you just held stocks. And this is with the most optimistic, precise timing[2].

We hear a lot of concern about the "New Normal" and how we can no longer count on our economy growing at roughly 3%. We hear that GDP growth is going to be slower around the world from here on out, and we should therefore expect lower returns from stocks. Our discussion so far has been on a year to year basis utilizing a timing strategy. But what if we were to aggregate the time periods for these same 19 countries and plot real GDP growth on the horizontal and real equity returns on the vertical axis?

Most people believe that GDP growth drives equity returns and that there is a strong, tight relationship between the two. When plotted you would expect to see a straight linear relationship; the highest GDP countries would have the highest equity returns. What we actually get is a broad scattering of results, and though there is an upward slope in aggregate, the relationship isn't tight.

Occam's loves graphs like this because they can be applied to many different conversations and debates. In our discussion, this graph dispels the belief that slow growth GDP countries don't have strong equity returns and that high

GDP growth countries do. We could pivot here and discuss more "social" or "less free" countries and equity growth but that's an article in and of itself. Nevertheless, I promise you the data boggles the mind. Note: if our readers request this article, I'll write it.

What do we see in this graph? If we take a horizontal sampling of the UK, the U.S, and Canada, you'll see similar equity returns with drastically different GDP growth. The same can be seen with a vertical sampling of Ireland, Finland, and Italy with the opposite result. There is much that goes into equity returns that isn't at all related to real GDP growth. We're talking about earnings and cash flow of public corporations, vs. private enterprise, government spending, net exports, etc. of the GDP equation. There is a lot of economic activity that contributes to the GDP but not corporate earnings. The GDP pie is big, and the portion that is made up of corporate earnings is a fairly small slice; last year, that amount was roughly 10% of our total GDP. It is precisely because of this that the relationship between the two is tenuous at best.

What are our conclusions? GDP has been linked to higher incomes, increased longevity, lower infant mortality rates, better education, and increased life satisfaction. But we need to draw a line in the sand somewhere. We aren't saying that the market won't go down, or we won't go into a recession if our elected officials fail to find a resolution. Frankly, neither we nor anyone else knows what is going to happen to the markets in the future. What we do know, however, is that when investors try to time their allocations around recessions their results have been overwhelmingly worse than if they had stuck to their guns. Regardless of what effect the pending "cliff" has on the markets, it, like everything else, will pass. A broadly diversified portfolio with an appropriate mix of stocks and bonds is your best defense and ally.

All of us at McLean Asset Management want to wish you and all of your loved ones the best during the holiday season.

Until next year,
-Occam's


**REFERENCES:**

1. MS and Angus Maddison (1995) Monitoring the World Economy 1820-1922, Paris: OECD Development Centre, updated by the Gronigen Growth and Development Centre for 1900-2008. Real GDP Growth and Real Equity Return data are adjusted for inflation.

2. Australia, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, S. Africa, Spain, Sweden, Switzerland, UK, & U.S.



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