The Rear View Mirror is Broken: **The Past 8 Years are Not Indicative of the Future**

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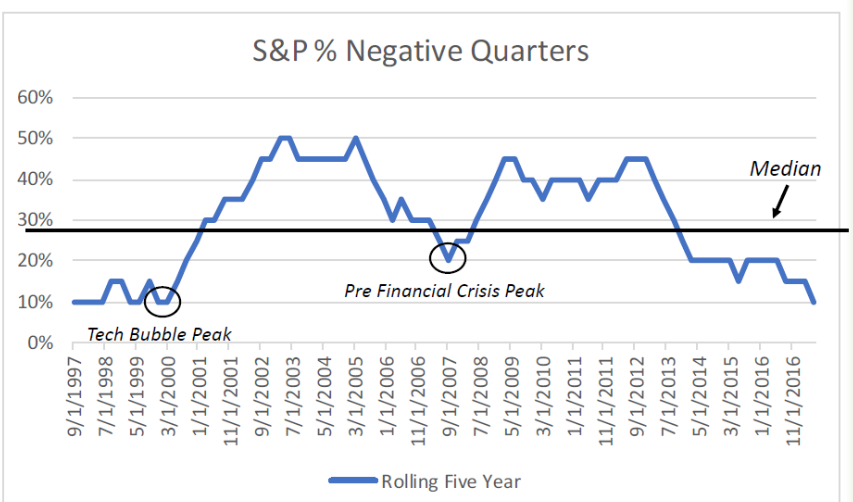
As I sit in the passenger seat teaching my 15-year-old how to drive, I always tell him to look where he is going and keep both hands on the wheel. Those basic instructions also apply to the investing world; however, it seems that many institutional investors are staring at the rear view mirror instead of looking forward 20 years down the road. The main problem is that they are using a mirror that provides a limited view of the past eight years, to help them drive **forward**. While it is important to learn from history, we need to put the events of recent years in **perspective** and understand how unlikely past events are to repeat themselves. If we want to find any **meaningful** information, we should use a mirror that views long-time periods to capture past **market cycles** so we can understand what may lie ahead of us 20 years from now. The equity markets have only moved in one direction since 2009, with very few bumps along the way.

This extreme bull market is not likely to repeat itself over the next few years and this perspective must be understood if we are to even glance in the rearview mirror. What do we see in our rearview mirror anyway? The Federal Reserve has flooded the market with over **$3 Trillion** in cash through its quantitative easing programs since 2009. Additionally, it has been more than a year since there has been as much as a 5% pullback in the S&P 500[1]. We have not seen a normal occurrence of negative periods since the bottom fell out of the market in 2009. In fact, recently we have matched an all-time low in the percentage of negative quarters for the last five years.

What is Missing in This Market? – A Normal Occurrence of Negative Periods



Source: Intercontinental Exchange Inc.

SEC rule 156 requires the disclosure: **Past performance is not indicative of future returns.** This is a phrase most investors know, yet few actually adhere to the sentiment. Psychologist Karen Franklin, Ph.D., has found that it is only useful to measure past human behavior if the following occurs[2]:

1) The situation is essentially the same as the past;
2) The behavior remains unchanged;
3) Predictions work over short time intervals.

Our past market conditions don't satisfy any of these criteria because the central banks have removed any semblance of a **normal market cycle**. Quantitate Easing 1, 2 and 3 have come to an end, and the market impact generated by these monetary policies during the past eight years in not likely to repeat itself. That is the primary reason the rear view mirror is broken. As James Montier, noted portfolio manager at GMO, says, "We have a bubble of complacency and people are acting as if they have no risk." Investors are not driving with both hands on the wheel!

About the Artist: Anthony Brooks is an Equity Portfolio Analyst for Sawgrass Asset Management. During his college years, Anthony worked as a staff cartoonist for various publications including the Jacksonville Free Press, Jacksonville Advocate, and The FSView/Florida Flambeau (Florida State University's student newspaper).

Institutional investors and active portfolio managers should build a portfolio that can survive a **variety of challenges** over the long run. This sounds simple; however, in reality, institutions are reacting to what has worked over the past eight years that don't include **a true market cycle**. Investors are now doubling up this bet after the fact and, when they see what has worked best in the **PAST**, they find index funds. Unfortunately, for most investors who recently switched to index funds, the timing of this means they have most likely **missed** the best relative run for index funds and their return stream will not include the strong returns since the market bottom of 2009. You cannot buy the past performance and it is worth noting that $500 billion flowed out of active portfolios and into index funds over the past six months[3]. James Montier has also said "Going passive now is classic **returns chasing behavior**," and "The light at the end of the tunnel is that the more people buy on the basis of market cap (indexing), the greater the opportunity for active managers."

The current low volatility market environment is **hiding a great amount of risk**. With so many dollars chasing an index fund without regard to fundamentals, there is too much comfort in the market. Investors are investing as if market cycles are a thing of the past, just like a cassette player in your car. This complacency adds risk to portfolios, and the role of an active manager should finally be rewarded. Active investors have a **sell discipline** that has not been rewarded during this recent bull market. This past abnormal market has blurred our vision and judgement.

In conclusion, most institutional investors have a long-term investing focus, yet they measure returns over short three or five year periods. If investors want a truly good look in the rearview mirror, they should use historical data over the past 20 or even 50 years to frame their asset allocation and investment decisions. The market conditions that fueled index funds over the past eight years are less likely to repeat themselves over the next eight years. Investors need to look forward and identify what they think will work best over a **true market cycle**. Look where you are going and keep both hands on the wheel, active investors are preparing for the road ahead.

Sources: [1] Barron's 7/17/17, [2] Psychology Today 1/3/13, [3] Bloomberg 7/7/17