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After the fling…the Pregnancy Test

The Occasional that talks sense… most of the time

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All of us have been really naughty last few weeks. We have done unspeakable things with the unmentionables. And have done these with highly unsafe practices.

So I though it a good idea to do the right thing and administer a pregnancy test to ascertain whether there is indeed a bull embryo somewhere inside this rally.

So how does one perform a pregnancy test on a rally, to figure out whether it is a bear market rally or an incipient bull market?

Well, the medical approach is to pee on the rally, and see if the color or some such thing changes. I have pee-ed on the rally last 20 days and its color hasn't changed (well, it has changed a bit in the developed world, but not so much in Emerging Markets.)

So the medical approach has to be discarded in favor of a more financial approach.

And here's what I decided to do:

The Pregnancy Test for the Rally

Let's first pay our *devoirs* to the rally. It has killed both the bulls and the bears, in a salute to the resurgence of Communism. It has leveled the playing field, making everybody poor. The bears have been cleaned out, and surprisingly, even the bulls (like the Long-only funds) haven't fared too well at all, because they were all overweight "quality", and "quality" has been an absolute dog.

Quality has been an absolute dog…

Now, there is something in this statement that's making me think: *how can "quality" be a dog in what is supposed to be a bull market?*

Let's start with this central theme and commence our Pregnancy Test (medically-inclined folks can still take a pee).

I asked my quantitative guys to run the following back-tests for the period April 2002 to October 2003. This is the period in which we saw the last bear market wend its way slowly to a global equity market trough in March-April 2003, and then the famous bull market began…yes, the same one that led us to this sorry mess.

The objective of the investigation was simple: ***does the trade change when a bear market metamorphoses into a bull market?*** That is, do the countries or sectors, that you are long/overweight, short/underweight, need to be changed in your portfolio composition, when a bear market ends and a bull market begins? In other words, do you have to undergo a *wholesale* reshuffle of your portfolio, in fact, turn it upside down, when a bear market truly ends, and a bull market truly begins?

The thought for this investigation came from listening to the pain of clients: even the smart guys on hedge fund side who went net long on March 9, still hurt badly…they either remained flat for this period, or made a bit of money, or worse still, even dropped a bit of money.

Even the long-only guys hurt badly, for they were weighted in favor of "quality" or defensives…the consumer plays, the utilities, the healthcare/pharmaceuticals, etc. all of these hurt performance big as the performance disparity between them and the "junk" was nearly two times, in most cases.

So we decided to do a bit of snooping around. Nothing very arduous, mind you, for at my age, the mere act of stirring from my analyst armchair is quite enough exercise. But just enough to get a clue as to whether this is indeed an incipient bull market, or merely a tarted-up bear market rally, painted knees and all.

We did this at multiple levels: Emerging Markets country bets, ie, if you were long the best performing emerging markets in the 12 months preceding April 2003, and short the worst ones, in the same period (essentially the last one year of the previous bear market), how would your performance have been in the 3 months, 6 months, 9 months and 12 months after the start of the last bull market, assuming you made no change to your portfolio in that period?

The same question was asked for Europe: if you were long the best performing countries in the bear market and short the worst ones, made no change to your portfolio when the bear market transitioned into the bull market, in April 2003, how did you do?

For the US, we asked the same question, except that we did it on a sectoral basis: what if you were long the best performing sectors of the bear market, made no change to your portfolio in April 2003, then how did you do in the early stages of the bull market.

We asked the same question, as we did for the US, of an Emerging Market called India. The rationale being that India has a vast number of sectors, like the US, and unlike most other EMs, which are dominated a handful of sectors.

(The long only funds can simply replace the terms "Long" and "Short" with "Overweight" and "Underweight". Separately, the base of the analysis was either sectors or countries, and not stocks. The reasoning behind this was that stocks can undergo very fundamental changes in a cycle, through mergers, divestitures, change of strategy, etc, which can make comparisons across periods difficult, and prone to wrong conclusions.)

The Results of the Pregnancy Test

The anxious parents of this purported baby bull have become restive by now: what did the pregnancy test show? Is there a baby bull in there or not? Or is it a misconception?

In a short sentence, based on the analysis of these markets, in the above period, the answer is: No. Based on this limited analysis, it appears that this is still very much a bear market rally.

Let's get into the details of the Test…

The Emerging Markets Pregnancy Test…

Let's start with Emerging Markets. Remember the question: you have a long/short ratio of 50:50. You are long the best performing EMs of the period April 2002 to April 2003, short the worst performing ones, and change nothing in your portfolio when the bear markets ends in April 2003, and transitions into the bull market.

For the period ending April 2003, the portfolio delivered a return of +15% in the bear market, while ***FIRST GLOBAL's Emerging Market Index*** (closely tracks the MSCI EM Index) delivered *negative* returns of 23% in the same period.

Now for the bull market returns. Nothing was changed in the portfolio. In the 6 months post April 2003, the portfolio gained 8%, while the EM index gained 24%. The fund lagged market returns, of course, because it maintained shorts.

But the interesting thing is: the longs went up by 46% in the 6 months after the start of the bull market, while the shorts went up by 32%. Again, to jog your memory a bit: you remained long the same EMs that outperformed the bear market, and made no change in your portfolio when the bear market ended and the bull market began.

What comes through is key: the outperformers in bear market, remained outperformers even in the bull market. You needed to change nothing in your portfolio (except add some leverage or increase the long/short ratio to capture extra returns. But your components of your portfolio did not need to change at all, when the bear market transitioned into the bull market. The same longs did better than the same shorts.

In fact, the performance gap widens if a period of 9 months and 12 months is considered: in the 9 months post April 2003, the long basket went up 66% while the short basket went up only 34%. The FG-Emerging Markets Index went up by 35% in the same period. In the 12 month period into the bull market, the long markets went up 83% while the short ones went up 51%. The Index returned 50% in the same period.

See the disparity here? What was quality in the bear market remained quality even in the bull market. You needed to change nothing in the core portfolio.

And the Test for India

For India, the results are near identical: the outperforming sectors in the bear market returned you +10% between April 2002 and April 2003, while the underperforming sectors delivered *negative* returns of 34%. The market was *down* 15% in the same period.

When the bull market came up, in the 6 months post-April 2003, the bear market outperformers delivered 104%, while the laggards delivered 84%. In the 9 months post-April 2003, the bear market outperformers delivered 140% vs 126% for the laggards, and for the 12 months, the outperformers delivered 160% vs 134% for the laggards. The market delivered 129%.

Again, the message comes across loud and clear: when a true blue bull market comes, the trade doesn't necessarily have to change. The portfolio doesn't need to undergo complete U-turns, the way we would have needed to do if we had to survive this March's rally.

…The US Test

Let's now turn to the US. The results are quite the opposite. Yes. They don't confirm what the analyses of Emerging Markets and India threw up. The US results are quite to the contrary. And since we are on the subject of contrary results, even the results of the analysis of Europe, agree with findings of the US.

First, the data. In the US, the outperforming sectors of the bear market still delivered negative returns (contrast this with the data above on EMs and India, wherein the outperformers in the period April 2002 to April 2003, actually delivered positive returns). It was the same as the US, in Europe, as well.

But it's the returns in the 6, 9, and 12 months into the bull market, that are dissonant with the findings from Emerging Markets and India. In the 6 months post-April 2003, the outperforming sectors of the bear market, went up 26%, while the dogs of 2002, went up 50%. In the same period, the US market index delivered 30%. Extend the period to 9 and 12 months, and you get the same result: in 9 months, the (bear market) "outperformers" went up 42%, while "underperformers" went up 65%, while the market returned 37%. In 12 months, the "outperformers" went up 59%, while the "underperformers" went up 80%, and the market returned 48%.

In Europe, the results are identical. The bear market outperformers lagged the bear market underperformers widely, in the bull market.

In other words, in the US and Europe, what was "quality" in the bear market, turned out to be the worst places to be in, in the bull market.

You would have had to do a complete portfolio U-turn if you had to survive.

This was diametrically opposite to the findings from the Emerging Markets analysis.

So what explains the above disconnect? Why the investigation point to separate directions when we analyzed developed markets vs emerging markets?

Hmmm…with your permission, I offer an explanation:

Did Developed Markets actually have a bull market between 2003 and 2007?

The short answer is: No. The US and Europe had, what was essentially a big bear market rally. At the end of this rally, they barely reached their levels set back in 2000. That's what Jeremy Grantham calls the move from 2003 to 2007, in the US: a giant bear market rally.

I agree. A bull market has to necessarily take out its previous high to be called a bull market. Everything else falls in the category of a bear market rally.

Begin to see the drift?

The results are different for the US and Europe precisely because they never had a bull market between 2003 and 2007. That is why "quality" suffered and "junk" rallied in the US and Europe, while "quality" rocked in Emerging Markets and India. That is because the only place(s) in the world that enjoyed a true bull market between 2003 and 2007, were Emerging Markets. They took out the old highs of 2000 and went well, well beyond. That is a true bull market. And only the Emerging Markets enjoyed one.

Now, cut to present day: Quality has lagged, low quality has rallied. Going by the evidence presented above, it stands to some degree of reason, that these characteristics are displayed by markets in a bear market rally, rather than in a true bull market. For, as the analyses above shows, these were the precise same characteristics displayed by the US and European equity markets between 2003-2007: Quality lagged the rally post April 2003, beaten down names did well.

Therefore, based on the limited review of history, it can be reasonably concluded that the present move up by the markets is nothing more than a cute, cuddly bear market rally. The magnitude appears big precisely because the move down in 2008 was extraordinary…markets down 40-60% in a year are not normal. So, we were set up for a rally that would also surprise us, and we've got one.

There's another thing that causes dissonance to the bull market theory: the VIX still remains highly elevated in 38-40 range. While in context of what we saw in October last year, this appears low, fact is, it is still very, very high.

Which means that this entire talk of "risk aversion" falling is pretty much poppycock. From an equity market perspective, the VIX is arguably the most reliable measure of what levels of fear and risk perception exist out there, and looking at these readings, risk aversion is still awfully high.

For a market move of this kind, the VIX should have nearly halved, as it did back in March-April 2003. This time, it has been a reluctant faller. I don't blame it for this.

Actually, there is an intuitive answer to the above puzzle: after all, how can one build a case that in a bull market, we have to abandon all our Buffett-esque investment philosophy of buying quality companies, and jump right in at the deep end of the pool and buy up rubbish like financials, real estate, infrastructure, commodity players, insurers, etc., in order to look good? It makes no sense. In fact, making the opposite case is a one-way ticket to investment hell: that in a bull market, never buy quality companies, buy only companies with suspect fundamentals and even more suspect financials. Nothing could be more ridiculous than that.
But even beyond this, there is a certain basic reason why quality hasn't participated in the rally at all. Fact is: quality isn't cheap at all, anywhere in the world. Buying things at 15-18x earnings is hardly a formula for making 50% or 100%. These simply haven't gotten cheap enough.

Citi was the Dollar Tree stock

On the other hand, low quality got really cheap. In absolute price terms, that is, not in valuation terms. After all, Citi at a buck is a whole lot cheaper than at three bucks. Not in valuation terms, but in affordability terms. Owning Citi was never more affordable, so folks went in and bought it. It was as simple as that. It can be no sensible person's case that Citi at a buck was a cheap stock…in a bank, the lower the stock price, the more expensive the stock because of higher risk, because of higher gearing coming from higher total assets/market cap ratio…$0 is a lot closer to $1, than it is to $10. It is simply that Citi was a more affordable stock, just like many, many low quality stocks in varying industries, across the world. And the Great Unwashed loves things cheap, in these days of down-trading. Anything available for a buck is great.

That's why low-quality rallied and quality didn't. Overall, markets are simply not cheap enough even now. Dollar Tree stocks were.

Practically any sub-segment of any sector you take globally…the beaten down end did better than the quality end, even within industry segments. The pattern has been repeated pretty much across the world.

So, there you are, anxious would-be bull parents: the Pregnancy Test has failed. There is no baby bull in there. More like there's Rosemary's Baby in there. And we don't want babies like that, do we…

(Of course, like all tests, this can give false results. But the chances are low.)

But despair not. We will get the baby bull. Anytime between now and 2015. That's a safe enough prediction.

What's been the complexion of the rally from March 9, 2009?

One last thing before I wrap up this edition: the obvious question that bubbles up is: how did the "quality" vs "low quality" performance parameters stack up now, in this, present bear market and the rally post March 9, 2009?

The results are fairly in character:

Let's take the US. If you were long the best performing sectors in the US, from Oct, 2007, till March 9, 2009, and short the worst performing ones, your longs fell 31% while your shorts fell 78%. This yielded you pretty solid returns.

But, assuming you changed nothing in your portfolio from March 9 till end April, your longs went up only 10% while your shorts climbed 57%! The market went up 27%. You got killed. And remember…go back and see the stats for the Real Deal bull market of April 2003. The market was a lot fairer in its rewards.

India, another market analysed on a sectoral basis, exhibits the same characteristic: in bear market from Jan 2008 till March 2009, the best performing sectors sectors fell 37%; the worst performers fell 82%. The market fell 60%. You made money on the long/short strategy.

But, from March 9, the same portfolio massacred you: your erstwhile best performers went up 23%. Your worst performers of the bear market went up 47%. The market went up 36%. See the huge performance divide and contrast this with the April 2003 –onwards returns. Big difference. Same with Emerging Markets. Same with Europe. Big performance divide, unlike what we saw in the bull market rally of April 2003.

What does come across in this study is fairly clear: True bull markets are less skewed. They are more participative. More democratic.

The present rally, unfortunately, does not exhibit much by way of democracy.

And that's probably where the problem lies…

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