The DNA of a Successful Client

"*Both optimists and pessimists contribute to society. The optimist invents the aeroplane, the pessimist the parachute.*"
– George Bernard Shaw

Every Monday at 9 AM, we gather to discuss feedback we're hearing both internally and externally. Often it is full of cross currents. Some people are nervous, while others feel like they should be taking more risks. I'll liken it to a music teacher who walks in before class starts and hears all of the students playing their own tune. Rarely is there uniformity in the sounds. To be clear, this is the normal state of things. As I write this, we have over 800 clients, so it would make sense that we're hearing a broad mix of perspectives and attitudes. But today, the notes sound eerily similar. The collective choir seems to be mostly singing the same tune in unison. If I had to pick a song to signify it all, I might choose Kenny Loggins' timeless hit *"Danger Zone"*.

It makes sense that investors are waiting for the other shoe to fall. We are almost two years into an unforeseen global shock that, while hugely disruptive to humanity, resulted in no damage to clients' financial assets. In fact, quite the opposite of damage... If I told you before this started that portfolio returns would be where they are, you'd certainly have called me a liar. Further, there seem to be very large outstanding risks on the horizon including but not limited to: escalating China-US tensions, fiscal policy uncertainty, a debt ceiling showdown, likely tax increases, lofty stock prices, historically low yields on bonds, inflation risks, the increasing odds of an energy crisis, and fears of new Covid Variants.

Said very simply, much of what we're hearing is that many people have the uneasy sense that they are whistling past the graveyard. Ironically, the times we typically see sentiment in such harmony are times of crisis when almost everyone is panicking. Today, it's the other side of the same coin; investors are largely afraid because something has *not* gone wrong with their investments.

This letter is not intended to one-by-one dismiss the potential risks I've listed above. Instead, I'd like to describe what I think has allowed us--and will continue to allow us--to successfully guide our clients through endless possibilities of future market conditions. I want us to see the very real potential growth and success we desire for our clients.

There are two fundamental factors that, above all else, allow us to successfully manage our client's assets: classification of investor mindset and tactical diversification.

Investor Mindset:

After nearly 20 years of observing investors, I could broadly categorize the outlook and attitude of anyone into just three types. The pessimist, the optimist, and the meddler. I'll go into detail about all three, but here's a spoiler: the first two are both sufficient mindsets to be an effective investor, the last ensures poor investment results. Let me also add, categories don't just apply to "amateur investors" but all investors, including those deemed professionals. Even among our very own investment committee, we have individuals on both sides of the fence.

1. The Pessimists:

The pessimist tends to bristle at this title and feels labeled as a cynic who is rooting for bad things to happen. You may hear them say things like, “I am not a pessimist, I am a realist and I’m sorry if you don’t like the truth.” They tend to worry even when things seem to be going well, like a gambler on a hot streak, expecting their luck to normalize. In short, they are disciples of the concept known as “mean reversion” which is the mathematical term for the gambling analogy I described. Often, they feel that the world around them is naïve. They cite historical events where some crisis has occurred as supporting evidence for their guarded outlook. Accordingly, they focus on studying the past and believe that while history doesn’t repeat itself it often rhymes.

This psychological perspective leads these individuals to collectively adopt some common characteristics when it comes to investing. First, they tend to prefer a more conservative stance. This means favoring safer investments. Generally, they choose value stocks over growth stocks. Cash is viewed as an ally and a source of dry powder for times of market turbulence. They consider investments that provide cash flow to be far superior to those that rely on future price appreciation. In the game Monopoly, the pessimist is the player who loves buying the railroads. They are more than willing to trade upside for stable cash flow. However, these individuals, despite all their trepidation, can be quite good at disciplined buying during times of panic. While this may seem counter-intuitive since the very type of event they worry about is transpiring, it is also precisely what they’ve been preparing for. The person who’s most relaxed on doomsday is likely the doomsday prepper. The same is true for the pessimistic investor who, after being in a defensive posture, is now ready to pounce on the opportunity.

2. The Optimists:

The mindset for these individuals is one that’s focused on the future. They will point to the progress of humanity. Two hundred years ago railroads were considered progress, today we are sending tourists into space. They adoringly talk about technology and are typically more tech-savvy, often helping their pessimistic friends with their iPhone, WI-FI, or Bluetooth. The future for them is exciting and full of wonderful things to come. When talking about politics they think things will eventually get resolved and compromises will ultimately be reached. When they land on Boardwalk or Park Place they buy them, they don’t think that saving their money and passing GO one more time is a smart way to play the game.

When it comes to investing, instead of focusing on historical crises or “reversion to the mean”, they focus on different fundamental market “truths.” They will tell you that on average stocks have appreciated 8-9% annually and that on a calendar year basis the stock market is positive more than 70% of the time. When it comes to stocks, they don’t focus on companies that pay a dividend and ditch these in favor of more innovative companies. Technology companies are a typical favorite. Unlike Pessimists, cash is not their friend but is seen as an anchor on their portfolio’s long-term results. In bull markets, Optimists tend to vastly outperform their more cautious counterparts by letting the winners run. After all, there is a reason they’re called winners! During times of market turmoil, optimists aren’t always eager buyers. For starters, many times they don’t have any cash on hand to use for buying. Second, they tend to favor market momentum, which in times of panic is noticeably absent. They, however, also do not sell everything and run for the hills because at their core, they believe that things will ultimately improve. The optimist uses phrases like “we’ve seen this before……markets bounce back……this too shall pass….etc”

3. The Meddler:

At this point, I expect that most readers probably identify with either the mindset of the pessimist or optimist. I want to be clear, being an optimist or a pessimist is not a bad thing. However, if you're the type of investor who turns into an optimist in bull markets and a pessimist in downturns, you are creating a recipe for portfolio disaster. Because by definition it violates one of investing's most fundamental axioms. Instead of buying low and selling high, a meddler does the complete opposite.

In our industry, there's a saying that goes "Bulls make money, bears make money, pigs get slaughtered." I cannot think of one adage I agree with more when it comes to investing. As I described the attitudes and investment tendencies of the pessimist and optimist, even if you found yourself in the "opposing" camp, weren't you still thinking there is validity to the other perspective? Likely, you were because both perspectives ARE valid. However, the most dangerous and near certain recipe for poor returns is to be an investor that thinks that they have the power to predict when it is time to be an optimist or a pessimist. In simple terms, these individuals believe they can read the future like a psychic (or at least as psychics allege they can). I have yet to meet a rich psychic. What's hard about being a meddler, is no one thinks they are a meddler. For example, when the stock market is soaring, I pour all my money into the highest-flying stocks, and then when it crashes I sell everything and only re-enter the market again once I "know" it's safe. Nobody wants to admit they do this, yet I can tell you with 100% certainty that many investors do exactly this. How can I be so certain? I've seen clients do it and frequently they return with hat in hand, after suffering a serious financial haircut.

Our job is not to predict what the markets will do. Our job is to categorize our clients by optimist or pessimist and then use a second tool (which I will now talk about) to navigate market cycles. I want to highlight, that understanding which type of investor you are is critical. It allows you to maintain your investment conviction even during the times when the markets aren't shining on you. It doesn't mean you're doing something wrong, it's a reminder that optimists do better at times and pessimists do better at other times, it isn't always YOUR TIME. As one of our clients likes to remind me "no one gets everything."

Tactical Diversification:

When people learn that I work in the investment world, often without solicitation, I find myself hearing personal theories on investing. Inevitably, at some point during the monologue, they will say something like, "but I'm protected because I diversify." In most instances, I nod along for fear that anything I say could extend the conversation. However, the term "diversification" which is largely misunderstood and/or abused, is perhaps the most critical tool in our investment process. It is the backbone for protecting client assets and it's essential for a sound portfolio. I said the term diversification is misunderstood or abused; strong words I know, so let me explain. Let's start with two basic questions: What is diversification and why is it important? Both seem simple in theory but in practice are much more complicated.

What is diversification?

Maybe it's simple. If you own 40 different stocks, therefore, you're diversified. But are you? What if all the stocks are in the same industry. Let's assume that the stocks are nicely spread across a wide array of different industries…. are you now diversified? Well, yes, maybe diversified across industries but what if the stocks are all US companies? You have a well-diversified portfolio from an industry perspective but geographically speaking you are clearly not diversified. Now, you adjust and decide that your 40 stocks need to be spread across a variety of industries and differing countries. Now you're diverse, right? Well, you now have a diverse portfolio of STOCKS but is that the only asset class you want to own? The answer may be yes; however, most people are far from satisfied with this level of diversification—especially in bear markets!

The next logical step is to add some components of cash and bonds (or income securities). Historically, having a portion of your portfolio in bonds has helped dampened portfolio volatility over time making for a smoother ride. Cash has its role as well since cash doesn't go up or down in value (ignoring for now the effects of inflation) and can be used to buy during periods of market distress. So is a diverse portfolio of cash, bonds, and stocks enough to declare a portfolio as "diversified?" Maybe, but there are still more ways to diversify a portfolio. (This may be even more pressing question today when longer term government bonds no longer seem to be providing the downside protection as they did formerly.)

Above I mentioned inflation, which is making headlines as experts debate whether the current spike of inflation is transitory or something more permanent. If you fear the latter, there are ways to diversify your portfolio against inflation. Historically, asset classes like energy and some precious metals have proved to be useful hedges against inflation. Private investments can play a role in portfolios, too. Often private investments, unlike public ones (i.e. stocks/bonds), can offer idiosyncratic versus market returns. In plain English, investments in private companies are not tied to the success of the overall economy. If you invest in the next hot restaurant in your town, this could do well even if the stock market struggles.

At this point, you're hopefully starting to understand that there are degrees of diversification. A little isn't enough and yet there becomes a point where it can become "deworsification". Finding the appropriate amount is not a simple exercise and requires thoughtful strategy and execution. Diversification has the obvious benefit of spreading out your risk to avoid certain outcomes you want to protect against, but it does something else that's subtle yet profound. Assets do not move together in perfect unison. In a diversified portfolio, some things will go up while others go down and often in hugely divergent magnitudes. In the financial crisis when stocks fell 66% from their peaks, US Government bonds went up in value. In the inflationary 1970s, commodities provided powerful portfolio protection at a time when government bonds did not. In reality, beyond just spreading out risk, diversification offers a powerful secondary benefit for skillful investors who can rotate within asset classes.

Bottom Line:

I've outlined what I believe to be the two most powerful steps investors can take to ensure their success. The first: identify how you see the world. You may see this as a silly exercise and dismiss it as interesting but not useful. I do not agree. Understanding how you think about markets gives you one of the most critical skills for any investor: conviction. This is what allows you to stay the course even when you feel lost. Conviction for investors is as important as the stars were to early navigators. Without them, you wander in circles, headed nowhere intentionally and the same is true with investing. However, this alone is not enough, which leads us to the second key: tactical diversification.

We are not soothsayers, fortune tellers, or mind readers. Sure, we have some educated opinions about what may lie ahead for markets but by no means do we have a crystal ball. Nobody does. What we do know, however, is that our process for navigating market cycles is highly effective for those who are willing to follow it. I’ve said many times that we aren’t paid by our clients to predict how markets will behave, but rather, we are paid to react to what they present us. We are managing people’s money and that is something towards which most have a strong affinity! And since markets rarely behave exactly as we all would like them to, this means taking what you’re given. This goes back to tactical diversification. If we build a sufficiently diverse portfolio for a client and we methodically toggle within these asset classes, we can reposition away from risk and into opportunities when appropriate. Successful long-term investors do not play a binary game of selling all their stocks when they’re worried or selling all their safe investments when they’re confident about the future. They try to fade the extremes.

Today, we are faced with a very confusing set of investing circumstances. Stocks look expensive, bonds offer little yield, and cash balances could be eroded by future inflation. Our playbook remains the same. Build portfolios with a breadth of diversity and then find pockets of opportunity when the market presents them. If our clients remain convicted, and we stick to an investment process that’s allowed us to use market volatility to our advantage, I know that our optimistic and pessimistic clients alike will be happy that they’ve chosen Evergreen.

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