THOUGHTS FOR THE WEEK

THAT WHICH WORKS

October 04, 2024

That which works gets repeated. More people see a process that is working and do the same. But all processes, or systems, or prices for that matter, have a natural capacity limit. And once that limit is breached, the formerly stable becomes unstable, and in danger of toppling.

The above is sometimes referred to as a "Minsky Moment", the moment when the proverbial sand pile topples. Economist Hyman Minsky developed an economic theory predicated on the idea that a long period of steady prosperity and investment gain encourages a diminished perception of risk, leading to additional risk taking, which eventually leads to "too much of a good thing" and the formerly stable risk environment turns highly unstable. The analogy is a sand pile – you can build it to a point, but eventually there is too much sand in the pile, and it collapses. It wasn't Minsky himself who coined the phrase, "Minsky Moment"; it is attributed to Paul McCulley of PIMCO.

Minsky wrote of cycles that occur in credit markets and business activity. But his theory extends beyond finance. "Minsky Moment" forms can be found virtually anywhere you look. Take offensive play calling in football. A germ of an idea for a new offensive concept originates, often in the high school ranks. The offensive concept exploits a weakness in prevalent defensive schemes. The concept works, and more and more teams start employing the scheme, adding players that excel in the specific concept. Defenses notice, and begin to adjust. Eventually the defenses catch up to offenses, and the concept is no longer effective – it's "stability of success" collapses, and it's time for a new concept.

Or consider the launch of a niche consumer product. The product fulfills an unmet need of a small cohort. Initially sales accelerate, the product price is stable, and the company goes all out on production. But once the need of the small cohort is met, additional sales rely on expanding the customer base, and the expanded customer base doesn't have the same unmet need, so product utility is lower for this larger group. To compensate, price begins to fall, and the "moment" is eventually reached – the natural capacity for the product need is reached, and sales stability slips (maybe even collapses).

We write primarily on topics tied to financial planning, investing, and behavioral biases in decision making. We also don't make market predictions. So, don't take anything we're writing here as a prediction. Now, let's turn to stock and bond markets to see how a "Minsky Moment" <u>could</u> build.

	1 Year	5 Year	10 Year
US Large Cap Stocks (S&P 500)	36.4	16.0	13.4
US Small Cap Stocks (Russell 2000)	26.8	9.4	8.8
International Stocks (MSCI EAFE)	25.4	8.7	6.2
Emerging Market Stocks (MSCI Emerging Markets)	26.1	5.8	4.0
Bonds (Bloomberg Agg)	11.6	0.3	1.8

as of 9/30/2024 | Source: Morgan Stanley

Looking at the above, it's clear what *has* worked: US stocks, particularly US large cap stocks. So, guess where the average investor portfolio (we're talking all investors, not clients) has likely become increasingly concentrated: that's right, US large cap stocks. And what don't many investors want to own? International and emerging market stocks. It's hard to look at the last 10 years and NOT want to own *just* US large cap stocks.

Again, we're not making a prediction that US large cap stocks are about to hit a rough patch. But that which works gets repeated. So, in our view, if there were a part of capital markets susceptible to the proverbial sand pile, it might be US large cap stocks. We own plenty of them on behalf of clients, and don't have plans to sell. But we own other assets, on behalf of clients, too. And that brings up the point of this writing: it's hard to diversify when one asset class has shined above the rest for a decade.

But diversification builds resilience. It's the fabric girding our "bend but don't break" investment plan. We're in the supremely fortunate position in our practice to work with extraordinary clients that have built extraordinary wealth. None want to have to do that again. It's our job to make sure they don't have to. And part of that involves owning a collection of assets on their behalf that don't all respond to the same incentives, and that increase resiliency – the ability to withstand occasional economic or market shocks without disrupting the lifestyle the investments are meant to sustain. So, we diversify, not mindlessly, of course. There is an investment case behind anything we own on a client's behalf. But those cases are predicated on potential return *and* potential risk: the risk of loss; the risk of having to endure a long stretch of price declines; and most importantly, the risk of liquidity becoming an issue.

There is nothing wrong with investing behind something that is working. But be mindful of the risk of "too much of a good thing". That's where diversification comes into play. It helps lessen the impact of acute shocks, and lowers the probability of an un-satisfactory outcome. The trade-off? It might sap some return potential from an investment portfolio. That's a risk we're often willing to take when thinking long-term about how best to help ensure your assets are there to meet your needs.

Mike, Cate, Scott, Willis, Suzy, Oscar and Wes

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Awards:
2024 Barron's Top 250 Private Wealth Management Teams
Source: barrons.com (Awarded May 2024) Data compiled by Barron's for the period Jan 2023-Dec 2023.

2024 Forbes Best-In-State Wealth Management Teams
Source: Forbes.com (Awarded Jan 2024) Data compiled by SHOOK Research LLC based on time period from 3/31/22-3/31/23.

Mike Burbank | **2019-2020 & 2022-2024 Forbes Best-In-State Wealth Advisors**
Source: Forbes.com (Awarded 2019-2020 & 2022-2024). Data compiled by SHOOK Research LLC based 12-month time period concluding in June of year prior to the issuance of the award.

Mike Burbank | **2017-2024 Barron's Top 1,200 Financial Advisors: State-by-State** (formerly referred to as Barron's Top 1,000 Financial Advisors: State-by-State)
Source: Barrons.com (Awarded 2017-2024). Data compiled by Barron's based on 12-month period concluding in Sept of the year prior to the issuance of the award.

Mike Burbank | **2013-2020 Financial Times 400 Top Financial Advisors**
Source: ft.com. Data compiled by the Financial Times based the following time periods:
Awarded 2013-2020; data 12/31/12 - 6/30/19
Awards Disclosures

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S&P 500 Index is an unmanaged, market value-weighted index of 500 stocks generally representative of the broad stock market. An investment cannot be made directly in a market index.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives, and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally, the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer.

Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.