Thoughts on Paradigm Shifts by Ray Dalio – August 2019

- ***Ray Dalio of Bridgewater recently published an extended paper detailing multiple paradigm shifts in markets over the last 100 years. It is vital reading for anyone investing in today's markets***
- ***These shifts tend to occur when investors have become so used to the current paradigm that they are no longer attentive to the possibility of a different market dynamic.***
- ***Mr. Dalio sees the low volatility, low interest rate, low inflation paradigm of the last decade being replaced by increasing volatility and likely increased debt monetization***
- ***While Mr. Dalio suggests investors turn to gold as the key to protecting against such a market environment, we believe it is far better to approach the coming paradigm shift by staying liquid and diversified while underweighting or avoiding the assets that have run up in value during the most recent paradigm. There will be time to play offense when the shift comes but for now humility is the best answer in the face of uncertainty.***

Recently Ray Dalio, the founder and CIO of Bridgewater Associates, the largest hedge fund in the world, put out an extended paper called Paradigm Shifts.[1] We consider this to be vital reading for anyone investing in today's markets.

He posted it publicly and you can find it here:

https://www.linkedin.com/pulse/paradigm-shifts-ray-dalio/

It provides a detailed analysis of market history and we thought we'd highlight it in part because it provides further support for our positioning of client portfolios underweight to equity markets over the last 12-18 months.

The central thesis of Mr. Dalio's paper is that markets exist in certain extended paradigms that eventually shift and that these shifts come when investors have become so used to the current paradigm that they are no longer attentive to the possibility that a quite different market environment might come.

Mr. Dalio walks through the last 100 years of US capital market history, showing that roughly every decade or so a new market environment emerges that, while not necessarily the polar opposite of the prior environment, is a significant and largely unanticipated turn. Note these turns happen in both directions.

Obviously in 1929, 1999 and 2007, the market was not anticipating a subsequent equity market collapse. But so too in 1919 and 2009, with stock yields substantially above bond yields, market participants were not pricing in a subsequent dramatic equity market rise.

There are numerous lessons in Mr. Dalio's piece that are worth highlighting. Here are just a couple:

1.) Markets exhibit unavoidable cycles due to the tendency of market participants to over-bet on the recent past continuing. For example, when volatility or inflation is low, markets start pricing in a continuation of that environment. Credit becomes cheap. Concern about bad, volatility-inducing outcomes recedes. Inappropriate risks are taken. At some point, a spark starts a fire, volatility returns with a vengeance and a new paradigm gets established. Now even good investment opportunities are foregone by scared investors, leading to quite attractive low-risk returns until investors regain their bearings.

2.) No one asset class or investment style is appropriate across all environments. Any one style or investment would have come close to if not entirely bankrupted its practitioner at some point over the last 100 years. Humility and diversification are key. See below annualized returns cross some high level asset class buckets:

Asset Class Nominal Returns by Decade

	20's	30's	40's	50's	60's	70's	80's	90's	00's	10's
Stocks	17%	-2%	9%	18%	8%	5%	17%	18%	0%	13%
***Bonds**	15%	37%	31%	-7%	-3%	4%	12%	10%	10%	8%
Gold	0%	5%	1%	-1%	0%	30%	-3%	-3%	15%	2%
Silver	-6%	-3%	8%	2%	7%	27%	-12%	0%	13%	-1%
Commodities	-4%	-2%	8%	0%	1%	15%	-1%	2%	12%	0%

Source: Paradigm Shifts by Ray Dalio / *At Equity Vol.

Mr. Dalio goes on to describe what he sees as the coming paradigm shift, where some combination of the low volatility, low interest rate, low inflation paradigm of the last decade will be replaced by increasing volatility and likely increased debt monetization. In his view, debt monetization will be necessary to support nominal GDP growth in the face of rising debt (government and private) as well as non-debt (healthcare, pension) liabilities while things like corporate tax cuts, share buybacks, and increased profit margins due to automation are no longer available to support stock and other asset prices.

[1] *Dalio, R. (2019, July 17). Paradigm Shifts, Retrieved from https://www.linkedin.com/pulse/paradigm-shifts-ray-dalio/*

He believes this paradigm shift will likely create the following dynamic across asset classes – and it's here where we differ, at least somewhat, from his conclusions:

1.) Monetary debasement will occur which would be inflationary and bad for holders of cash

2.) Bonds might hold up in nominal terms as the Fed could buy all or almost all available bonds to push interest rates down. But real yields will be negative in the context of rising inflation. So USD bonds would hold value in dollar terms, just not relative to what one could buy in physical things (including gold).

3.) Equities will suffer. Valuations are currently high relative to cash flows. This means that future returns have been pulled forward. In the end, valuations are going to matter and whether rates rising to combat inflation or the Fed keeps them low through monetary debasement, multiples come down.

4.) Gold will go up as a store of wealth when central banks debase their currencies to try to maintain nominal growth and support debtors

While we agree with the central thesis about the nature of paradigm shifts in markets and understand his conclusions about asset classes, this final analysis feels a bit deus ex machina to us.

We agree with his conclusion that markets are largely efficient in the short term and long term but in medium term there are paradigms that get entrenched and investors too often miss the turn. Further, his central point that investors tend to assume toward the end of a regime that the current state of affairs is permanent when it's not, is particularly apt when applied to current market thinking in regards to inflation and volatility. Still in our view it is a bit of leap to then conclude, "Buy gold!"

We agree that gold can be an opportunity cost asset – it's value goes up when real returns fall so if real returns are going to disappear or even go negative then gold is probably a great store of wealth (for additional reading on the topic we recommend: Gibson's Paradox and the Gold Standard, NBER Working Paper No. w1680, by Robert Barsky and Lawrence H. Summers[2]).

But it's less obvious to us that measured inflation will rise as there are a lot of broader trends that could keep at least measured inflation intact.

In the end, we're all wrestling with the following broad question:

While central banks, by reducing interest rates and volatility, have successfully pulled asset class returns forward (to make people feel richer so that they spend more and support economic growth), *what happens when Central Banks are no longer effective?*

One response could be – *what makes you think they won't be effective going forward?* This strikes us as equivalent to the "this time is different" mentality that sets in at the end of any market paradigm. It tends to get investors into a lot of trouble. Of course, our skeptical view of central bank efficacy has caused us to be underweight equities for almost 2 years and, as a result, underperform benchmarks somewhat over that period.

Another answer is that equity multiples come down – maybe hard though maybe the rally simply stalls while nominal earnings catch up – and there's a correction in risk premia where strategies like direct lending and other trendy investments (tech unicorns, private equity) that have been overdone in this paradigm have a healthy reckoning.

To which Mr. Dalio then adds "So you should buy gold!"

But we think there's a better answer, and it is *"stay diversified and liquid"* – which naturally encompasses gold to some extent.

A quick though relevant aside - Eli Cohen, a GenTrust founder and member of the investment team met Warren Buffett once while at Harvard Business School in 2002. He was able to ask Mr. Buffett a question in front of 1,000 other students. At the time, Mr. Buffett had been on the record as saying that the US Dollar was *very overvalued*. So Eli asked, "Given that you think the US dollar is overvalued, what companies would you buy as a result?" Mr. Buffet (in his polite Midwestern way) answered something equivalent to "Kid, that's a really stupid question. If I think the dollar is going to go down, I bet on the dollar going down. And if I think a company is cheap I buy the company. Don't buy a company because you think the dollar is going down."

This lesson is hugely valuable in the context of uncertain markets approaching the end of a paradigm. One can still go on YouTube and watch clips of an investor named Peter Schiff accurately predicting in 2007 the coming financial crisis and yet his investors suffered losses when the crisis he predicted eventually came.

[2] *R. Barsky, L.H. Summers (August 1985). Gibson's Paradox and the Gold Standard, NBER Working Paper No. w1680, Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=283338*

He'd bet that because, as he rightly predicted, the US mortgage market was a bubble, the dollar would suffer. Instead of shorting mortgages (which at that point only a few people had figured out how to do), he bet against the dollar. Everything he thought would come to pass did. He was eerily prescient. Except the world freaked out, investors ran to safety and the dollar appreciated (doubly so because it turned out EU banks were long US mortgages causing capital to flee Europe into US treasuries). In other words, even if you accurately predict not just the timing but the direction of the coming paradigm shift, knowing what to bet on isn't easy.

Mr. Dalio's conclusion on gold thus feels to us to be a step too far. It's not necessarily wrong but it's not so obviously right that it's worth being aggressive about. Far better to approach the coming paradigm shift by staying liquid and diversified while underweighting or avoiding the assets that have run up too high in value during the most recent paradigm (underweight equities, avoid direct lending and venture). There will be plenty of time to play offense when the shift comes. Humility is the best answer in the face of uncertainty.

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1450 BRICKELL AVENUE, SUITE 3050, MIAMI, FL 33131 | 900 THIRD AVENUE, 35th FLOOR, NEW YORK, NY 10022
TEL: (305) 677 6688 | FAX: (305) 677 6699 | WWW.GENTRUSTWM.COM