Quarterly Newsletter - January 2019

January 15, 2019

Dear Client,

The fourth quarter of 2018 was like few others before it. The S&P 500 reached an all-time high on September 20th and then proceeded to decline 13.52% in the fourth quarter. Most other equity asset classes followed the trend. Meanwhile, bonds, as measured by the Barclays Aggregate Bond Index, had the reverse fortune. Through the first three quarters of the year ?the Agg,? as it's known, was down 1.60% but in the fourth quarter it was up 1.64%.

?What happened to the stock market? The economy is doing so well!?

Yes, but the ?economy? and the ?market? are two different things. The ?economy? is the past (economic reports tell you what just took place) while investors (i.e. ?the market?) are trying to divine the future. When it comes to placing their money, investors don't care about the past, they want to know the future. And the future is chock full of uncertainty ? the government is shut down, there's a trade war with China, the Fed raised rates, everyone is fighting over immigration, the labor market is tight which raises inflation fears. And that's just to name a few. We've all seen the headlines. More often than not (quite often in fact), uncertainty translates into volatility ? we just experienced ?the worst Christmas Eve ever? for the S&P (down 2.71%) immediately followed the day after Christmas with the single highest one-day gain in history (up 4.96%). Sudden down drafts followed by recoveries ? a common sight when uncertainty reigns.

Uncertainty brings volatility and volatility equals risk.

?The essence of portfolio management is the management of risks, not the management of returns. All good portfolio management begins, and ends, with this premise.?

-- Benjamin Graham quoted from The Intelligent Investor

And this is what we do. We manage risk, along with behavior. To manage risk is to have a plan and to manage behavior is to know how to react before risk (volatility) arrives.

This is a time of testing for our style of investing. In the midst of a sharp market correction it can feel like madness to do what we do. The small stocks and the international stocks are being hit especially hard. Bonds ? and especially short term high quality are doing well. So, what do we do? We sell what is doing well ? the short-term bonds ? and buy what is doing badly ? currently small stocks and international. Our pre-determined rebalancing thresholds dictate that we act this way ? managing behavior which in turn manages risk. Without this in place, your portfolio can drift out of the risk profile you signed up for.

There is a range of opinion out there on what happens next. Economic theory suggests that recessions are inevitable and are part of the business cycle. It is too early to know if this is the beginning of a recession but in the least it classifies as a correction. There are many cries to run for the hills but we beg to differ. To head for the hills now means to drop any chance to make very good returns later. It is by no means guaranteed ? but markets are lower now than they were and therefore a better buy. If they go lower they become an even better buy. Buy unwanted and unloved stocks now and sell later, hopefully at a higher price. That is our approach. Capitalism will prevail and accepting risk is the nature of a capitalist system.

Which reveals the dual, some would say opposing, roles played by volatility. While volatility is an indicator of risk it also creates opportunity and so is the friend of the equity investor. It drives stock prices down to the point at which investors consider the price low enough that they are willing to buy. Frightened investors sell, and we buy what they are selling. That is volatility creating higher expected returns. For us and our clients. Management of behavior and risk.

If this ride worries you, please contact us and we can schedule a time to update your financial plan. Your plan will quantify what the recent market turmoil means to your situation. We can help separate your short-term goals from your long-term goals and develop a funding strategy for both. If changes in your spending level need to be made, we can address it. Rather than change your investments during a down market, it is better to adjust your spending or reassess the path to your goals. Going to cash may feel tempting but the comfort of cash is a false comfort. The enemy of the long-term investor is inflation. Cash does not protect against inflation. Equities (generally) do because earnings, and so dividends, rise as product prices rise. The false comfort of cash can leave an investor's portfolio stranded as the cost of products relentlessly rise.

Fear creates opportunity. Many investors, both professional and individual, run from fear ? as they are doing now. They are throwing away the chance for superior returns, a chance given by the low present prices on equities worldwide.

Hold on. Ride it out. That is our advice.

Jim John Richard & Ryan

