First Quarter Commentary

April 2019

By now it should surprise no one that 2019 investment returns have been very strong in the early going. The so-called "baby bear market" that ended on December 24th is now a distant memory. However, recent market volatility allows us to make a few points regarding successful investment programs.

THE MARKET LOOKS AHEAD

US stocks fell significantly over 2018 despite the fact that corporate earnings were simultaneously growing at a near-record pace. This, of course, followed a significant corporate tax cut and fiscal stimulus in the form of high government spending. And, as expected, year-over-year earnings growth was more than 17% for each of the first three quarters. Despite this, the Russell 3000 index (encompassing both large and small company stock) declined more than 20% from peak to trough within the year.

If investors were merely looking at current results, this should have been enough to generate significant equity gains. These contrary results should serve as a clear reminder that investors in capital markets are always looking ahead.

LOOKING AHEAD INVOLVES UNCERTAINTY

Of course, looking ahead entails uncertainty and allows for varying viewpoints to be expressed. The more varied the viewpoints, the higher the expected market volatility. The primary catalyst for market movements over 2018 was the expected outcome of trade negotiations between the US and China. When the matter appeared to be resolving constructively, markets registered gains and vice versa. This remains true, today. Recent economic news has been disappointing with a variety of economic indicators suggesting that global economies are slowing, yet greater optimism over trade negotiations has allowed the market to run.

UNCERTAINTY DRIVES FEAR

We trust markets to arrive at a fair price over time. This is what we mean when we say markets are "efficient". However, it is also true that momentum can take hold in markets and drive equities significantly in one direction or another and lead to security pricing that is far from what an objective look at the facts would suggest. In downturns, this can lead investors to panic and sell at the absolute worst time. Ironically, investors who act in such times feel they are protecting themselves but, usually, this leads to some form of permanent destruction of wealth.

Discipline Wins

Research firm Dalbar famously publishes information each year showing that retirement plan investors reliably receive a lower return from the funds in which they invest than the funds themselves earn over the year. Why is this? Because they enter and exit the funds at the wrong time. These investors reliably commit what is called *behavioral finance mistakes*—perhaps selling their equity positions just after a market swoon or buying after a run-up. They also switch across funds based on recent performance records. These investors would be better off setting a consistent allocation and remaining disciplined. In fact, substantial destruction of wealth can occur when selling into market weakness but remaining disciplined is difficult and it is one of the benefits of working with an advisor.

While we welcome and expect challenging conversations during times of heightened volatility, we'd like to provide a hat tip to our clients—none of whom succumbed to the temptation to change their risk tolerance by shedding equities in the midst of the last year's brief bear market. As a result of those decisions, they have not locked in a loss and have, instead, benefited nicely from the extraordinary gains since then.

Adapting to the Environment

Discipline can be pursued and honored even while innovating and adapting within a coherent and consistent portfolio architecture. The first step lies in acknowledging that the current era is fundamentally different from the period that preceded it. Certain strategies that were relied upon in the prior era simply no longer work or face long odds while the appeal of others may ebb and flow.

Over the course of several years, we have drastically reduced our clients' exposure to actively managed equity, cut costs, eliminated Managed Futures and Long-Short Equity. We've added strategies that blossom when volatility increases such as Put-Write and Structured Notes. Hedge fund allocations have been dramatically reduced and repositioned solely as bond replacements. Our strategic allocation to Developed International equities has also been cut by a third. We have done this while maintaining a constant approach—the blueprint for how we think about investing and managing capital has not changed but the component strategies and weightings have changed to better suit the environment.

Our Own Version of Looking Ahead

When asked to explain the secret to his success NHL Hall of Famer Wayne Gretzky famously said, "I skate to where the puck is going to be, not where it has been." For investors, this has never been about predicting stock and bond market movements (market timing) which is futile. Instead, it is about reading the environment correctly to discern which strategies hold the most promise in the current era. We remain disciplined in our risk allocations for clients to help them avoid behavioral mistakes but work very diligently to add value through discerning portfolio construction.

As always, we are grateful to each client for the trust they have placed in us. We work hard to remain worthy of that trust every day.

Best regards,

Sean Cook
Chief Investment Officer, Cedar Rowe Partners

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