March 5, 2018

Re: The New Normal and Conference Call

Dear Client,

After a nice peaceful and relaxing vacation in Cartagena, Colombia came to an end in early January, I found that the U.S. equities markets were again plowing ahead. The markets were calm with little volatility. Then suddenly, in February, the volatility returned and the markets became reminiscent of the volatile market days of the past.

The unusual calm and upward trajectory of the stock market in 2017 and early 2018 isn't the norm and actually, quite abnormal. This kind of volatile market action usually typifies the later innings of a bull market. While I remain positive on stocks, the U.S. economy and the stock market is late in the game. Maybe 8^{th} inning or so? To be sure, the stock market has entered a more volatile phase with large daily swings in prices. In my past newsletters and conference calls, I have been warning that a correction could occur and I have said any correction would be caused by a rise in interest rates.

This time is no different. Although the correction in absolute numbers has been scary, the magnitude in percentage terms is much less and not overly worrisome. At least not as of today. Taking a look at a simple sampling of the portfolios under our management, it looks like we have given up January's gains and little else. However, each client portfolio is different and should be judged accordingly. The equity market zoomed up approximately 8% in January which is more than the market returns in some years. That alone is abnormal and the large rise in prices caught my attention. Much of the market action is a result of program traders and speculators buying and selling stocks in mass quantities without fully looking at the fundamentals. Therefore, much of the latest stock market decline is technical in nature although there are some fundamental reasons for the turbulence.

In past newsletters, I have written that markets are constantly sending signals through the price mechanism. The hard part is discerning the truth from the noise. However, what the pricing mechanism is telling me now is similar to what I have said in the past: that a significant rise in interest rates will be hard for the stock and bond markets to digest. Granted, interest rates are really not that high at the moment, but the stock market is anticipating a price mechanism and looks down the road. The market is not worried about current interest rates, but future ones and is concerned that the Fed will be behind the curve when it comes to inflation. Without getting too technical, inflation is a component of interest rates.

In my visits with you, I have been saying that we will most likely keep the current asset allocations until interest rates rise between 3.25% and 3.50%. This range is my signal to reduce the stock allocation and to invest the proceeds into bonds. With the 10-year U.S. Treasury currently yielding 2.80%, we are a considerable distance away from that "magic number". However, I did sell the homebuilders because those stocks are, in my opinion, extra sensitive to a rise in interest rates. This is giving me an opportunity to move some stock positions out of the United States and into lesser expensive foreign markets.

There is one caveat to my plan and that is a Black Swan event. It looks like a major trade war could be that event, but as of today, it is too early to tell how that will play out. I am looking for my signals. If it turns out that a trade war is looming and that the Fed is behind the curve in relation to interest rates, I may reduce the stock allocation quicker than I had planned. Of course, this doesn't mean we will not have equities. We must have a reasonable amount of equities and ride out the storm if it occurs. Here is the reason why:

Using the 10-year U.S. Treasury as an example, I will illustrate some of the illusions of safety in an all bond portfolio. As of March 3, 2018, the 10-year U.S. Treasury yields approximately 2.82%. Given that inflation is approaching 2% (maybe even higher in the real world), this leaves a 1% real return. After paying Federal tax (assuming a 37% tax bracket), this leaves the investor with a .63% real return after inflation. Not too great and very bad for people who expect to live a long time or leave money to their kids and grandchildren. This is why I have always advocated a balanced approach which includes bonds, stocks and, at times, gold and real estate (REITS). This is why outside of YYR, we never have a 100% stock portfolio.

Just as events this month have demonstrated that market disruptors come out of nowhere, we can ride them out by knowing that our portfolios are balanced.

Benjamin Graham, the fabled investor and mentor of Warren Buffett, wrote in the “Intelligent Investor” that portfolios should have a mix of stocks and bonds. When the market is high, the investor will have more bonds and less stocks and conversely, when the market is low, the investor will have more stocks and less bonds. Of course, we have refined Graham’s simple formula with our model being aligned with our research colleagues at BCA and Alpine Macro, the principles of Graham remain the same.

The cash positions in the portfolios are larger than normal. This is because we are waiting for the Fed to raise interest rates in the middle of the month (March 21st) before we buy some bonds. We had sold some long maturity bonds so we could shorten up the overall maturities of the bond portfolio and now plan on purchasing some more bonds with the proceeds.

One of the benefits of employing a good active investment manager is that he can intelligently use asset allocation (the split between stocks and bonds) to the investors’ advantage as Graham professed. Indexers have no such advantage. According to Bloomberg, between January 1, 2000 and March 3, 2018, the S&P 500 index has delivered an annualized return of 6.32%. Using the Fidelity Advisor Balanced Portfolio (FABLX) as a proxy for a balanced portfolio, the annualized return during the same period as referenced above was 5.07%. In my opinion, the balanced option would be the superior one because I believe it poses less risk than having an all equity index portfolio. Of course, some active managers did better than the Fidelity fund while others did worse. And there is no guarantee that past results will be indicative of future ones. I am just illustrating one of the fallacies of indexing. Maybe someone should ask Warren Buffett why he doesn’t index his portfolio and why his stock price return doesn’t keep up with the S&P 500 index. That’s a story for another day.

Please join us on our next conference call which will be held on **Monday, March 12, 2018 at 6:30pm**. To join the conference call, **please dial the toll-free number: 1-800-914-8405. Once prompted, enter the access code: 5486434, followed by the # button**.

Best regards,

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Investment Counsel