



February 28, 2020

Quote of the Day:

"Don't buy or sell your businesses based on today's headlines."
– Warren Buffet

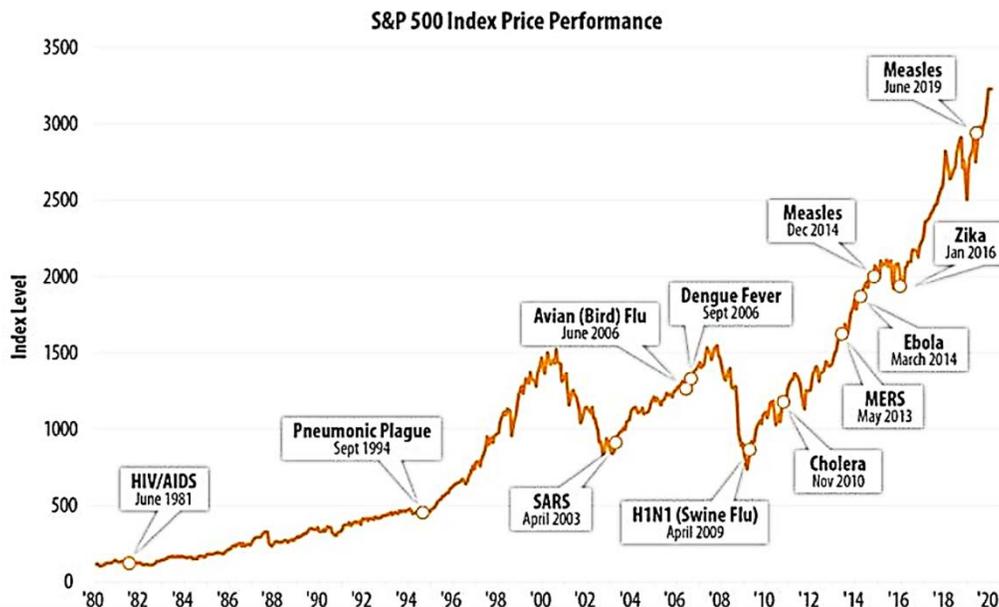
Markets Have the Virus

Well, the fear over the Coronavirus is hitting the markets and we're clearly in "correction" territory on the major stock indexes. This is a circumstance where I think complete candor is necessary and the truth is that we can't yet gauge the full economic impact. By the time we can, the volatility may have passed.

The Dow Jones Industrial Average was hovering around 29,500 earlier this month and, as I'm writing this on Friday morning, it's about 25,000, representing around a 15% drop in about 2 weeks. These drops have wiped out all the gains for the year. It's actually surprising to me that the market had been so resilient. Maybe it's because recent history with stocks and viruses is that markets overreact (see chart below on the S&P 500), leading to significant buying opportunities along the way. Will it happen again this time? I don't know but we've been concerned about general valuations for some time and it's difficult to predict what might be a catalyst for investors to reassess their capacity for volatility.

Epidemics and Stock Market Performance

Since 1980



Source: Bloomberg, as of 2/24/20. Month end numbers were used for the 6- and 12-month % change. *12-month data is not available for the June 2019 measles. **Past performance is no guarantee of future results.**

The S&P 500 Index is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index. Index returns do not reflect any fees, expenses, or sales charges. Returns are based on price only and do not include dividends. This chart is for illustrative purposes only and not indicative of any actual investment. These returns were the result of certain market factors and events which may not be repeated in the future. The information presented is not intended to constitute an investment recommendation for, or advice to, any specific person.

I'm not an immunologist so take whatever I say with a block of salt but I am following the news closely on this, trying to separate out the emotion from meaningful data, and it looks to me like the most rational voices are saying a few consistent things: that it's likely to be categorized as a pandemic – though mild; that much of the world's population could become infected and become carriers, many with no symptoms at all; that scientists are making progress on vaccines. This whole thing is a human tragedy and we should never take human life and suffering lightly but for most of us, it's not a major health threat. On an economic basis, this outbreak is also disrupting supply chains around the world and therefore impacting short to medium term earnings expectations, which ultimately drive stock prices.

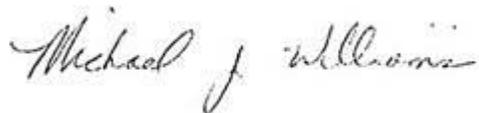
One interesting bit of unintended good news is that many companies had already been shifting supply chains away from China due to the Trump Tariffs. If they weren't considering it before, they will be now as they realize the importance of diversification. I'm betting this trend will accelerate moving forward and it shows the amazing adaptability that markets, businesses and ultimately individuals have.

Though you may know that I think most economists today put too much weight on consumption behavior and not enough on the roots of production in assessing economic strength, the US consumer does seem to still be on solid ground and will continue to be one of the key drivers to US economic growth in the year to come. I believe, just like all the other viruses we have seen over the past decades that have dissipated, the Coronavirus will likely be no different. Right now, markets are reacting to the news because the outcome is unknown. In a way, COVID-19 has "infected" markets all around the world and, in times of market uncertainty, traders believe the best approach is to sell. Fear is driving decisions and that's why we're seeing the big drops in stock indexes. Nobody would blame you if this uncertainty gave you a bit of anxiety, as well. Remember, we are not invested strictly in any passive indexes but a specific list of securities (really businesses) that we believe have underlying durability for our client portfolios. As you know, we also have significant hedging with short term cash equivalents, some funds that do short the indexes and precious metals holdings. None of this applies necessarily to individual portfolios and should NOT be taken as specific investment advice, especially for our readers who are not clients, but I hasten to add those comments because we are, generally and for the time being, very much outperforming the major indexes during this downtrend.

On the other hand, one could look at the chart above and ask, "ok, great – what are we going to buy?" but we believe in being disciplined about valuations regardless of headlines and relative charts. We are starting to see some interesting values in a few areas, but many market participants have assumed that if the market continues to go up despite steep valuations, then the valuation measures must somehow be incorrect, but that's not really how valuations work. If overvaluation itself was enough to drive stock prices lower, one could never really see the extremes like 1929, 2000, 2007 or possibly today. While the advance to extreme valuations often encourages investors to throw out any anxiety about risk, these periods have historically proven to be temporary and that's often when we see a catalyst of some kind (like this virus) make people react the other way on the emotional roller coaster from overconfidence to panic.

Don't Buy Snow Tires in a Blizzard

In general, I am pleased with how our portfolios are holding up and want to make sure you know we are monitoring both the news and the businesses we've invested in. We've already got some snow tires on and we'll be navigating the road ahead with the same discipline we've been using for a very long time. Please don't hesitate to let me or Taylor know if you have concerns about this evolving story or your accounts.



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