LEWIS WEALTH MANAGEMENT

Quarterly Newsletter

1st Quarter 2018

April 25, 2018

Market Data as of March 31, 2018

		1st Qtr 2018
U.S. Equities	Russell 3000 ETF	-0.69%
International Equities	MSCI EAFE ETF	-1.72%
Emerging Markets Equities	MSCI Emg Mkts ETF	+1.15 %
U.S. Bond Market	Barc Agg ETF	-1.49%
U.S. Bond Short Duration	Barc U.S. 1-3 Year ETF	-0.41%
Hedging Strategies	Credit Suisse Hedge Fund	+2.30%
Commodities	S&P GSCI Comm ETF	+1.90%
Real Estate	iShares U.S. Real Estate ETF	-6.00%

Executive Summary

We finally had a 10% stock market correction, and the capital markets have been volatile.

There is a lot of fear and anxiety in our current geopolitical climate, and the risk of policy error is high. Many of us descend into the safety of our respective cable news echo chambers and see the world through our own preferred, distorted lens.

In this climate, it's hard to remain objective when making decisions about our investment portfolios.

Market volatility is back, and many economists predict our next recession will occur in the next 24 months. It's a good time to take a look at your portfolio.

As for stocks, diversify into multiple sectors and market caps.

As for bonds, stay short in duration and high in quality while the Fed keeps raising rates.

Be skeptical of more exotic investment strategies that use leveraged derivatives.

Prepare your finances for our next recession and stay one step ahead of the game.

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High Anxiety

> It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way – in short, the period was so far like the present period, that some of its noisiest authorities insisted on its being received, for good or for evil, in the superlative degree of comparison only.

Charles Dickens, *A Tale of Two Cities* (1859)

We are living in the best of times and the worst of times. We have been enjoying the second longest bull market in history and a slow and steady economic recovery since 2008. However, there is also unprecedented political turmoil and anxiety, and now volatility has returned to the capital markets.

It seems like a year's worth of news comes every week. The 24-hour news cycle is now compressed into an hour. It's exhausting and nerve-racking, and it's starting to play with our investing brains.

Policy risks are incredibly high right now. It feels like the country is being pulled apart. The Mueller investigation has everyone on edge. We don't know what the president will tweet next. The nightly news is filled with porn stars and Playmates, hoaxes and witch hunts. One half of the world versus the other half: it's gotten crazy and it's likely to get crazier.

There are other geopolitical fires burning as well. President Trump is saber rattling on trade, and this has the markets concerned. Trade wars mobilize the populists, but they never end well for the participants. President Trump and Kim Jong-un are supposedly going to meet soon – what could possibly go wrong . . . or right? Russia continues to interfere in our election process as we face an important midterm election this November. The president wants to decertify the Iran nuclear deal. Gas prices are on the rise. ***The 10-year U.S. Treasury bond yield hit 3% for the first time in four years.***

Whatever our political view, hidden players with nefarious agendas are pushing misinformation through newer channels, like Facebook. This misinformation is designed to capture our vote and our dollars. ***Cable news allows us to descend into our respective echo chambers and view the world through our preferred, distorted lens.*** It's manipulation on a global scale.

How does this impact our investment portfolios? ***Well, political and social anxiety makes investors and the capital markets fearful and nervous.*** In the midst of all this turmoil, the long-awaited correction in the stock market arrived in late January. ***The S&P 500 went down 10% between January 26 and February 8.*** This rattled investors, who had grown complacent with low volatility and steady growth over the past couple of years.

The VIX, a measure of market volatility, suddenly spiked in late January after a long quiet period.

Many investors overreacted to the sudden increase in volatility. ***But in the background, economic performance remains relatively strong.*** GDP growth has picked up. Employment is full, and wages are growing again. Bank balance sheets are healthy. The new tax reform package will strengthen corporate earnings.

This strong economic performance is giving the Federal Reserve an opportunity to tighten monetary policy. ***The Fed is raising short-term interest rates. It is also starting to sell the trillions of dollars in***

assets purchased after the financial crises in 2008-2009. All this activity will be a drag on future economic growth but is also necessary for the Fed to replenish and reload its monetary policy toolkit.

We are in the late stages of the second longest bull market in modern history. It may be over as I write – how long it can last is not clear. ***Most respected economists predict our next recession will begin in the next 24 months.*** Bull markets and economic expansions do not last forever, unfortunately. The business cycle continues. It's time to consider how our investment portfolio, finances, and psyches will hold up when the next recession hits. Are you ready?

Recommendations

It looks like we are heading for a period of increased volatility, and now is a good time to evaluate the overall risk level in your portfolio. Here are some considerations.

Evaluate Your Stock Portfolio

Your stock portfolio should be well diversified. It should be exposed to many different sectors with companies of different market caps. I am not a believer is focusing exclusively on one sector or style or other "high conviction strategies." If we expect greater volatility, you don't want to be caught holding all your eggs in the wrong basket.

Consider the following Morningstar style box for the Russell 3000 Index ETF (IWV). As you can see, it breaks down the 3,000 largest U.S. stocks into nine different segments differentiated by size and market cap.[1]

Russell 3000 (IWV) (%)			
25	25	28	Large
5	6	6	Mid
2	2	2	Small
Value	Blend	Growth	

In the past few years, many investors have gravitated toward the FAANG stocks.[2] The FAANG stocks all reside in the large, growth-style box. What about the other eight boxes, like value stocks and small and midcap stocks? If you are overexposed to large growth, consider diversifying into the other style boxes. If the market takes a sharp dive, large growth may not perform well. Remember, during the tech bubble large/growth technology stocks lost 85%.

Of course, the easiest solution to this problem is to buy the index (like the Russell 3000 ETF). ***Consider making an index the core of your stock portfolio.*** If you want to hold some specific sectors, hold smaller positions that surround the core. And don't forget about international and emerging market stocks. This approach works well with them, too.

[1] You can explore how your investments fit inside the Morningstar style boxes by going to www.morningstar.com.
[2] FAANG stocks refer to **F**acebook, **A**pple, **A**mazon, **N**etflix, and **G**oogle (Alphabet). It's easy to see why the FAANG stocks are so popular. Many of us use products and services from these tech titans every day. But what about the rest of the market?

Evaluate Your Bond Portfolio

While indexing strategies work well for core stock exposure, bonds benefit from more active management. When evaluating your bond portfolio, three of the most important factors are duration, credit quality, and credit spreads.

Duration is mathematically complicated but easy to use. Roughly speaking, duration measures a bond's cash flows weighted by the time they are received as compared to its current market value. Investors use duration to measure interest rate risk. The longer the duration, the more the price of the bond is sensitive to interest rates changes. Interest rates and bond prices are inversely related. If interest rates rise, bond prices will fall. In a rising interest rate environment, the price of bonds with longer durations will fall more than that of bonds with shorter durations. ***With the Fed raising interest rates right now, it is safer to hold shorter-duration bonds.***

Credit quality refers to the creditworthiness of the issuer. Some issuers have a better credit rating than others. All things being equal, higher credit quality bonds are less sensitive to changes in interest rates than lower credit quality bonds.

Credit spreads refer to the differences in yield between U.S. Treasury bonds and other types of bonds. High yield bonds have lower credit ratings but pay more interest. However, the credit spread between U.S. Treasury bonds and high yield bonds is currently at a historical low. This means that the buyer of a high yield bond is receiving very little additional interest for taking the risk of owning a lower credit quality bond. For this reason, ***your bond portfolio should favor higher quality bonds at this time.***

Of course, depending on your tax situation, you should consider owning a number of different types of bonds: government, municipal, mortgage, corporate, international, etc. Like your stock portfolio, your bond portfolio should be well diversified. For many investors, investing in bond mutual funds or ETFs is the easiest way to invest in bonds.

Morningstar has a style box system for bonds as well. The boxes are organized by two factors: quality and duration. Here is a hypothetical portfolio that places more emphasis on high quality, low duration bonds.

Hypothetical Bond Portfolio (%)			
50	20	0	High Quality
20	10	0	Medium
0	0	0	Low
Ltd	Mod	Ext	

Evaluate Your Allocation Between Stocks and Bonds

Take a look at your overall allocation between stocks and bonds. How many stocks and other risky assets do you own relative to bonds and other less risky assets? Has the percentage of stocks in your portfolio drifted higher over the past few years? Is it time to rebalance those asset classes?

Determining a good asset allocation to achieve your long-term financial objectives is the single most important decision you make as an investor. Yet very few investors give this issue serious thought. Instead, they are collectors of investments: a five-star fund here, a recommendation from a friend there. After a few years, their portfolio is really a hodgepodge of investments that are not designed to work well together.

During periods of market volatility, it's critical to understand your own risk tolerance and how stable it is over time. For some investors, their risk tolerance is entirely situational. When markets are tranquil, they feel confident and secure. They usually describe their investment style as "aggressive." When volatility strikes, those same investors become very nervous and confused. Now they describe their investment style as "conservative."

Ideally, you want to find a portfolio that you can live with in all market conditions. You may want to add asset classes to create different risk/return profiles. If you are not confident in tackling this step, you should consult an expert.

Consider Other Asset Classes

Professional managers and advisors employ additional asset classes. These asset classes could include commodities, real estate, and hedging strategies. Unless you are an experienced and sophisticated investor, I caution against adding these asset classes, which are complex and can behave in unpredictable ways.

Discover What's in Your Black Box

Some portfolios contain more exotic strategies. These are complicated investments that are usually trying to do one of two things: 1) provide increased return for the same level of risk or 2) provide the same return with lower risk. In many instances, these strategies contain speculative positions in leveraged derivatives.

I view these investments with skepticism. They are difficult, if not impossible, for most investors (and even their advisors) to understand. Sometimes, the traders executing these complex strategies are straying from their own investment policy, and funds with complex investing algorithms produce strange results.

Many of these strategies are being employed by large hedge funds. That means that there are billions of dollars invested on the same side of the same trades. When market conditions change abruptly, everyone seems to want to unwind the same trade at precisely the same time. This causes a lot of trouble and, in an instant, losses can be devastating, or even total in some cases.

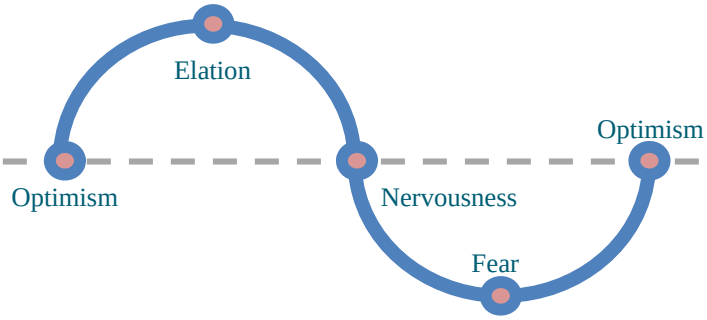
Here are examples of two exotic investment funds that recently used leveraged derivatives. LJM Capital Preservation (LJMIX) was supposed to be engaged in a diversified set of strategies with the objective of preserving capital. Instead, its traders became complacent and bet against the return of volatility. It worked for a while, and then it didn't. The fund lost 85% in one day, a shocking loss for a fund dedicated to "preserving capital."

The Credit Suisse VelocityShares Daily Inverse VIX Short-Term Exchange-Traded Note lost 100% in one day by betting against an increase in volatility. The fund would have lost more than 100%, but Credit Suisse shut it down before its own assets were at risk.

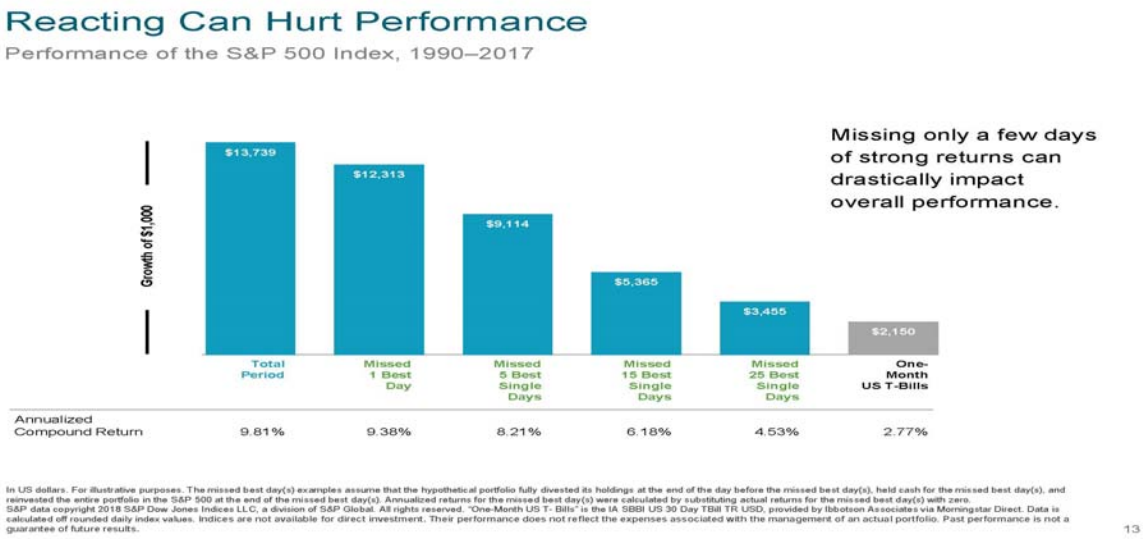
Forget About Market Timing

In my experience, during periods of market stress, many investors try to time the market. Their long-term returns almost always suffer, and it's easy to see why.

When volatility strikes, investors tend to soldier on for a while, but as losses accumulate, fear takes over and investors go to cash. Initially, they feel some relief, but shortly afterward the markets start going up and the fear of missing out emerges. These investors are tentative and worried about a double or triple dip. They wait. When the coast is clear, they feel elated and they get back in the market.



If you sell when you are fearful and buy when you are elated, you can see what happens. You are selling low and buying high – exactly the opposite of what you wanted to do. Also, during a down market, there are occasionally big up days, and you need to be fully invested on those days to capture the overall market return. Take a look at the chart below.



It sounds boring, but buying and holding while rebalancing produces better long-term returns. Timing the market is impossible. It's easier to just rebalance as the market moves. It's easier to execute, and your long-term results will be better.

Prepare for the Next Recession

Most economists believe our next recession will arrive in the next 24 months. Most believe it will be milder than the financial crisis we experienced in 2008-2009. Even so, being prepared is a good idea. Here are some ideas:

1) Pay off any short-term debt.
2) Keep a cash emergency fund of 3-6 months of living expenses.
3) Keep investing in your professional network in case your company runs into trouble.

If you have questions or concerns about your situation, please give us a call at (855) 353-3800.

Thank you,
Austin Lewis

Source of charts: Dimensional Fund Advisors. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. The S&P data is provided by Standard & Poor's Index Services Group.