LEWIS WEALTH MANAGEMENT

Quarterly Newsletter

4th Quarter 2018

Executive Summary

US markets sharply contracted in the fourth quarter. International markets were off all year. It was the most difficult year for investors and portfolio managers since 1972.

It's too early to tell whether or not we just experienced a sharp correction or the beginnings of a bear market.

Leading economic indicators are weakening somewhat, and our current expansion is getting long in the tooth. Most economists are predicting a recession in 2020.

By the time economists confirm that a recession has occurred, we are out of it and the stock market has already rebounded. Trading around a recession is difficult, if not impossible.

If you are nervous about your portfolio, go back to your goals and objectives. If your investment philosophy and approach are sound, execute on them.

There are 12 pieces of investment advice about volatile markets for you to consider. Take a look.

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Market Data as of December 31, 2018

		2018
US Equities	Russell 3000 ETF	-5.39%
International Equities	MSCI EAFE ETF	-13.83%
Emerging Markets Equities	MSCI Emg Mkts ETF	-14.98%
US Bond Market	iShares US Core Bond ETF	-0.05%
US Bond Short Duration	iShares US 1-3 Year ETF	1.45%
Hedging Strategies	Credit Suisse Hedge Fund	-2.02%
Commodities	S&P GSCI Comm ETF	-14.28%
Real Estate	iShares US Real Estate ETF	-4.29%

Christmas Bear Attack

Santa Claus showed up with a large sack of coal for investors just in time for Christmas.

The S&P 500 peaked at 2,925 on October 3, and then sharply descended to 2,351 on Christmas Eve, a drop barely shy of 20%. A drop of 20% or more is the traditional definition of a bear market.

For the first time since 1972, not a single one of the eight main asset classes was up at least 5% in a single calendar year, according to Ned Davis Research. In fact, most asset classes were down significantly in 2018.

It was a very difficult year for investors and portfolio managers. The US stock market outperformed international markets by a wide margin until the US stock market plunged in October.

Is This a Bear Market or a Sharp Correction?

It's too soon to tell. Bear markets drop at least 20%. The average correction for the S&P 500 since WWII lasted four months and prices fell about 13%. The average bear market lasted about 22 months, and prices fell about 30%.

The first two trading weeks of 2019 have seen somewhat of a bounce. If we stabilize from here, this latest drop will be considered a sharp correction and nothing more. If markets become less stable and drop further, this will probably be considered a bear market. Only time will tell for sure.

What Is Causing This Volatility?

1) The Federal Reserve

To fight the financial crisis in 2008-9, the Fed lowered interest rates to near zero and employed other measures to stimulate the economy, like buying bonds. ***But in late 2015, the Fed started slowly unwinding its monetary stimulus.*** Since then the Fed has hiked the fed funds rate nine times, most recently in December. The Fed has been selling off some of the bonds on its balance sheet and has stated that one to three more interest rate hikes are coming in 2019. ***Higher interest rates increase borrowing costs on businesses and consumers.***

Stock traders are furious. They believe the Fed is crazy to be raising rates while the market is tanking. They believe the Fed should pause further hikes, or even consider lowering rates again.

The Fed has a dual mandate. They are trying to promote maximum employment, stable prices and moderate long-term interest rates. From the Fed's perspective, employment is full and prices are relatively stable, but long-term interest rates are still artificially low. The Fed is trying to raise rates until they are "neutral," which means that current interest rates are neither simulative nor contractionary. The Fed believes we are not quite there yet.

It is not the Fed's job to support stock market prices (although they do watch them carefully). This frustrates traders and investors. But the Fed has made it clear to the markets that any future interest rate moves are "data dependent." This means the Fed is watching economic indicators carefully (including the stock market) and they will act accordingly. ***The Fed has recently signaled that it may be more dovish going forward, and this appears to have placated traders for the time being.***

2) The Trade War with China

We are in a trade war with China. Both sides have threatened each other with punitive tariffs. Make no mistake – ***tariffs are taxes***, and there are no winners when higher taxes are imposed. Chinese imports will cost more for US consumers and vice versa. Economic growth will be negatively impacted.

That said, ***the Chinese have engaged in unfair trading practices for years***. US companies are forced to transfer their intellectual property in order to do business in China. This intellectual property is then misappropriated by the Chinese. This is one of our main complaints. The Chinese believe that we agreed to this practice years ago as a way to help modernize its economy. We believe it's time to end this practice – and we are right.

Years ago, the US believed that if China adopted US-style capitalism, it would lead to the downfall of their Communist regime, similar to the fall of the Soviet Union. That didn't happen. As it turns out, the Chinese have figured out how to bend capitalism to work under their Communist control. China is now a big player on the world stage.

Trade negotiations are under way, and some progress has been made. The Chinese are promising to buy more US goods, but the intellectual property issue remains a sticking point. I imagine some deal will be struck in the spring, but it will not get us everything we want. I expect the markets will receive any deal favorably.

3) The Partial Government Shutdown

The partial government shutdown continues. President Trump wants his wall, and the Democrats refuse to give it to him. ***Fearing a backlash from their respective bases, no one is in the mood to compromise.*** Something or someone will have to give. Perhaps the president will declare a state of emergency and order the wall to be constructed by the military, but that will face an immediate court challenge. Saying that he has done all he can, the president may then sign a spending bill to reopen the government. Eventually, federal workers like TSA agents or air traffic controllers could walk out, paralyzing the country. ***Something has to give.*** This can't continue much longer.

4) A Slowdown in Global Growth

Most economists are predicting a further reduction in global growth in 2019 and 2020. No one is predicting a crash. While trailing economic indicators in the US are still relatively strong, forward-looking indicators are weakening. Importantly, all central banks are pursuing a contractionary monetary policy at the same time. The markets are trying to price in this future slowdown.

Are We Heading into a Recession?

Again, it's too soon to tell. ***Our next recession is lurking. Most economists are predicting one sometime in 2020, but these are only guesses.***

The stock market is a forward-looking economic indicator, but it's not always an accurate predictor of where we are heading. Not even a bear market is a very good predictor of a recession. In fact, it's a coin flip. ***While there have been 13 bear markets since WWII, a recession has followed only seven times, or 54% of the time.*** As the Nobel Prize-winning economist Paul Samuelson said over 50 years ago, "The stock market has predicted nine of the last five recessions."

When a bear market hits and there is no subsequent recession, those bears are typically shallow and short. When a recession does follow, they tend to be deeper and longer.

As I have said many times, this expansion is getting very long in the tooth. At some point, the business cycle will turn over. It is impossible to say exactly when, but it's coming and you should be prepared.

When We Realize We Are in a Recession, It's Usually Over

A recession is typically defined as two consecutive quarters of GDP decline. Stock prices tend to move down well in advance of a recession and then recover during the middle of it. ***By the time economists collect the trailing GDP data and confirm that a recession has occurred, stock prices have long since recovered.*** My point here is that if we try to time the markets by pulling out until the next recession is over, we will likely miss a lot of stock market upside.

What Should You Do?

12 Tips for Volatile Markets

During periods of market stress, I like to go back to the basics. Revisit your investment philosophy, your investment approach and your beliefs. If something is broken, fix it. If it's not broken, execute on your approach and stay disciplined.

1) **Understand why you are investing in the first place.**

Most of us are not investing for entertainment or to pass time. We are saving and investing for our long-term goals and objectives. This typically includes retirement and sending our children to college. We want to be financially independent so we can make work optional one day. We are trying to be good financial stewards.

Recommendation: ***During market turbulence, go back to your goals and objectives. Before making any changes, ask yourself if those changes are consistent with your long-term goals and objectives.***

2) **Use an asset allocation – please.**

I get the privilege of looking at a lot of investment portfolios. The difference between a portfolio designed by a professional and a novice is the asset allocation. The professional uses one, and the novice doesn't. The novice investor usually brings me a collection of investments that they have acquired over the years, and there is no rhyme or reason to that collection.

Recommendation: If you are not using an asset allocation, evaluate your overall balance of stocks and bonds across all your investment accounts. ***Control the risk in your portfolio by paying attention to the balance between these two asset classes.*** If you feel you are taking too much risk, move money into bonds. If you need to take more risk, move money into stocks. ***Move slowly and incrementally.*** Resist the temptation to make large moves during periods of market turbulence.

3) **Taking risk means occasionally suffering losses, but financial markets have rewarded long-term investors. And if you don't take enough risk, you won't reach your long-term objectives.**

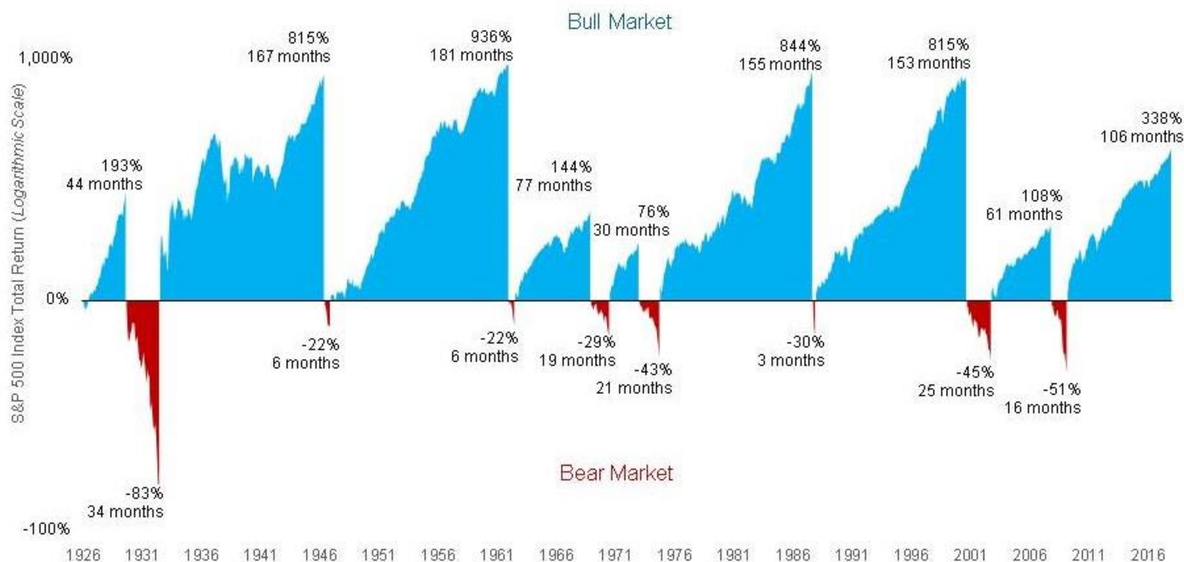
When markets are down and losses are mounting, it's very tough not to be fearful, or even angry. But if you are invested correctly, the right move is usually not to abandon your portfolio and search for something "smarter." Taking the long view (see below), it's easy to see why disciplined long-term investors usually finish ahead. Yes, there are the occasional bear markets, but the bull markets are longer and more sustained.

Also, ***since 1928, the US stock market has experienced two down years in a row only four times*** (1929-1932 the Great Depression, 1939-1941 WWII, 1973-1974 Deep Recession, and 2000-2002 the Tech Bubble). ***If historical averages are correct, 2019 might be better than you expect.***

A History of Market Ups and Downs

S&P 500 Index total returns in USD, January 1926–December 2017

Using a 20% threshold for downturns



From 1973 to 2017, a balanced strategy of 60% stocks and 40% bonds has earned, on average, 10.8% per year. For most investors, this return is more than sufficient to achieve their long-term financial goals. Markets will work for you if you just let them.

When volatility hits, some investors retreat to the safety of certificates of deposit, annuities or cash. This may be appropriate for a portion of your portfolio, but not all of it. These investments will not produce a long-term rate of return sufficient to meet your goals. It feels conservative and safe in the short term, but ***you are really taking extraordinary long-term risks***.

Recommendation: During difficult periods of market volatility, I look at long-term, historical performance figures and charts. Client financial plans are built around future returns that are more modest than historical averages. ***I have faith that a well-designed portfolio will deliver returns in the long term. I trust my portfolio. Do you?***

4) **Invest, don't speculate.**

Investing occurs when natural resources, skilled labor, intellectual capital and financial capital are skillfully combined in an enterprise to generate profits. As investors we want to capture some of that wealth and make it our own. This is how capitalism works, and it has been working very well for a long time. The bulk of personal financial wealth in the world has been created through this time-tested process.

Speculating is not investing. It involves making a bet against someone else that the value of something is going up or down, usually on a short-term basis. Because there are two sides to every bet, there is a

winner and a loser. It's a zero sum game. To win as a speculator, you must be right many more times than you are wrong over a long period of time. This can be a very daunting and expensive task.

Recommendation: ***We have a much better chance of financial success when we act as long-term investors the great majority of time.*** But during periods of market stress, some investors want to engage in speculation. Resist that temptation. While an occasional bet may be warranted, it should only be with a very small part of your overall portfolio.

5) **Diversify.**

Diversification means not having so much of one thing that we make a killing, but also not being killed by any one thing. A properly designed investment portfolio must be properly diversified. On the equity side, it should contain hundreds of different stocks of companies in the US and abroad. On the bond side, it should contain many different types of bonds (government, municipal, corporate, mortgage, etc.) with different maturities and currency denominations. In more sophisticated investment portfolios, additional diversification can be achieved by adding asset classes like real estate and commodities because these asset classes have not been closely correlated with stocks and bonds over long periods of time.

Recommendation: ***Even though every investor knows they should be diversified, I frequently see a dangerous lack of diversification in a lot of portfolios, especially vested holdings of employer stock.*** Unwind concentrated positions over time. This is one of the easiest and more important things you can do to prevent potential catastrophic losses in your portfolio.

6) **Risk and return are related – always.**

The higher the potential return of an investment, the higher the risk and the potential for loss. Most investment scams begin with a pitch about how they can avoid this financial law of gravity. Bernie Madoff told his clients they would earn 12% on their investments every year regardless of market conditions – and sophisticated, high-net-worth investors were taken by the score. I hear pitches all the time about real estate investments that have "secured" rates of return of 16-18%. If someone is offering you 12-18% on your money, there is considerable downside risk, believe me.

Recommendation: During periods of market stress, many investors go in search of "better" alternatives. Do your homework and read the fine print. ***When any investment promises high returns with low volatility, great risk is always lurking.*** Buyer beware.

7) **Market timing won't save you from experiencing losses. Stay invested.**

I am the first to admit that the lure of market timing never goes away. Sometimes you can even understand long-term trends – and that can be helpful. Our next recession is a good example. I believe another one is coming, but the information I really need is the precise timing of when it will start and when it will end. If I knew that, I could trade the recession and make lots of money. But I don't have that information, and no one else does either. There is no better way to destroy your long-term return than by trying to time the market.

A Morningstar study has shown that the average stock mutual fund has earned 12% per year on average over the last 20 years. The average stock mutual fund investor has earned just 2%. Why? It's because they

are jumping in and out of the market. They would have done much better if they had simply remained invested.

Recommendation: Stay invested. If you need to do something, rebalance. ***Suddenly pulling out of the market is usually a mistake.***

8) Avoid panic and euphoria. Keep your emotions in check.

As an investor, your temperament is important. Some investors run hot and are easily distracted by the next new shiny investment product they see, or they are obsessed by what is going on in Washington. They check their investment accounts daily, always tweaking and trading. Others are more sanguine. They hardly look at their portfolios. There are a number of studies that compare the investment performance of these two groups. The portfolio checkers consistently underperform their "lazier" counterparts.

Recommendation: When it comes to your investments, ***tune out the noise***. Stay focused and disciplined. Separate your political passions from your investment strategy. Keep calm and carry on.

9) Learn how to be a contrarian and stop running with the herd.

Human beings are naturally wired to believe that when something is happening, it will continue to happen. If markets are dropping, they will continue to drop (this makes us fearful, obviously). If they are moving up, they will continue to move up (this makes us greedy and overconfident). This is how most of us are wired to think, ***but it's not how markets actually work***.

When markets are dropping, they don't keep dropping forever. Eventually, after sellers are done panicking, prices drop to a level that attracts bargain hunters. Asset prices bottom and start to rise again. As Warren Buffett has said, be fearful when others are greedy and be greedy when others are fearful.

Recommendation: We have just gone through a fairly violent correction that may or may not be the start of a bear market. Are most investors fearful or greedy right now? I would argue that most are overly fearful. To me, this means staying in the markets right now and looking for bargains, not getting out. It means that asset prices have fallen, but they will bottom at some point and be attractive to buyers. Can the market go down still further? Yes, ***but at some point, depressed asset prices recover. They always do***.

10) Listen to fiduciaries, not salespeople.

For the most part, the investment industry is really a sales-driven business. Most investment and insurance professionals are compensated by sales commissions. This means there is an inherent conflict of interest between many professionals and their clients. These sales professionals have an agenda – they are being incented to push certain products to their clients. Unfortunately, your financial goals and objectives take a backseat. The advice they give is not always objective.

Recommendation: A market downturn energizes the sales force. They will be coming out with products that promise consistent returns and low risk. Be skeptical. ***If you seek advice, look for a fiduciary who puts your interests first.*** The advice they are giving is going to be more objective than the commissioned salesperson. If I'm having car trouble, I don't pull into a new car dealership. I already know what they are going to say.

11) Don’t reach for yield.

Many retirees believe they should live off their interest and dividends and not touch principal. But that is simply not possible for most retirees in today’s low-rate environment. Even so, some retirees reach for extra yield by investing in junk bonds and other risky income-producing investments. Resist this thinking. When markets are in turmoil, these high-yielding investments often get discarded in favor of safer alternatives. That means they can suffer large, unanticipated capital losses. Instead, consider the total return of your portfolio (which would include interest, dividends and also capital appreciation).

Recommendation: ***Do not get overly focused on yield in this low interest rate environment. Think more about safety.*** Just because an investment pays interest or a dividend doesn’t mean the underlying value of that investment can’t go down sharply during turbulent markets.

12) There are no shortcuts, secrets or free lunches.

Many investors believe there is a secret club of smart, rich and connected people, and only those people have access to proprietary trading strategies that make them even richer. It’s just not true. There are no shortcuts or free lunches. It’s rare when someone develops a new, proprietary strategy that has never been used before. But when they do, speculators are just waiting to reverse engineer it. They quickly drive out the potential for above-market returns. Markets are very efficient, and millions of participants are watching every move carefully. Even the most exclusive investment managers have difficult years. David Einhorn’s exclusive Greenlight Capital hedge fund was down more than 30% last year alone.

Recommendation: A solid, long-term investment strategy is no secret, but it works. Many investors can’t execute a long-term strategy because they lack discipline and perseverance. ***Stop digging for gold that doesn’t exist.***

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

Thank you,
Austin Lewis

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