November 4, 2018

Overview

The S&Ps' 500 sunk 6.84% in October while the Russell 2000 (US Small Caps) went down a whopping 10.84%. Internationally, the S&P EPAC BMI (international developed markets) dropped 8.72 while emerging equities were down 8.78% (MSCI EM).

The sharp correction in the US equities markets this past month extends the rather miserable decline in equities worldwide that started in the early part of the summer. It is now reaching the US markets. To give some perspective to the extent of the damage, below is a table that shows the sub-par Year-To-Date performance of some major assets classes.

YTD Performance as of October 31, 2018		
VWO	Emerging Markets	-15.90%
EZU	European Equities	-11.80%
TLT	US Long Bond	-8.86%
EWJ	Japanese Equities	-7.78%
VCIT	Intermediate US Corporate Bonds	-3.04%
VTWO	US Small Caps	1.43%
JPST	Ultra Short Term ETF	1.70%
SPY	S&P's 500	2.74%

The US bond market performed poorly again with the long bond dropping 2.50% and most other subsectors down from .61% for the municipal bond market to down1.79% for the High Yield sector and down 1.37% for intermediate US Corporate bonds.

In September, our fully deployed client portfolios were down from 4.95% to down 6.10% (new accounts have fared better as I have refrained from deploying their cash since the later part of the summer). This compares to a monthly performance of -3.70% for a purely US-centric portfolio consisting of 50% SPY (S&P's 500 ETF) and 50% BIV (US bond aggregate proxy). On a year to date (YTD) basis our portfolios are down 2.54% to 5.51%, net of fees. This compares to a yearly performance of .22% for our benchmark.

As a reminder, our allocations to equities currently vary from a minimum of 30% to a maximum of 70%, depending on each client's risk profile.

Market developments

The violent market correction in October results from the accumulation of investors' anxieties over on-going trade uncertainties, rising US interest rates and the perception of peaking corporate earnings. That said, none of these factors are new so why now and not earlier? After all, anxieties over trade negotiations and rising interest rates go back more than a year for the latter and at least nine months for the former. As for concerns over peaking corporate earnings, those first surfaced in May.

The chart below shows a clear connection between the timing of Fed Chairman Powell's speech of October 2 addressing the National Association of Business Economics and the ensuing reaction of US equity indices:

The vertical line marks the day of his speech. While the red line (US Small Caps) was already on a downtrend by that time, that was not the case of the blue line (S&P's 500) or the orange one (Nasdaq Composite). The power of one man!

All he said is that interest rates were likely to go up more (we knew that) and that the move towards equilibrium (neutral rates) could be some way off in the future. The market interpreted that statement as too hawkish for its taste and freaked out. The rest is history.

If there is one thing we can conclude from this episode it is that, no matter how well one is prepared for a storm, it rarely happens on schedule.

Tilts and Allocations

There is an aphorism attributed to Warren Buffett that comes to mind after my experience as a money manager this past October. It goes like this: "It is only when the tide goes out that you learn who has been swimming naked…".

The markets corrected sharply in October. I was positioned for it. I had been sensing that something might be afoot for quite sometimes. All portfolios had raised cash or quasi-cash to sustain a correction. I had also made some investments into defensive sectors such as utilities. Yet, all of this did not prevent an average loss of 5% in October for those portfolios that were fully invested (I was able to reduce losses to 1% or 2% for all newer accounts since I have stayed mostly in cash or quasi cash since early September).

I was certainly not swimming naked, but my swimming trunks were yanked some nevertheless. Here is why:

Our main US equity allocation is to a growth fund (BUFTX) that has had a spectacular long-term performance since I first invested in them in late September 2001. Since then, BUFTX has had an average yearly performance of 11.80%. The S&Ps' 500 returned about 8.30% annually in comparison. This is a fund that has traditionally gone down less than most during market downturns and that has bounced back faster as markets improved. This is why I have used it, until now, as our choice investment for US equities. However, a good long-term performance and risk profile do not mean that a fund is positioned properly for today's market conditions. BUFTX was not. After their October performance, when the fund went down 11%, it has become clear to me that the managers in this fund have increased the fund's risk profile. It performed worse that the Nasdaq Composite (down 9%). I was not expecting this, as a 7% to 8% decline would have been more in line with prior experiences.

As I saw BUFTX dipping unusually fast in early and mid-October, I switched about 10% out of it in favor of VTWO, a small cap ETF. That has proven helpful, so far. Small caps are up 4% since their bottom on October 26. I was also happy to see that our investment in XLU (the utility ETF) in August and September, provided some portfolio relief. All that, however, was insufficient to compensate for the large losses in BUFTX.

Consequently, and for now, my plan is to gradually reduce our position in BUFTX over the coming weeks and months. This slow approach will allow us to spread the tax effects of the rather large accumulated capital gains associated with this investment over two calendar years and allow the managers of the fund to correct their risk and return profile, if they so choose. I'll be monitoring the price action daily to assess whether they do or not.
This deliberate approach will give us an opportunity to bounce back, markets allowing. I intend to redeploy the cash that will be freed from those sales slowly, if at all. The market correction started with the month of October may not yet be over.

Concluding remarks

There has been a lot of anxiety in the markets recently. Part of that anxiety comes from the upcoming mid-term elections. Not that the outcome matters that much to markets in the short run (they generally do not), but the sheer fact that there is an unknown associated with them, perturbs market participants. So, the removal of this uncertainty, with an electoral decision in less than three days, should by itself improve the mood.

As for the other anxieties, caused by the economic war with China, the fear of declining corporate earnings or faster rising interest rates, at least one of them (China) may be partially resolved by November 20 when President Trump and XI meet in Argentina for the G20 meeting. If the beginning of a resolution is found, we may enjoy a good bounce back until Thanksgiving or a bit later when the next FED rate decision (mid-December) will start activating investors again.

A market correction such as the one we just experienced comes with a silver lining and that is the opportunity that it gives me to make your portfolios more downturn resistant by building a deeper moat around them. This is what I am going to do over the next few weeks

Thank you for your continued trust.

Cordially,

Jeff de Valdivia