FLEURUS INVESTMENT ADVISORY

October 4, 2015

Overview

During the month of September the US equity markets declined 3% to 5%. The S&P's 500 Total Return Index and the Russell Mid Cap Index dropped respectively 3% and 4% while the Russell 2000 (small cap) slumped 5%. Bonds offered a bit of a support with the US long bond up .83% and the corporate sector faring a little better at 1.40%.

The downside volatility came in good part as a result of the Federal Reserve's decision to delay raising the Fed Fund rate. The market interpreted this postponement as a lack of conviction in the strength of the US economy within a generally weak international environment.

Our international and small cap allocations contributed meaningfully to the decline of our portfolios from -1.25% to -2.50%, net of fees. On a YTD basis, this puts our performance across portfolios between -1.25% and -2.75%. This compares to a -5.75% YTD performance for the S&P's 500 and a -3.00% YTD performance for a portfolio consisting of 50% S&Ps' 500 and 50% US bond aggregate.

Market developments

Market tensions remained high in September as a result of the uncertain start of rate tightening by the Fed. The questionable strength of US economic activity, together with weak growth internationally, makes the job of the Federal Reserve particularly tricky. In addition, the looming third quarter earnings season is likely to add to market tensions. Investors should be ready for a fairly volatile month of October.

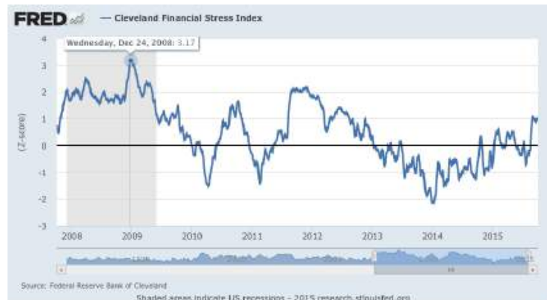
To give a long-term perspective on market performance and its correlation to market risk, below is a chart illustrating market volatility (VIX index in orange) and equity performance (S&P's 500 Index) over the past five years.

The low market volatility period from mid-2012 to August 2015 is historically unusual and directly connected to Fed policy. By pushing interest rates to zero the Fed has engineered an artificially low-volatility environment that we are now in the process of exiting. The current volatility levels, with a VIX index in the 20's, is more in line with historical norms. Daily market swings of 1% and above are likely to become more common over the next few months and years as the Fed "normalizes" policy.

That does not necessarily mean that markets will decline. The negative correlation between periods of heightened volatility and market swoons is undeniable over the long run. That said, we believe that the current environment is one of "transition" more that one of "mutation". We are moving from an abnormally supportive Fed policy to a period of moderately rising interest rates. This "regime change" is generating uncertainty and markets are reacting accordingly.

We believe that we are in a correction phase and not necessarily entering a bear market. Indicators of market stress seem to confirm, for now, our interpretation. While stress in equity markets remains high and close to crisis level, as illustrated below…

the overall financial stress is nowhere near 2008 levels:



Tilts and Allocations

We did very little in September. In keeping with our inclination to refrain from significant investment decisions when markets move violently, we increased marginally our international equities in mid-September and remained inactive the rest of the month. We see no compelling reason yet to commit more assets to equities in general.

Consequently, our allocations to US and international stocks remain below our long-term targets. We have decided to adopt this “wait and see” attitude until the earnings season is well on its way. May be more clarity will ensue.

We feel no urge to move at this point, all the more as “technical indicators” such as moving averages seem to tell us that US markets may be stuck in a range for a little while. With respect to the S&Ps’ 500, we would not be surprised to see it meander between 2000 and 1850 for the foreseeable future. It closed at 1951 this past Friday.

The chart below shows the S&P’s 500 below its 400 day moving average since August 24. It has since been unable to close above it (2003). While we do not base our investment decisions on market charts, they inform them. US equities are not likely to resume their march upward until this level (2003) is cleanly broken. We will remain particularly prudent until then.

Source: Gerring Capital Partners, StockCharts.com

Concluding Remarks

When it comes to life in general and investing in particular, I am a contrarian. I tend to question the consensus or the prevailing views.

This contrarian streak serves me well in anticipation of market corrections. More often than not, I anticipate a coming correction and manage to mitigate its effect.

The flip side of this coin is that I tend to want to jump back in when people start saying, “we are entering a bear market…” or “there is more to go here…”. When most market observers talk about bear markets, as is the case these days, I tend to revert to thinking more positively and to naturally go against the prevailing mood and invest, often too early. I am currently fighting this urge.

I am aware of this behavioral bias and am in the process of setting clear guidelines in place in order to avoid being “too early”. This correction may have more legs, even though my contrarian streak inclines me to think otherwise.

The current market environment, with its heightened volatility, makes us more prone to emotional reactions. Emotionality and savvy investing do not mix well. What are your investment behavioral biases? Are you aware of them? Are you doing anything about mitigating their effects on your portfolio? Now may be a good time to think about them and develop techniques and tricks to rein them in.

As usual, please feel free to provide your feedback.

All the best,