MARKET COMMENTARY

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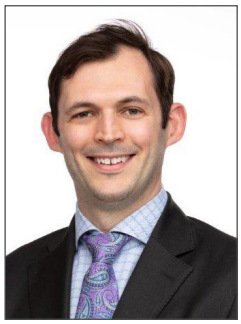

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2020 Vision

First we start with a definition of "exogeny". In an economic model an exogenous change is one that comes from outside the model and is unexplained by the model. Keep that in mind.

Then we refresh in our minds the efficient market theory (EMT) in financial economics that states that asset prices reflect all available information. The implication is that it is difficult if not impossible to "beat the market" consistently on a risk adjusted basis since market prices should only react to new information.

Then there is modern portfolio theory (MPT) which has been around for seventy years and postulates that it is possible for an investor to build a diversified portfolio of multiple assets or investments that will maximize returns while limiting risk.

When the concepts of EMT and MPT are understood, timing the business cycle is a requirement to allocate to assets that are at their optimum benefit stage from the cycle.

The business cycle is characterized by expansion and contraction. During expansion the economy experiences growth while a contraction is a period of economic decline. Contractions are also called recessions. Please note as recently we were in the expansion phase and that may still be the case. During contractions unemployment rises, production slows down, sales start to drop because of a decline in demand and personal incomes become stagnant and may contract. As of February 2019, none of these conditions existed.

Now let's review the last three weeks events along with market activity.

1. During the first week of March, it appeared that the U.S. Democratic primaries were perfectly correlated to market volatility. Bernie Sanders successes were followed directly by falling markets, while a surge by Joe Biden was followed by a spectacular recovery day. It appeared, by Friday February 28 that the markets were relieved that a moderate (Joe Biden) was gaining momentum.

2. We had experienced a 10% market correction well within normal range. Coronavirus was still distracting the markets, but on March 6 oil takes over, plummeting in price as a price war begins. The markets opened on Monday morning down 5% at the open. The selloff continued throughout the week.

3. Coronavirus takes control of investors anxieties as it spreads to many countries, of which some do not seem to be prepared. Leadership seems to be disorganized and uncertain as to whether a "sledgehammer" is necessary to kill the perceived "ant". Late in the week of March 9 to 13, governments, health authorities and corporations take much more serious actions to isolate and mitigate spread of the virus.

The stock markets rallied on Friday 13 as some confidence is restored in our system.

So now let's get back to portfolio management and particularly the exogenous events affect.

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The typical characteristics of rising interest rates, excess consumption, rising inflation and lower employment numbers were not signaling the end of the expansion phase of the business cycle.

The fall in energy prices is a negative for that sector of the market but lower energy prices support overall growth in the mid to longer term.

A moderate candidacy for the White House is a positive for the economy.

Coronavirus is the wild card as it is an unknown. It does seem controllable, although the measures required may create conditions that imitate a recession for a short period of time. A significant portion of the commerce lost during the fight against the virus will be recovered when we normalize and that deferred business gets transacted along with a significant rebuilding of inventories in the supply chains.

In addition lessons will be learned and technologies will be developed to better manage health events in the future.

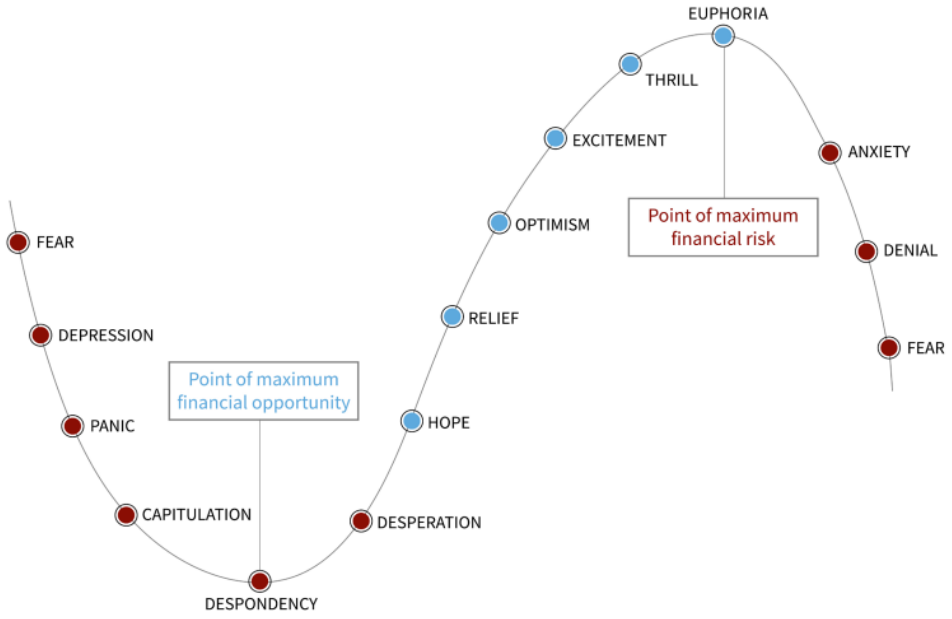
We know this is an uncomfortable time as portfolios devalue. It's a good time to not over react and have commitment in your strategies. We are reviewing all holdings to see if upgrades would help us recover as fast as possible once we have the data necessary to make "efficient" decisions.

All the best,

Andrew's Planning Corner

We are living in unprecedented times. Graham has addressed the broader economic and political climate surrounding the spread of the coronavirus, and the rapidly changing response. It is also important to understand the recent market movements from an emotional and sentiment basis, and how these shifts play into longer term financial goals and plans, even when making short term decisions.

The recent stock market volatility is dramatic and compressed, but has to be placed into the context of a broader economic cycle. The stock market goes through highs and lows routinely, but when these shifts happen rapidly, human emotion can impact investment decision. Commonly called the investor cycle of emotions, and it typically follows contemporaneous market movements:



As recently as mid-February, when the markets were setting record highs, broad investor sentiment was in the excitement and thrill categories. The exogenous coronavirus impact and corresponding market sell-off has many investors in the panic and even capitulation ("maybe the market isn't for me…") mindsets.

While the full impact of the COVID-19 pandemic has yet to be seen, broad investor sentiment could not be much lower than it currently is. To quote Warren Buffet, it is wise to be "fearful when others are greedy and greedy when others are fearful." When most investors are greedy, they are likely overpaying for assets, and inversely will sell at any cost when they are afraid, which presents an opportunity to invest or buy at a discount, as long as purchase decisions are made prudently.

All this to say that while there is no question that the recent market impacts are serious and severe, they are not permanent and are part of a longer-term cycle. As part of this cycle, it is important to keep the longer term goals and financial plans in mind, and look at a few key points to remember:

- Don't panic – Panicking, or other emotional investment decisions, places the investor onto the broad cycle of market emotions. At the very least, this leaves the investor chasing the market, and panic selling transforms temporary potential paper losses, reflected in current lower values, into a real loss directly to the investor.
- Be patient - Successful investing is a long-term commitment and requires investors to stay invested through good times and bad times alike. Over time there will be periods of stock market declines, but overwhelming historical evidence suggests that equity

markets give investors the greatest possibility for long-term growth in asset value and percentage return on their investments, far superior to any other kind of investments.

- Maintain perspective – One of the oldest lines in media is, "if it bleeds, it leads". Negative news tends to dominate headlines and viewership. Be prepared to discount media dramatization of the daily financial fluctuations in the market. The "worst case scenarios" tend to dominate short-term news coverage, causing speculation to rise and emotion to override reason in some investors.
- Review your investment strategy – Volatile times in the market are good times to review the diversification of the investments in your portfolio and your asset allocation strategy. The questions to ask are: Have any fundamentals changed to affect the underlying quality and intrinsic value of my investments? Has my ability to tolerate risk changed, and as a result, should the asset allocation be re-balanced?
- Look for opportunities – Investors in a down market often go to the sidelines and neglect to take advantage of strategic investment opportunities. Dollar cost averaging is one way to lower your cost on existing investments. By regularly investing, regardless of market conditions, the investor takes advantage of downturns in the market and reduces the average share cost over time. The other opportunity is to go looking for quality investments whose price has been dragged down by an overall market decline but whose business value and future prospects are expected to be good.

Specifically to the last point, the recent market volatility has led to the indiscriminate sell off of nearly all businesses and companies, regardless of cash position, strength of company, and business outlook. This means that there are now high quality companies with sound business models now trading at a much lower level than as recently as February, making for a potentially attractive entrance point.

Maintaining discipline through all markets, and not going to cash, has proven to be by far the strongest investment strategy over the long term. The hardest part about selling off investments and holding cash in knowing when to re-enter the markets. Typically, the strongest market growth days are the turnaround after a pullback, where the recovery starts to take hold. Holding cash means that an investor is more likely to miss these investment days, and frequently uses these days as an indication to get back into the markets (again, chasing returns). Although it is impossible to predict exactly what the market is going to do next, missing these strong markets days (regardless of when the major down days are) irredeemably harms long term returns.

Sourced from JP Morgan, the chart below shows how $10,000 USD, invested in the S&P 500 index for the 20 year period of 1999 – 2018 would have performed under various scenarios:

Going to cash

Scenario	Ending Value	Average Annual Return
Fully invested	$29,845	5.6%
Missed 10 best days	$14,895	2.0%
Missed 20 best days	$9,359	-0.3%
Missed 30 best days	$6,213	-2.4%
Missed 40 best days	$4,241	-4.2%
Missed 50 best days	$2,985	-5.9%
Missed 60 best days	$2,144	-7.4%

SOURCE: JP Morgan

CNBC

As you can see, missing only the 10 best days out of 20 years reduces the average annual return of the investment by 64%, and missing any more than the 10 best days effectively eliminates all growth over 10 years.

Keeping these overall emotional and planning factors in mind can ensure that each investor is able to mitigate the actual impact to themselves in the short term, and place themselves in the best possible position for the future.

If you have any questions, or if there is anything that we can help with, please do not hesitate to let us know.

Take care, and stay safe!

Sincerely,
Andrew Gilchrist, CFP®, BA
Financial Advisor