STAUB FINANCIAL

NEWSLETTER FALL 2017

Hello and Happy Fall

We hope that this newsletter finds you all in good health and spirits. This has been a long stretch between newsletters and we have a number of mini-updates to share in the coming months in regard to:

- *YOUR DATA SECURITY*
- *TECHNOLOGY UPDATES AT STAUB FINANCIAL*
- *TAX REFORM*

We are happy to hear that most clients in the Southeast escaped the wrath of Hurricane Irma. Thankfully, my brother and clients in the Houston area survived Hurricane Harvey. Lastly, our pocket of clients in Northern California dodged severe wildfires months ago and more recently in the Napa Valley region.

Perhaps an analogy is prudent. It is common-place to build strong structures to protect against natural disasters. Similarly, as advisors, our portfolios are built from the bottom up. These "all-weather" portfolios are focused on protection and withstanding financial downturns when they arise. And while the current weatherman on Wall Street is focused on rainbows, we remain grounded. Our umbrella and rain gear are indeed, handy.

"BUY NOT ON OPTIMISM, BUT ON ARITHMETIC."

-BENJAMIN GRAHAM

Historical Context

Over the course of the past year, most have been warned about the record-setting levels in the stock market and our professional concern regarding this issue.

To reiterate, more value oriented stocks started to regained favor in 2016 ([1]Morningstar Dec 2016) until the November election. Since then, it has been GROWTH STOCKS leading this stock market surge ([2]Morningstar Sept 2017) not unlike the last few years.

Put candidly, we are not forecasters. Those who try to predict the direction of the market in the short-term are fools. However, we would be fool-"ish" to overlook some of the current metrics. From an earnings perspective, the valuation of the S&P 500 is now almost equivalent to the peaks we saw in 2000 and 2007 prior to two of the worst stock market downturns in history. One should recall that beginning in 2000, the S&P lost half of its value by 2002 while the NASDAQ lost almost 80%. In 2008, the S&P was down 39% ([3]John Hussmann April 2017). Please let that sink in with your actual portfolio dollars for a second.

> ***"One should recall that beginning in 2000, the S&P lost half of its value by 2002, and the NASDAQ lost almost 80%."*** *– 3 John Hussmann April 2017*

Our clients do not have such concentrated portfolios, however even a 60% stock and 40% bond portfolio lost 28% in 2008 ([4]Morningstar office). It is shocking and perhaps ironic when we review newer portfolios to uncover how aggressive they are and how little idea the client has of the inherent risk involved. We have recently re-balanced our current clients' portfolios at a feverish rate and feel this is an important time to do so. Before you argue that Amazon and Netflix are great companies, let me state that we use both; just because a company is great doesn't mean that the stock isn't overvalued. Comparably, a company that is out of favor or appears average and boring, can sometimes become undervalued and worth investing in. First Eagle Funds, discussed commonly as our largest fund family, has recently shared the following during their mid-year call:

- Undervalued stocks are hard to come by
- The overall market is extreme
- As a byproduct, the cash levels have risen further ([5]Matt McLennan First Eagle Funds, July 2017)

Howard Marks, manager of Oaktree Capital, and highly respected by Warren Buffett (see past newsletters) recently wrote an article entitled "*There they go Again…Again.*" Frankly, it is one of the most insightful articles I've read recently. He addresses the current market valuation, economics, and most importantly, ***market psychology.*** He touches on the following current events:

- Uncertainties are unusual in terms of number, scale, and insolubility in areas of economic growth, the impact of central banks, interest rates and inflation, political dysfunction, geopolitical trouble spots, the long-term impact of technology
- Prospective returns are just about the lowest they have ever been over ALL ASSET CLASSES
- Risky behavior is commonplace ([6]Howard Marks Oaktree Capital – July 2017)

"A glass case of emotion"

The non-reaction and quick reactions of investors take years to shake out in markets, but can be summed up in this way:

A. Investment Fundamentals fluctuate cyclically followed by investor overreaction to these fundamentals, whether positive or negative
B. The level of risk aversion fluctuates between excessive and inadequate
C. Normally stock markets go from severely depressed to new highs

Investors get lulled to sleep thinking that when things are good, they will remain positive and when they are bad they will never get better. When it comes to your nest egg, it is critically important that we manage you against that very real feeling. It is seemingly right in front of us but emotions cloud rational thinking and logic.

We see it blindly in everyday examples:

- Whether at Oakland Hills or Flatbush, people are inquiring about stock picks
- "Detroit real estate won't ever go down again." Not long ago I couldn't twist someone's arm hard enough to convince them that Detroit would ever "come back"
- A client inquiring about putting 100% of their 401k into Fidelity Growth Fund because it is up 30% this year (Morningstar Office)

This mentality is very prevalent today. You simply cannot allow emotion or greed drive your investment decision-making. You will get burned. History doesn't repeat itself but it certainly rhymes. Right now, it appears to be rhyming with the late '90's tech bubble.

Temper Your Expectations

This leads us to setting expectations. Given the current interest rates and market valuations, some forecasters predict that the S&P could produce returns between -1% to +3% annually over the next 10 to 12 years ([7]John Hussmann April 2017/First Eagle Summer 2017). Moving forward, in order to see the normal 8-10% annual stock returns, the market would have to drop between 50-60% today, in order to revert to that kind of 8-10% "norm."

In summary, for those in the 55-70 age range, this period is particularly important. For many, we have already adjusted portfolios. If you have not recently adjusted your portfolio, please ask yourself one simple question:

"How much am I willing to watch my portfolio decline over a 6 month-1-year period without feeling the need to change my portfolio greatly?"

If the answer is "I'm not sure" please call us to have a very meaningful conversation to highlight potential risks in your portfolio. We want to be proactive versus reactive. This time is potentially different from the late 90's when there turned out to be pockets of value outside of technology in other sectors such as small caps, healthcare and foreign stocks ([8]Morningstar Office).

> ***"Long-term success is more a matter of avoiding major losses than matching the market during good times."***

Lastly, sometimes this business requires us to be "out of favor" from an investment perspective. You must understand that showing up late to the party (heavily invested in what is hot) is not fashionable in this business. There is no focus on this market and economy. The focus is in Washington. What will happen when that focus returns to the market and economy? To reiterate we are not forecasters and concur that no one knows when a market correction will occur. But I don't think it is a question of "if" but a matter of "when." Long-term success is more a matter of avoiding major losses than matching the market during good times. Potentially reducing those losses in a down market may add to long-term returns. This may also help keep your fears at bay during times of true distress like that which we endured in 2007-2009.

I refuse to end this newsletter in a doom and gloom manner. The same technology that is extremely complex and creates risk, also does create efficiency, which is a positive for the economy. Managers with liquidity and rising cash levels are poised to put that cash to work when stocks become cheaper. As advisors, overall, we must have conviction from a value prospective to prudently guide clients…especially when the rainy days do show up.

Stay positive personally…and grounded financially.

Happy Fall,
Corey and Dan

1-Morningstar Dec 2016, 2-Morningstar Sept 2017, 3 -John Hussman April 2017, 4-Morningstar Office, 5-Matt McLennan First Eagle Funds – July 2017, 6-Howard Marks Oaktree Capital – July 2017, 7-John Hussman April 2017/First Eagle Summer 2017, 8-Morningstar Office

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