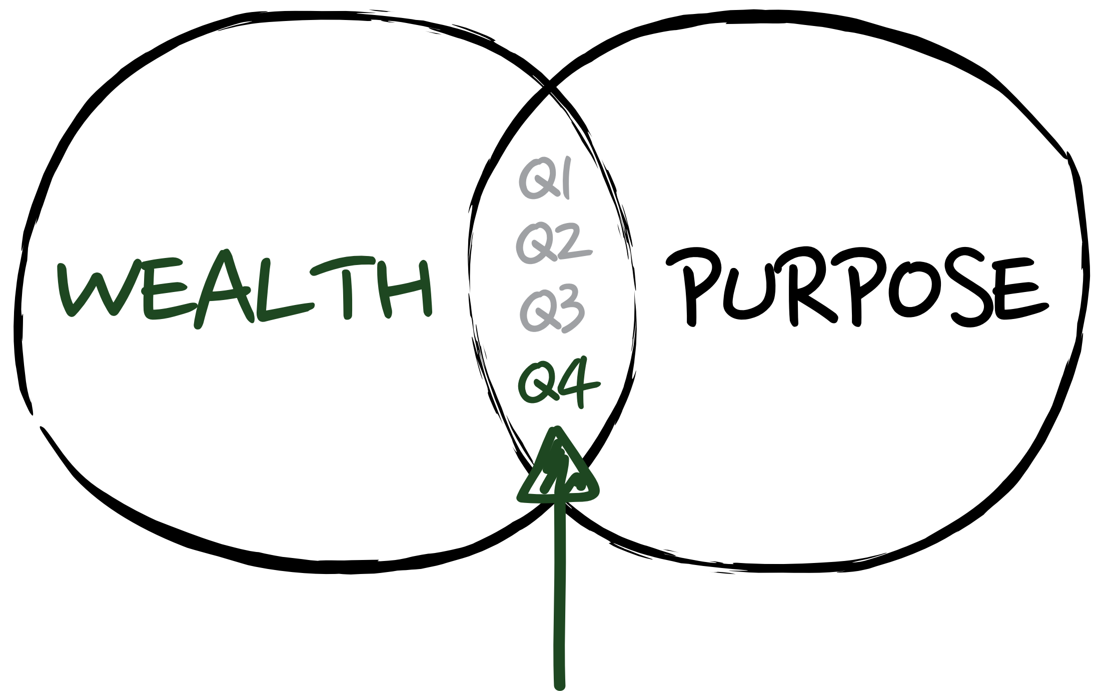


CONNECTING QUARTERLY

JAN 2019

Happy New Year Friends!

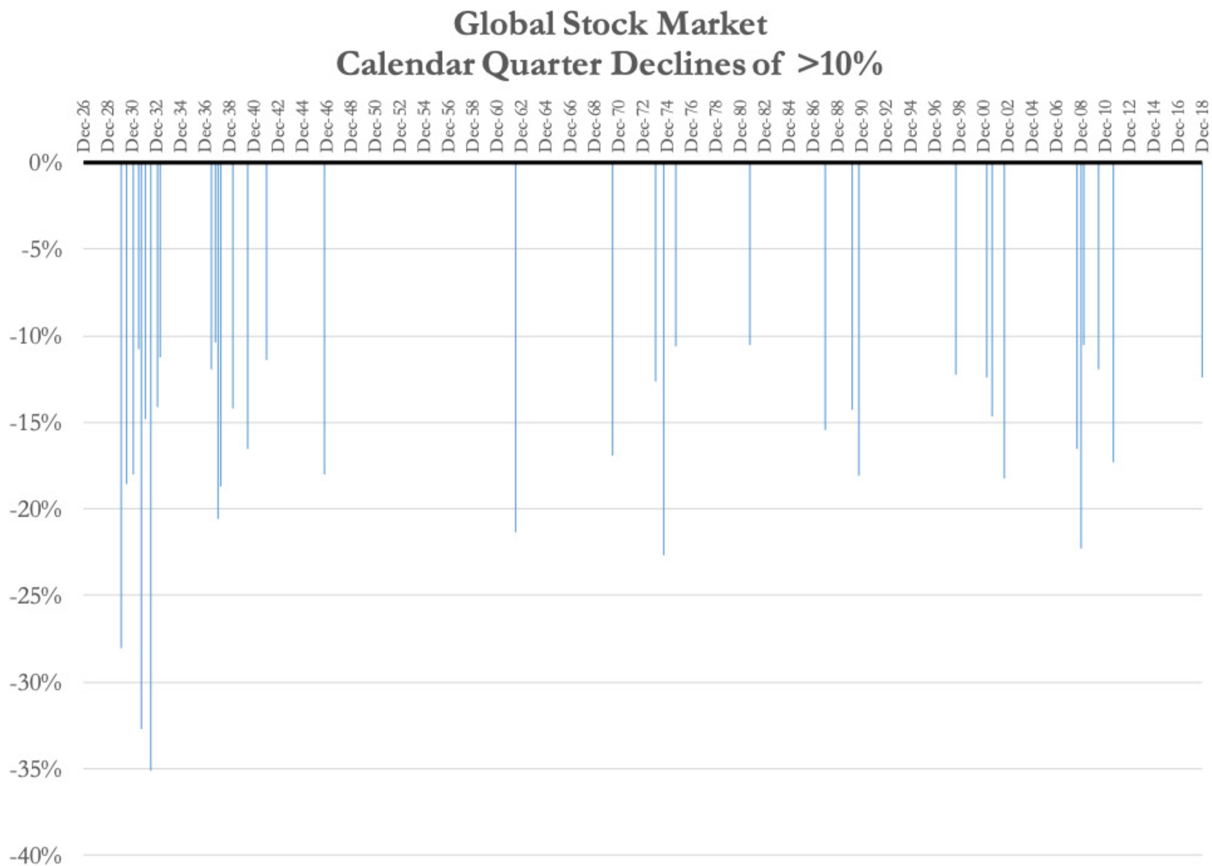
This Christmas brought with it a new bike for my eight-year-old son. He was a bit of a late bloomer to two-wheeled bike riding, only learning how to ride about a year ago. He now seems to believe a Tour de France appearance is in his future. As he build up his skills over the past 12 months, my wife and I have had to come to grips with a related issue: Crashes.

His crashes have been unpredictable. He can slalom for miles at high speed down winding hills without incident, only to launch himself onto the pavement while puttering at 2 mph in the neighbor's driveway. When the leg gashes and bruised forearms first started, my wife and I debated whether we needed to transform him into a combination cyclist/hockey goalie: knee pads, elbow pads, face mask, etc. After careful consideration, we decided a helmet was sufficient.

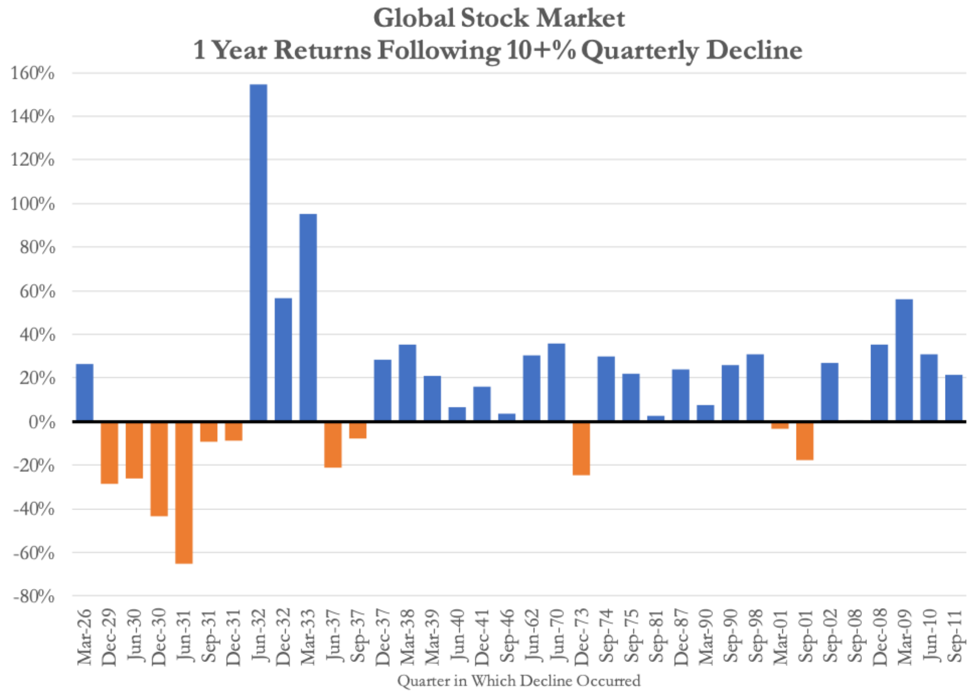
In hindsight, we have witnessed something we didn't specifically expect. By exposing our son to the non-life-threatening risks of cycling and not trying to insulate him from every

little bump and bruise, we have probably helped him become a safer bicycle rider in the long run. He has had the opportunity to learn the temporarily painful consequences of attention lapses and poor judgement. In effect, we have turned an apparent "glitch" associated with bike riding (crashes and their resulting aches and pains) into a "feature"; a potentially long and safe love affair with the bike.

Confusing a glitch with a feature is a common mistake amongst many investors. When markets experience sharp downturns, some investors immediately start fretting, wondering "what's wrong?" and searching for solutions to fix it. For example, in the fourth quarter of 2018, the global stock market declined about 12%. Media outlets began pointing fingers at a variety of scapegoats: the Federal Reserve, the President, computerized traders, passive investors, China, etc. Profit-hungry financial institutions who prey on the emotions of investors took the market's declines as an opportunity to sell their newest high-fee "protection" strategies, certain to make investors temporarily feel better in these "unchartered" waters. But as we see from the graphs below, double-digit quarterly declines in the stock market aren't a black swan. In fact, they have occurred 36 times since 1926.



More important than understanding the frequency of such declines is answering the question "what should we do NOW ?" As usual, we turn to long-term historical evidence for some clues:



The chart above shows the performance of the global stock market in the year following each of the 36 double-digit quarterly declines. As you can see, 25 of the 36 subsequent years saw positive stock market returns and more than 50% of the 36 years had returns of 20% or more. Clearly, there is little evidence here to support the fear that a bad quarter in the market is a sign of worse to come.

Five-year subsequent returns look even better: In 32 out of 36 cases following a double-digit quarterly decline, the global stock market has posted positive five-year returns, and the average cumulative five-year return is 80%:

When you think about it, the historical evidence of strong returns after bad quarters in the market makes sense: The significant return premium that stocks have historically earned relative to less-volatile investments like cash doesn't occur DESPITE these big downturns, it occurs BECAUSE of these big downturns. Short-term speculators and day traders get scared when big drops in the market occur. They are so fearful that they willing to accept low prices to sell their holdings quickly. Others see these sharp declines and avoid stocks altogether because they feel too risky and uncertain. But these periodic market declines, just like my son's bike crashes, are the features that lead to the greater long-term returns of the stock market. If there were certainty and safety in the stock market, stock prices would be so high that their future returns would resemble the low returns of ultra-safe investments like Treasury bills.

No one knows if the next 12 months will be like cruising down a smooth winding path, or whether investors will acquire more road rash. Either way, we think it is important to view the periodic "spills" in the stock market as a necessary requirement to acquiring the long-term "thrills".

As always, we welcome your questions and comments.

Sincerely,

Chuck Carroll, CFA, CAIA
Chief Investment Officer
TFO Phoenix, Inc.

Data source for all charts: Dimensional Returns 3.0 software. The global stock market is represented by the MSCI All-Country World Index from 1988-2018, the MSCI World Index from 1970-1987 and the CRSP US 1-10 Index from 1926-1969. Indexes are not available for investment and no not reflect any management or advisory fees. The returns shown are not intended to represent returns of actual TFO clients.

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