# Portfolio Managers Commentary – Q3 2016

*"Wealth isn't primarily determined by investment performance, but by investor behavior" – Nick Murray*

**The Elephant in the Room**

September has come and gone and we have exited the month following a period of unusual complacency. Complacency is Wall Street speak for days upon days when the major market indices trade within an unusually narrow range. LPL Research pointed out that the trading range of the U.S. stock market, as measured by the S&P 500 for the month of August, was the seventh narrowest since 1928.

One thing that is absolutely certain – periods of sheer boredom for the short-term trading crowd will eventually come to an end. We don't know when, but it will happen. In this case, a modest bout of volatility returned to the market by mid-September.

Much of it was related to interest rate worries and chatter from various U.S. Federal Reserve officials. While I'm going to steer clear of the Fed in this report, I do want to go into a bit of detail on a couple of items, including what I sometimes like to refer to as the "pink elephant in the room." You know, something that everyone at the cocktail party is aware of, but we all decide it's best to pretend it's not there with us.

Today's pink elephant is the upcoming U.S. election. No doubt, politics can fuel all types of emotions on both sides of the border. Even Canadians sometimes feel strongly about certain issues or certain candidates that are running for U.S. office.

Recently I've seen a lot of hand-wringing from investors worried about the upcoming election. Many people have told me, "I'm afraid to make any financial decisions until after November." The thinking goes that once we know the name of the next President, we'll be able to predict what the markets will do. Only then should we make any decisions.

But this line of reasoning is wrong because <u>no one actually knows what will happen to the markets after the election</u>. Whether the winner is Hillary Clinton or Donald Trump, we can *try to predict* what the effect will be, but no one actually knows. That's because **We Don't Know what Each Candidate Will Do in Office?**

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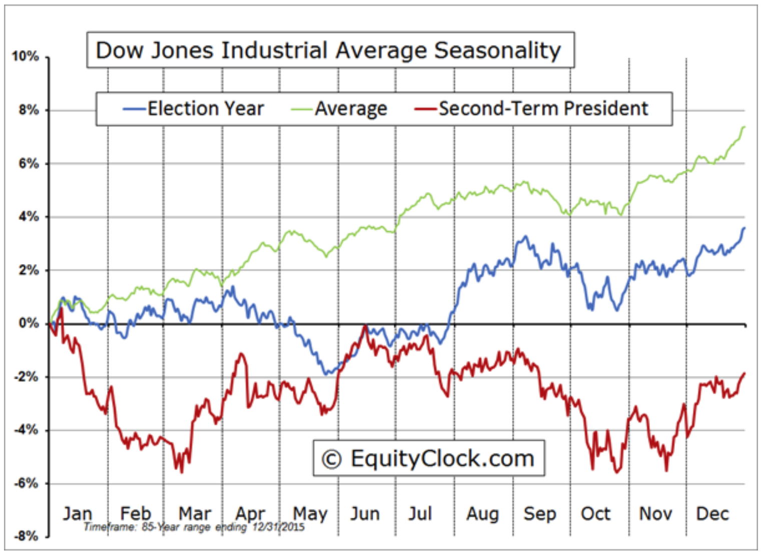
The markets respond to more than just who occupies the White House. The markets move for no man or woman. No one principle governs them and no single event determines their destiny. The markets are complex, because *so many things* can affect them. The President is just one person. Similarly, the election is just one event. An important one, true, but the markets react to thousands of events throughout the year. Making financial decisions based on emotion is never a good thing. But too often, we let emotions get in the way. Emotions can prevent clear thinking and make us react impulsively.




As always, we should make financial decisions based on *planning* instead of predictions. *That's* the way to control your financial future. No one else controls it for you...not even the President of the United States. Keep your eye on your longer-term financial plan.

While we've seen very little volatility tied to the election so far, its possible things could get a bit bumpy as we approach Election Day.

The seasonality chart I've featured is based on the trading pattern of the Dow Jones Industrial Average for the past 85 years. The chart features an average year (green), an election year (blue) and a second-term president year (red).

While history doesn't always repeat itself exactly, I would suspect that the markets will follow the path of the red line for the remainder of 2016. Our expectations are for increasing volatility until mid-November followed by a resumption of the rising trend into the end of the year and into early 2017.

You've heard me reiterate time and time again: Markets go through choppy periods over the short term, but a disciplined approach is the straightest line to your financial goals.

Trying to time the highs and lows in stocks is much like trying to guess the string of plays your team will call as it hopes to charge down the field and score a touchdown. Or, it's analogous to trying to guess what the score might be midway through the fourth quarter, when your team sports a 21-9 lead heading into the locker room at halftime.

I enjoy listening to the keen insights of sport professionals during the halftime show. But none of them offer up a prediction of the final score. As baseball great Yogi Berra was fond of saying and I'm fond of quoting, "It's tough to make predictions, especially about the future."

**The German version of too big to fail**

Although the last bear market is far behind us, investors are still living in the shadow of 2008. While the wounds have healed for those who maintained a disciplined approach, the scars may still run deep. And that means some investors have a tendency to look over their shoulder, always wary that another crisis is lurking, ready to ambush them. The latest such instance hails from Europe – Germany to be specific.

Deutsche Bank (DB) is Germany's largest bank. With assets that tower nearly $2 trillion, it is Europe's fourth largest bank by assets (Statista.com). Safe to say, it's too big to fail.

Unlike their U.S. counterparts, which diligently raised capital in the post-2008 era, Europe's banking system is in a much more fragile state. And right now Deutsche Bank is the poster child for ailing European banks. At the end of the second quarter, the International Monetary Fund said Deutsche Bank posed the greatest risk to the global financial system (*Wall Street Journal*). In part, problems spring from profitability issues and the lack of a solid capital buffer.

Fast forward to mid-September when Deutsche Bank was asked by the U.S. Justice Department to pay a $14 billion fine for selling toxic mortgage securities (*Wall Street Journal*). It was a punch to the gut for a bank that was already wobbly. Then, two ill-timed stories hit the wire near the end of September. German Chancellor Angela Merkel reportedly ruled out any state assistance for the bank (denied by both parties), and about ten hedge funds that do business with the bank moved to reduce their exposure (Bloomberg).

Today, it is an issue of confidence.

**The bedrock of the financial system**

The foundation, the bedrock, the cornerstone (I can't over emphasize this) of the global financial system is confidence. Simply put, you and I hold our cash in banks. At any time, we have the confidence we can walk into our local branch and withdraw the entire amount. But, if everyone shows up at once, it would amount to a run on the bank.

If confidence evaporates and it happens to a 'too-big-to-fail bank,' tremors can quickly spread around the globe, as we saw in the wake of Lehman's failure. It's like throwing a giant wrench into the gears of the financial system.

**I don't believe Deutsche is a Lehman moment**

Bad things can happen; I won't deny that. I really do understand that some of you have concerns. If you would like to talk, you know I am always available to address any issues.

What ails Deutsche Bank also dogs many of Europe's large banks, all of which are grappling with a number of headwinds. However, I believe the 2008 crisis was a once in a lifetime event. Investors must be careful not to believe the sky is falling every time rain makes its way into the forecast. Such a posture will lengthen the path toward your financial goals.

What's different today, you ask? Unlike 2008, central banks and governments are painfully aware of the carnage that was sparked by Lehman's disorderly demise. Additionally, U.S. banks are much better positioned today. The economic fundamentals aren't deteriorating, and banks aren't floundering under the weight of toxic assets.

While European Union (EU) banking rules have been designed to limit taxpayer support of large institutions (*Financial Times*), it's hard to see a situation where Germany would allow a disorderly dissolution of its largest bank. Such an event would wreak havoc on its economy. Moreover, firewalls are now in place that weren't available in 2008.

It's not that we can't see some volatility if problems persist, but U.S. fundamentals, which have helped support shares during periods of recent volatility, remain intact.

**Bottom line**

Everything I write about circles back to a recurrent theme that permeates many of my communiqués – stick with the plan that's been tailored to your desired outcome and willingness to take risk.

Jumping in and out of the markets for no good reason is one of the biggest reasons so many investors fail to keep pace with the market averages.

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I’m not saying this is impossible to pull off, but research shows the vast majority of investors would be better off sitting on their hands instead of constantly trying to time the markets.

Of course, if your personal situation has changed, please reach out to me or one of the members of my team, and we can discuss any changes in your circumstances and how that might affect your current plan.

I hope you’ve found this review to be educational and helpful.

Thank you very much for the trust and confidence you’ve placed in my team and my firm.

Sincerely,

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*P.S. - I don’t often ask for referrals, but during these unsettling times you might have a friend, relative, or co-worker who is in need of level-headed counsel on investing. Give me a call if you think I can help.*