Portfolio Managers Commentary – Q4 2017

"The farther back you can look, the farther forward you are likely to see" – Winston Churchill

2017: The Year in Review

Every January, it's customary to look back at the year that was. What were the highlights? What were the "lowlights"? What were the events we'll always remember? Most importantly, what did we learn?

Rather than write a long recap of the entire year, let's first look at this chart to the right.

Obviously, this is hardly a full summary of everything that happened last year. And it doesn't even mention any terrorist attacks or the ongoing investigations into different government officials.

It doesn't mention the tidal wave of sexual harassment allegations that swept across Hollywood, the opioid epidemic, or any of a dozen other stories that dominated the news.

Month	Notable Events	S&P 500
January	Donald Trump is sworn in as president.	Up 1.79%
February	North Korea fires a ballistic missile over Japan.	Up 3.72%
March	The U.K. starts negotiations over leaving the European Union (Brexit).	Down 0.04%
May	A massive "ransomware" cyberattack strikes computers around the world.	Up 1.16%
July	More tension as North Korea fires its first intercontinental ballistic missile.	Up 1.93%
August	Hurricane Harvey strikes, the costliest natural disaster in U.S. history.	Up 0.05%
September	Hurricane Irma hits, one of the strongest hurricanes ever recorded. Hurricane Maria follows soon after. Equifax announces a massive data breach. In politics, Republicans fail to repeal Obamacare.	Up 1.93%
October	Fifty-eight people are killed in the deadliest mass shooting in U.S. history. In Europe, Catalonia declares independence from Spain.	Up 2.22%
December	Republicans in Congress pass the *Tax Cuts and Jobs Act*, the most significant tax reform in over 30 years.	Up 0.98%

But let's look closely at what it *does* mention. On the chart, you'll see:

1. National politics
2. Geopolitics
3. International incidents
4. Natural disasters
5. Cybersecurity

These were all major developments, many of them affecting hundreds of countries and millions of people. Of course, some items weren't necessarily *bad*, but each was significant in its own way.

And month after month, the U.S. markets kept chugging up the hill throughout the year.

What Can We Learn from This?

Politically, culturally, meteorologically, 2017 was a volatile year – but not for the markets. As a result, 2017 taught us a valuable lesson about investing, which is that:

Major news stories don't drive the markets!

Or at least, they're far from the only thing that drives the markets. Time and again, pundits predicted the latest natural disaster, story about gridlock in Washington, or geopolitical incident would bring the markets down. In 2017, that never really happened. That's not to say such events don't *ever* affect the markets; just that they often don't have the impact one would expect.

Take the Cuban Missile Crisis. The world has probably never been closer to nuclear war than during those nerve-wracking thirteen days in 1962, yet during that time, the Dow only fell 1.2%. By the end of the year, the Dow was up 10%.

More recently, look at Brexit. When the UK voted to leave the European Union in 2016, it took most analysts by surprise, and many predicted it would lead to a major drop in the markets. At first, it did. The vote took place on a Thursday. The next day, the Dow fell over 600 points, and then another 250 points the Monday after.

But less than a month later, the Dow climbed to a new record high. In 2017, the same thing occurred, with major events failing to impact the markets to any great degree.

What's the Explanation?

In a sense, the markets are like baking a cake. If you've ever made a cake from scratch, you know the list of ingredients is fairly long. Flour and sugar. Baking soda and salt. Eggs and milk, oil and vanilla, and any of a half-dozen other things.

That's complicated enough, but as any chemist would tell you, we've only just scratched the surface. Here's what *really* goes into a cake: hydrogen, carbon, oxygen, nitrogen, sulfur, sodium, potassium, magnesium, molybdenum, manganese and more – all in the correct proportions, too, or else you just get a mess.

The markets are like that cake – formed by hundreds, perhaps *thousands* of moving parts, decisions, stories, and most of all, people. So, in this analogy, the major news events that occur in any given year aren't even the sugar or the salt. They're the sulfur and selenium. Just a few elements in a giant bowl filled to the brim with them.

Why the Markets Went Up in 2017

So, what are some of the major elements that *did* move the markets in 2017?

Expectation is one. From the beginning of the year, the expectation of fewer regulations and lower taxes in the U.S. has been a major source of enthusiasm. (Both expectations were rewarded.)

Economic growth is another. The U.S. economy has been growing slowly but steadily over the past several years, and progress continued in 2017. The unemployment rate ended at 4.1% for the year, a 17-year low. Wages increased for many workers and many corporations reported strong earnings throughout the year, causing valuations in most sectors to climb.

Sheer momentum was also likely a factor. FOMO, or the fear of missing out, is always a strong motivator, and as the markets climb, more and more people want to hop on board.

So, What's the Takeaway from All This?

2017 showed us that the markets aren't a weather vane for any set of morals, political views, philosophies, or breaking news. History has repeatedly demonstrated that the markets are relatively unaffected by who the president is, which political party is in power, or how the winds of cultural change blow. In a more modern sense, the markets are far too large to be moved by anyone's tweets or which YouTube video went viral. In a way, that's a comforting thought. And it's a further example of why we must avoid assigning narratives to the markets, and then making decisions based on those narratives.

Throughout 2017, many pundits kept trying to pick this event or that event as the straw that would break the camel's back. I imagine many investors spent a lot of time searching for clues as to when the next correction would occur, and so missed out on opportunities for growth. That's certainly been the case for this entire bull market, one of the longest in history. It's a bull market that many investors have failed to take advantage of. (Per a survey by Gallup, only 52% of Americans report owning stock today, compared to 65% back in 2007.)

Of course, it's also possible to make the opposite mistake: assume that good news, whether political or economic, will continue to drive the markets up. Nothing lasts forever, including bull markets, and it's crucial that we avoid becoming irrationally exuberant, taking on more and more risk to chase higher returns. Investors who do that often make simplistic decisions based on specific news stories or trends that maybe aren't as important as they appear.

2018 Market Outlook

There's no crystal ball to investing, and it's impossible to truly know which "elements" will affect the markets most in 2018. Still, here are some of the trends we'll be keeping an eye on:

- Will lower taxes in the U.S. mean corporate earnings continue to grow?
- Will the Mueller probe into President Trump's campaign lead to any executive shakeup in the White House? (This only matters if it leads to policy changes that could impact the markets.)

- Who will control Congress after the 2018 midterm elections? (Again, this only matters so far as it affects policy down the road.)
- Many states are set to raise minimum wages in 2018. Will this lead to a rise in consumer spending?

At the moment it seems reasonable to expect a kind of "Goldilocks economy" in 2018, in which economic growth is neither hot nor cold, but moderate. But again, we're not going to make investment bets based on any storylines, nor are we going to react emotionally to future developments. Instead, we'll continue to remember that the markets are large, complex institutions.

General Principles

It will be worth reiterating, in the context of this annual letter, the nature of my philosophy of advice. Generally speaking my experience has been that successful investing is goal-focused and planning-driven, while most of the failed investing I've observed was market-focused and performance-driven.

My essential principles of portfolio management in pursuit of my clients' most important goals are fourfold:

1. The performance of a portfolio relative to a benchmark is largely irrelevant to financial success.
2. The only benchmark we should care about is the one that indicates whether you are on track to accomplish your financial goals.
3. Risk should be measured as the probability that you won't achieve your goals.
4. Investing should have the exclusive objective of *minimizing that risk* to the greatest extent practicable.

The nature of successful investing, as I see it, is the practice of ***rationality under uncertainty.*** We'll never have all the information we want, in terms of what's about to happen, because we invest in and for an essentially unknowable future.

Therefore, we practice the principles of long-term investing that have most reliably yielded favorable long-term results over time: planning; a rational optimism based on experience; patience and discipline. These will continue to be my fundamental building blocks of my investment advice in 2018 and beyond.

I hope you've found this review to be educational and of value. Once again, let me emphasize that it is my job to assist you! If you have any questions or would like to discuss any matters, please feel free to give me or any of my team members a call.

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.