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"Exit, pursued by bear…"

Stage notes from Act III, Scene III of Shakespeare's *The Winter's Tale*

Dear Friends,

Pundits say that most good things, when they end, end badly. Otherwise they wouldn't end. You have to admit there is a certain logic to this hypothesis. It goes without saying that the recent performance of the stock market and, more poignantly individual stocks, certainly fit the ending badly bill. We cannot recall ever discussing the nature of a bear market in one of our letters. Seems like an opportune time to do so. As we write, we are still four tenths of one percent from officially being in one as measured by the Dow; perhaps this is a premature obit for the bull. But it is factual that the run-up in the broad market from 2009-2018 is the most ancient bull run in stock market history. With the Dow commonly tumbling 600 points or more intra-session these days, this is an appropriate time for us to begin thinking about heavily marked down merchandise if we are to be in a position to take advantage of the sale. But first, exit stage left, pursued by a bear.

A Minsky Moment

Hyman Minsky (b. 1919 – d. 1996) was an American professor of economics who spent much of his career analyzing the inherent instability of markets. He developed a concept which refers to a time when markets fall into a crisis after an extended period of excess. If you will, a Minsky Moment. Minsky hypothesized that the longer speculation occurs, the worse the crisis will be. Think about the great bull market in housing from 2000 to 2007 fueled by easy access to credit, no down payment mortgages, home equity credit lines and, best of all, no capital gains taxes on the first $500,000 in gains on your home. Minsky went on to say, "There is nothing more powerful than a market which is changing its mind." From our point of view, that is exactly what we have witnessed over the past couple of months and especially the past few weeks. Trend followers buy in up markets and sell when hope no longer triumphs over experience (aka, capitulation). While admittedly cynical, it has been our hypothesis that stocks have been living on the morphine drip of miniature interest rates and momentum for the past year, leading to unsustainable valuations for stocks. The economy and therefore investors are now aware of the pain: a classical Minsky Moment.

Bear Market 101

As alluded to above, the classical definition of a bear market is a decline of 20% or more. We have attempted without success to find out exactly who it was who came up with that definition. Google, Wikipedia, etc. were of no help. What is interesting is the absence of *time* within that definition. 1987 lasted one day and two market hours; 2000 and 2007 lasted between 500 and 600 days. *The Wall Street Journal* very recently constructed a nifty chart depicting both the length and depth of bear markets since 1929. If you include 2018/2019 in the mix, there have been seven of them (there were a bunch more between 15% and 19.9% but not charted), a surprisingly small number for a ninety-year period. As to nomenclature, the first reference to a bear market popped up in 18th century England and related to the sale of bearskins prior to the actual taking of the bear. (Good thing for the bear.) Historical reference to

bulls is not as clear but may have been related to the abhorrent practice of baiting bears and bulls as a form of entertainment. Clearly Wall Street has advanced little over the past 220 years.

We tend to use statistics like a drunk uses a light post… for support. With that caveat, in order of severity, the 2007 bear market was the greatest @ 53% followed by 1974 @ 40%, 1987 @ 36%, 2001 @ 32%, 2000 @ 30%, 1990 @ 21% and 2019 @ 20% for an average decline of 33.1%. In terms of duration, the average period of time for a bear market to run its course has been about 260 days. It is also noteworthy that stocks demonstrably go down faster than they go up as bull markets tend to be measured in years.

Bear markets do not materialize out of Immaculate Conception. While there are common themes, each bear market tends to have its own given set of circumstances unique to itself. The first one your writer lived through was 1974 and was characterized by high interest rates, high oil prices/waiting in line to purchase gasoline, a tripling in the price of gold and inflation running at 10%. 2001 was attributed to the bursting of the technology bubble and, as you know, 2007 featured plunging real estate prices, failing banks and Wall Street houses and little access to credit. The point of this is to build the case that the past is not much of a guideline for predicting the length and depth of future bear markets, including the current one. However, we would say that the severity of malevolent economic conditions going into a bear market is at least somewhat correlated to the length and depth of the down trend. If we ranked 1987 (the one day wonder) as the least problematic macroeconomic climate and 2007 as the worst, we would place today's various forms of heartburn somewhere near the middle. In our last letter, we listed excessively high valuations to earnings, the poor quality of earnings gains (artificially boosted by the corporate tax cut), TINA (There Is No Alternative to stocks… which was not true) and the potential outbreak of trade wars as being our primary sources of concern. Good calls. Correct on all fronts. We argued that the best antidote to elevated risk was being less invested in stocks in favor of ultra-short term CDs and investment grade corporate notes. We went on to say that patience would be required to sort this all out and offered one of our favorite malaprops: Don't do something… just stand there.

Tearing Off the Band-Aid

John Dos Passos, the novelist and historian once said, "Often things you think are just beginning are coming to an end." As painful as it is to see your account suffer, it's critical to remember that the *purchasing power* of cash you have on the sidelines (aka… the Band-Aid) increases with each catastrophic day. It is equally important to remember the bromide which Warren Buffett offered at near the bottom of the market in early 2009 when he uttered, "There will be an end to the world, but this isn't it," followed by billion dollar investments seemingly being made weekly. If only the Band-Aid came off more easily!
We probably should have listed one more characteristic of bear markets as above: *the stock market is not homogenous*. Not all stocks go up and down synchronistically. Some stocks, financials, energy and semiconductors in particular, are already down 30 to 40% from their peak and are clearly investible. Given the kind of volatility we are now experiencing as measured by 600 points a day and more, we plan on taking a series of bites as we put cash to work as we never know when the bear market is over until long after the bottom has been reached. Did we say patience will be required?

The Panic of 1819

Two hundred years ago trade in cotton between London and the US was booming. Prices spiraled upward as Europe was recovering from the aftermath of the Napoleonic Wars. Credit became overextended leading to a speculative bubble. When news arrived in January of 1819 that the value of cotton had broken, dropping 25% in a single day, the ensuing panic drove both countries into recession. A notable character painter of the time was one Richard Dighton. Many of his works were serious,

others, such as our offering, were humorous. A number of his works can be found in the collection of London's National Portrait Gallery, including the one depicted below. We came across an early print of *Sell and Repent* in an over-the-top 1920s frame while on vacation in Cape Town, South Africa, and knew it belonged in my office as a reminder of speculative excess. Would that we all come through the current economic folly as rotund and seemingly well off as this repentant character.

Attached please find another in Chris Klavins's series of observations and aspirations in his *Thoughts From Outside the Corner Office*. Please accept our best wishes for a Happy and Prosperous New Year.
Best regards,

Steven N. Spence	Marcia Hull	Christopher P. Klavins
Senior Vice President	Senior Vice President	Senior Vice President
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The Klavins Report – Thoughts From Outside the Corner Office (***January 11, 2019***)
"Mama said there'd be days like this…"

—The Shirelles (1961)

With all due respect to The Shirelles, in our business, we think about investing over periods not measured in "days," or even quarters, but typically in years, economic cycles, or even decades. After all, retirement will hopefully span several decades for most of our clients, thanks to what we hope will be good health, clean living (this author excluded), or, in the absence of either, modern medicine.

The good news is that markets have an upward bias over the long term, tending to correlate with growth in economic output and corporate earnings. But there are times like this, often painful, when markets do not cooperate. 2018 was just such a year, with the pain coming fast and furiously in Q4. Despite rapidly rising earnings, low unemployment, and a solid domestic economy, sentiment soured and valuations contracted across most asset classes.

Looking beyond the S&P 500 With regard to stocks, in our discussions with clients we normally focus on the S&P 500 or the Dow as equity benchmarks as a matter of convenience. Why? Most people, not just financial wonks like ourselves, are familiar with them and the media utilizes them most frequently in its reporting. They are also domestic and focus on large cap stocks, in line with the majority of equities we hold on your behalf.

However, we do have a fair amount invested abroad for purposes of diversification and because we live in an increasingly global economy. And we do have some small and mid-cap exposure. With that in mind, here is how a broader selection of indices fared in 2018:

- S&P 500 (Large Cap Domestic): -4.39%
- S&P 500 Equal Weight (Not Market Cap Weighted): -7.65%
- Russell 2000 (Small Cap Domestic): -11.03%
- MSCI Europe: -14.34%
- MSCI EAFE: -13.32%
- MSCI Asia-Pacific: -13.27%
- Investment Grade Credit: -2.51%
- High-Yield Credit: -2.08%

Conclusion? Large cap domestic equities had a tough year. The year was worse if you looked at the average stock's return (see S&P 500 Equal Weight data above). Smaller domestic companies fared even worse. Foreign equities from almost any region did worse still. Even investment grade and high yield "credit" (bonds) had down years, as rising interest rates hit prices, particularly of longer dated bonds (fortunately we don't own those except in special circumstances).

Looking forward With markets down smartly for the year and even more from their former peaks (a nearly 20% decline in the S&P at the low), and at a time when people are channeling The Shirelles and lamenting "days like this," we are becoming more excited about putting some cash to work at increasingly appealing valuations. To that end we have allowed cash from maturing bonds to build quite a bit. We are not attempting to call a bottom. We make no claim to know if we have already seen the lows or if the markets will go lower still. With the benefit of hindsight we may well look back, some months or years from now, and wish we had done far more buying than whatever we may accomplish in coming months. That said, our objective is not to be heroic. There is simply too much we cannot know. Our objective is to take a long view, lean into stocks when it feels difficult, and in so doing act as responsible shepherds of your hard-earned capital.

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