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November 2018 Investment Commentary

Our sound and deliberate investment strategy continued to generate solid results in November as stocks continued to falter. As of the end of November, while the broad market indices and the most momentum-driven and popular investments have suffered meaningful losses for the quarter, our client portfolios have experienced strong relative strength. These results are not accidental. Over the past several years, we have watched from a distance as market participants threw money at companies that they didn’t completely understand, at prices that may not have made sense. Our Group could not figure out how much those investments were worth, and we kept our investor money away from them. Instead, we generated solid gains for our clients by investing in businesses that we felt we understood at prices that we thought were reasonable or cheap[(1)].

The results we have generated demonstrate the effectiveness of our investment strategy in achieving equity returns while protecting our investors from downside risk. Why is that important? Because we must manage all meaningful risks for our clients. When most investors think of risk, they think of market corrections, like the one we currently find ourselves in. In reality, every market correction in history has been temporary, and the same is true for the current one. However, other risks that get less attention can result in permanent or long-term wealth destruction. One such risk is inflation. While it typically doesn’t get attention in news headlines, average inflation in the United States cuts the value of your assets in half every twenty-five years. U.S. stocks have a track record of generating returns in excess of inflation, so they are an effective instrument for protecting client assets from inflation. Currently in the United States, neither major political party seems to have any hesitation about adding to our nation’s debt load. At some point, we as a nation will need to reduce the debt. One of the most politically expedient solutions will be to print dollars, which will most likely lead to a future period of accelerated inflation. It’s important that we prepare for this long-term reality now. That’s why equity returns in excess of inflation play a critical role in our Group’s retirement planning[(2)(3)].

Another major risk that has resulted in long-term investment losses is getting caught up in an asset bubble. While equity returns are a powerful tool for overcoming inflation and achieving one’s financial goals, investors must be extremely careful not to get caught up in bubbles. This is easier said than done. It requires patience, fiercely independent thinking, and the ability to watch others around you temporarily make easy money while you don't. If you follow the financial news in any capacity, you're going to hear about which investments have done the best in the recent past. Those investments then attract more investment dollars because many investors make the mistake of thinking an investment will do well in the future if it has done well recently. Additional dollars push the asset prices even higher, attracting more investors, again pushing prices higher, and this trend of price increases purely on the basis of momentum can continue for a long time. But it can't continue forever. In the past twenty years we've seen it happen with technology stocks in the late 1990's, residential real estate in the mid 2000's, and over the past several years, technology stocks. Eventually, market participants wake up to the fact that the fundamental underpinnings of these investments have not kept up with the price increases, and markets crash. While all investments fall by some amount during a market crash, the most popular investments that have created the bubble crash the most. While investments with strong fundamentals have historically recovered quickly from a market crash, those investments that created the bubble may take a decade or longer to recover. Some may never recover(4).

Many investors have been falsely led to believe that investing in mutual funds and index fund products provides adequate diversification to protect them from investment bubbles. Unfortunately, the exact opposite is true. The most popular stocks that have gone up the most become the largest portion of these funds, causing them to crash with the bubble and endure losses that have sometimes lasted decades. Examples of this include the time period 1964 to 1981 when the Dow Jones Industrial Index was flat, and the time period 2000 to 2013 when the S&P 500 Index was flat. These periods of no long-term gain resulted from overenthusiasm for the most popular stocks, first with auto and airline companies over 1964 to 1981, and then with technology and residential real estate from 2000 to 2013. It's no secret that investors have had a hefty enthusiasm for technology companies over the past ten years, and they are currently a good candidate for the next bubble. While that remains to be determined, technology companies have taken the brunt of the current market correction in a way that has historically coincided with the bursting of investment bubbles(1)(4).

So, it's important to invest in equites in order to protect your assets from permanent losses from inflation, but it's critical that you invest those assets in a manner that avoids getting caught up in bubbles. This is exactly what our Group has designed its investment strategy to do, and we will continue to work toward this mission for our investors.

Best Regards,

The Crescent Group
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Sources:

(1) S&P Dow Jones Indices LLC
(2) Bureau of Labor Statistics
(3) JP Morgan
(4) Fortune