Wealth
Management

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October 2018 Investment Commentary

Our sound investment strategy worked spectacularly well in October as U.S. stock markets fell, with stock indices led downward by some of the most popular investments. While the S&P 500 and NASDAQ ended the month down 7% and 9% respectively, our client portfolios ended the month virtually unchanged. In this commentary, we will review what happened in October and why it happened, and we will also discuss the most important lessons learned from October's market activity. October's market correction offered a sneak preview of what eventually happens when investors blindly follow the crowd into the most popular investments. This type of behavior leads to bubbles, and when markets correct, the most popular investments lead the crash. October's correction was very average. At some point, we will experience a full blown market crash, and in that situation we expect to see an even greater difference in outcomes between the general market versus our sound investment strategy[(1)].

During October, we began to see a change in the way market participants evaluate what have been some of the most popularity-driven investments. Despite reporting strong quarterly metrics that historically drove the share prices of these companies higher, Amazon.com fell 20%, Netflix fell 19%, Facebook fell 8%, and Google fell 10%. Why are the share prices of these companies, which went up so indiscriminately over the past several years, now falling and stalling? The simple reasons are over enthusiasm, unrealistic expectations, herd mentality, and envy. As typically happens with financial market bubbles, investors saw these companies going up the most, and made the mistake of thinking they would always go up the most. Envy drove investors to these stocks as many investors thought, "why is everyone else making such easy money"? At some point, stock prices went up so much that they already reflected most of the good news to come out of these companies, so that even when they reported very good revenue and in some cases profits this past quarter, the stock prices fell a lot[(1)].

Was October's sudden change in investment sentiment unusual? No. Whenever certain segments of the stock market have become overvalued in the past, sentiment eventually changed, and people who followed the crowd lost a lot of money. Think about what happened with housing and real estate in 2008. Some people went so far as to falsify their income in

order to flip homes they couldn't afford. Why? Because they saw everyone else flipping homes and making money, and had to follow the crowd and get in on it. It was considered a sure bet, since housing prices had never substantially declined. Until they did. The S&P 500 fell 53% from 2008 to 2009. Then there's technology stocks in the late 90's. People woke up one morning in 2000 and suddenly felt different about companies without profits and cash flows. Suddenly, profits and cash flows mattered again. The NASDAQ fell 75% through 2003, and the S&P 500 fell 46%[(2)(3)].

The next market crash has been brewing for a while now. We've seen companies without reliable profits and cash flows, with unproven long-term business models, skyrocket in value because of customer growth, speculation, and investors following the crowd into these stocks. The problem, as Warren Buffett has pointed out, is that revenue potential does not equal profit potential. In October, investors woke up and thought about this for the first time in five years or more. While the S&P 500 declined 11.5% in October, Amazon fell 20% and Netflix fell 19%[(1)].

The fact that Amazon and Netflix fell so much in October poses a big problem for the average investor. Why? Because the most popular and potentially overvalued companies make up the biggest portion of the S&P 500 and NASDAQ indexes. When sentiment eventually changes on these companies it will decimate the indexes, just as it has in the past. There are historical examples of this that we can look to. Warren Buffett gives the example of overenthusiasm for auto and airline companies in the past. These companies were the Amazon and Netflix of their era – the hot new technology companies that promised to transform the world. They had rapidly growing revenue. And they did transform the world. The problem is they ended up not making profits over the long-term. Warren Buffett cites overenthusiasm for auto and airline companies as a main reason why the Dow Jones index was flat from 1964 to 1981. Investors in the index saw no share price appreciation over a 17-year period. Similarly, the S&P 500 was flat from 2000 to 2013 as a result of overenthusiasm for technology companies. Over that thirteen year period, passive investors in the S&P 500 index saw no share price appreciation. How many investors have a retirement plan that allows for no return over thirteen to seventeen years[(1)(4)]?

The question isn't whether a large crash will happen with stock market indexes and today's most popular investments. The question is when. This is why our Group limits its investment strategy to proven, profitable, conservatively managed companies. Retirement horizons can last decades, and this fact drives our Group's long-term decision making. We have no problem sitting out the party and watching other people make easy money, because we know they will suffer a major crash at some point, while our investors will remain well-insulated. Our investors rely on their savings to build and fund their retirement. If our clients saw their savings cut in half, our Group would view this as an unacceptable failure on our part. Warren Buffett expressed similar sentiments to his investment partnership clients in the 1960s: "I have pointed out that any superior record which we might accomplish should not be expected to be evidenced by a relatively constant advantage in performance compared to the Average (Dow Jones Industrial Average). Rather it is likely that if such an advantage is achieved, it will be through better-than-average performance in stable or declining markets and average, or perhaps even poorer-than-average performance in rising markets…I would consider a year in which we were down 15% and the Dow declined 25% to be much superior to a year when both the partnership and the Dow advanced 20%."[(6)]

October's market declines were just a preview of the all-out crash that will happen at some point. Investors who follow the crowd into the most popular investments and market indexes will suffer. We will continue to protect our investors with conservative growth so that when that time comes, they will be well insulated, just as they were in October.

Best Regards,

The Crescent Group
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Sources:

(1) Yahoo Finance
(2) CNBC
(3) Thomson Reuters
(4) Fortune
(5) S&P Dow Jones Indices LLC
(6) Warren Buffett Partnership Letters

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