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September 2018 Investment Commentary

Recently, U.S. stocks achieved their longest continuous period of gains in history. The bull market that began on March 9, 2009 has experienced several substantial declines over the past nine years. But over that time period, U.S. stocks have not declined twenty percent, the threshold for entry into a bear market. As U.S. stocks have reached this new record period of gains and have continued to set new high levels, some investors fret over whether stocks are overvalued. But while doing so, many of these investors continue to flock to the most popular and overvalued investments, mainly shares of technology companies[(1)].

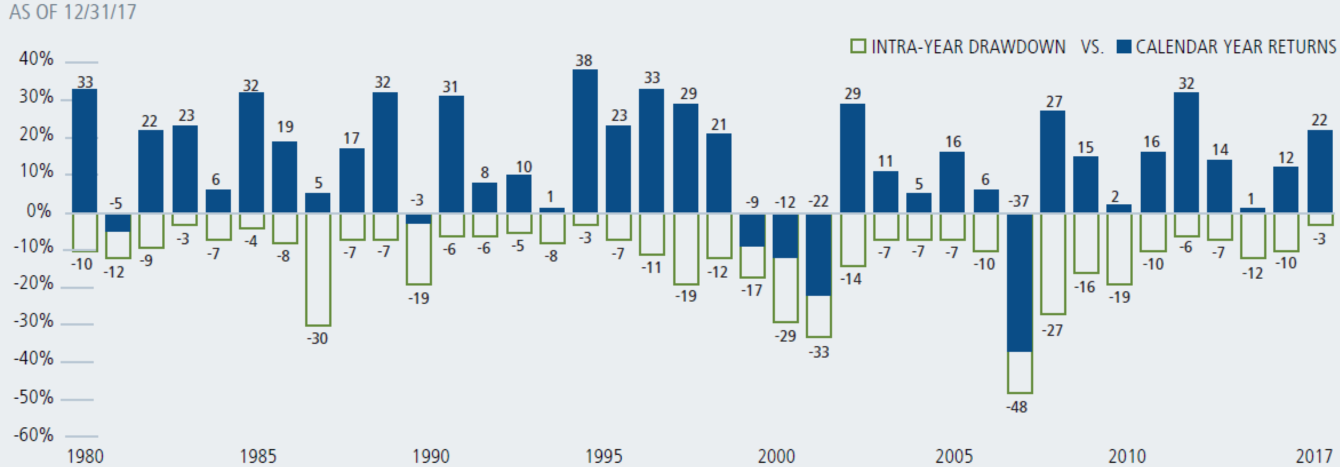
Financial market extremes require great discipline from investors who want to succeed over the long term. With investments at all-time high levels, driven by blind optimism, a herd mentality of greed and envy causes investors to want to chase after the highest-returning investments. We don't know when a market correction will come, nor what form it will take, and neither does anyone else. What we do know is that the investments that have gone up the most, often without fundamental underpinnings, have historically fallen the most during corrections. We gave examples in past commentaries of auto and airline companies losing money for investors over the long-term. Warren Buffett cited over-enthusiasm for auto and airline stocks as one of the contributing factors to the Dow Jones Industrial Average Index returning nothing during the 1964 to 1981 time period. Similarly, over-enthusiasm for technology stocks contributed to the S&P 500 returning nothing over the 2000 to 2013 time period. Investors have a demonstrated track record of becoming overly enthusiastic about new industries, and it will happen again. Today, investors similarly pour money into industries such as cloud computing, social networking, and internet-based advertising, with large revenue potential but unproven long-term profit dynamics. It takes discipline and independence of mind to see people who aren't as prudent as you are temporarily making more money than you. But that's exactly what you must do to succeed over the long term with stock investing[(2)(3)].

Put simply, if you want a different outcome from everyone else (all-out crash lead by the most speculative investments that have gone up the most), you cannot be a part of those investments on the way up. Warren Buffett wrote about this earlier this year in his annual shareholder letter, issuing a sobering description of his investment approach in the current market: “In the meantime, we will stick with our simple guideline: The less the prudence with which others conduct their affairs, the greater the prudence with which we must conduct our own”. Buffett’s own experience during the 1990’s technology bubble highlights what can happen when you invest with prudence while everyone else speculates: from August 1998 to March 2000, Berkshire Hathaway’s stock declined 47% while the S&P 500 increased 28%. Why did Buffett underperform? Because he did not invest in the most speculative companies that went up the most. Over the following twenty years, the stock price of Warren Buffett’s company (Berkshire Hathaway) increased 325% through August 2018, while the S&P 500 increased 153%. So while prudence can look dumb over the short-term, it was the right long-term decision. As Buffett further noted in this year’s letter, “What investors then need instead is an ability to both disregard mob fears or enthusiasms and to focus on a few simple fundamentals. A willingness to look unimaginative for a sustained period – or even to look foolish – is also essential[(2)(6)].

So, sticking to investments with sound fundamental underpinnings, even when unproven and speculative investments temporarily make higher returns, is one quality needed to succeed over the long term in the current record bull market. The other quality needed is not panicking when markets do inevitably decline. At some point, the current tide of optimism will turn. While no one can predict how the situation will unfold, we can be certain of one thing: the downturn will be temporary. During the 38 years ended 2017, the S&P 500 experienced an intra-year decline from peak to bottom every year, with the average intra-year decline equaling 13.8%. Despite that average annual intra-year decline, stocks earned positive annual returns in 29 out of those 38 years (see chart below). Over that 38-year time period, despite the 13.8% average intra-year decline, stocks returned about 10% annually, and the S&P 500 climbed 2,377%. And that’s why it’s a waste of time to try to pick the “top” and “bottom” of a market or stock. You’ll make more than enough money remaining invested, and you will fail in trying to guess short-term stock price movements. As a final example against market timing, consider a recent study reported by CNBC: buying stocks at the three worst times in the past thirty years still outperformed all other asset classes. If you bought and held the S&P 500 at the market top in 1987, you’ve made a 9.6% annualized return; if you bought at the top in 2000 and held, you’ve made a 5.7% annualized return; and if you bought at the top in October 2007 and held, you’ve made a 7.5% annualized return. According to the study, "at the worst times to buy in the last 30 years, the stock market has been the best generator of wealth than any asset class (data as of January 2018)." Compare this data to DALBAR's Quantitative Analysis of Investor Behavior, which shows that for the 30-year period ended December 31, 2013, the average investor in a blend of equity and fixed-income mutual funds had garnered only a 1.9% net annualized rate of return. Over that time period, the S&P 500 returned about 10% per year annualized. Undoubtedly, much of that low 1.9% return resulted from attempting to time the market[(4)(5)(7)].

S&P 500 MARKET DECLINES IN PERSPECTIVE: EVEN UP MARKETS SEE DRAWDOWNS

AS OF 12/31/17



Source: Morningstar. Data shown is represented by daily price return performance. **Past performance is no guarantee of future results.**

As investment markets stretch to new heights, we will continue to invest in conservatively managed companies with strong brands and proven, enduring products and services. We will not chase after what everyone else is overly excited about. We know that the current investing environment requires heightened prudence, and that’s why we invest in the highest quality companies with mundane products and services, selling at reasonable prices.

Our investment approach allows us to avoid what's hot and popular right now in order to protect our investors from financial bubbles, while earning them the return they need to achieve their financial goals. We have confidence that this is the correct strategy to succeed over the long term.

Best Regards,

The Crescent Group
Carsten Frederiksen, CFP® | Paul Hendershot | Nick Weege | Lindsey Wood, MBA

Sources:

(1) CNN
(2) S&P Dow Jones Indices LLC
(3) The Snowball (Alice Schroeder)
(4) CNBC
(5) JP Morgan
(6) Berkshire Hathaway 2017 Chairman's Letter
(7) DALBAR