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INSIDE STORY

Time Keeps on Ticking

"In the long run we are all dead."
– John Maynard Keynes

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Time Keeps on Ticking

Long term. I have probably used the phrase a million times, as has anyone who has been in the financial world. No matter how one says it, long term, long haul or long run, it is a phrase that has different meaning to different folks. Let's face it, time is relative. An hour and a half car ride is really not that long to me, but don't tell that to my eight-year-old daughter, who within twenty minutes will begin the "Are We There Yet?" ritual, shortly followed by, "This is taking forever."

Most of our readers know that I coach youth basketball. My son's practices last one hour, and that hour goes by in what seems like ten minutes. For a few years I would help with his baseball team after basketball was over; those one-hour practices seemed to last days. Of course, as any parent knows when one has children around, the days become increasingly long and the years proportionately shorter. This is a phenomenon that I have to admit I do not fully understand but must admit is true.

Different people even have different ideas of what the term "on time" means. I know people to whom anything less than fifteen minutes early is considered late, and others who figure if they are there within fifteen minutes of the start that is good enough. Once when I was five minutes late to a client meeting, one of the committee members let me have it. How dare I keep them waiting? I have been ten minutes late to a client meeting, apologized, and been told that I was being silly for apologizing. People just see time differently.

With so many differences, how are we to define what it means to be long term? I realized this a few years ago while meeting with a client. I was explaining that he had a "long-term" time horizon, and he quickly corrected me, saying that he only had ten years before retirement. I quickly realized that his idea of long term and mine were as different as my idea of a short road trip and my daughter's. I live in the world of the market, and he lived in the real world.

In the real world, things just do not change as fast. Markets may drop twenty percent from October to December, but reality does not change that quickly. In my world, where things do happen very quickly, the idea of long term keeps shrinking. I personally define long term as a three- to five-year time span. Some would define it as short as a year. I know a stock trader who defines it as six months.

Regardless of definition the term is too often misused, and used as an excuse to bury one's head in the sand during times of distress. "I'm not looking, because I am in it for the long term." Many are probably familiar with the quote I opened with from Keynes. However, most have probably never read the full quote in context, *"But this long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again."*

Too often the long term is pulled out by those who do not know what to do and therefore say just hold on and do nothing. Unfortunately, doing nothing is still doing something. Please don't misunderstand: We *should* make investment decisions based on the long term, and sometimes doing nothing is exactly the right thing to do; I'm just pointing out that one should not use these terms as crutches when things get a little scary.

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So, what should a prudent investor do when the market gets stormy? It always starts with the fundamentals. For us, there are three fundamental rules to prudent investing:

1) Prudent investors invest from the bottom-up. This means we analyze each individual investment on its own merits as opposed to trying to guess where the market is headed at any particular moment. Individual investments often start to look expensive before market downturns. No one can time the market, but one can pay attention to how expensive an investment is becoming.

In October of this past year Iron Capital increased its allocation to bonds and decreased our allocation to stocks for all of our clients who have a blended portfolio. We did not, and do not, have a crystal ball. We did not know or expect the market would drop as it did late in the year. We did know that stocks were getting expensive and bonds looked more attractive than they had in many years. This is investing from the bottom-up.

2) Prudent investors are absolute return-oriented.

This means prudent investors do not get involved in the dangerous game of competitive investing, always comparing results to an artificial benchmark or one's boastful (un-truthful) neighbor. Prudent investors don't chase Bitcoins because they are the hot item in 2017, and therefore do not experience the 80 percent drop in price when hot items suddenly become cold, as Bitcoin did in 2018. Of course, when market values drop it is almost impossible to maintain a positive absolute return. I know that no client likes to hear that they lost much less than they otherwise would have, but losing less when things are down is often the key to success over three- to five-year periods.

There is another potential issue for the absolute return-oriented investor: Outside factors, such as taxes, can impact some investors. If one has taxable investment accounts, then she may treat downturns differently. Gains on investments are taxed at capital gains rates. An investor does not pay taxes on gains until the gain is realized. In other words, if she owns a stock that goes up in value, she is not taxed unless she sells that stock and pockets the gain. These gains and other income up to regulatory limits can be offset with investment losses. Of course, losses work the same as gains in the since that one must actually sell the investments to realize the loss.

Many investors dislike selling investments when they are down. They want to hold out for – you guessed it – the long term. There are two things to realize here: First, taxes will impact your absolute return, and the tax deduction from realizing a loss has significant value. Secondly, one does not have to make money back the same way he lost it. He could invest in a replacement. If he owned an airline, then he could invest in another airline. After thirty days he can buy back the original investment and still maintain the tax benefit of the loss. Doing this in a disciplined way can have a very positive impact on the after-tax investment results of a taxable portfolio.

3) Prudent investors are also risk-averse.

This does not mean that we can magically avoid the fluctuations of the market, but prudent investors are always biased toward high-quality investments. They wish to invest in companies that will stand the test of time. They are also very aware of price. Real risk is paying more than an investment is actually worth. This is how permanent losses of capital occur. The pressure to pay these elevated prices flow from competitive investing and the feeling of missing out on something.

These two forces, the desire for quality and price sensitivity, are often at odds with one another. The highest quality companies tend to come with the highest priced stock. After all, we are not the only ones who recognize quality. However, the stock of these high-quality companies tends to drop right along with everything else when the market sells off. In fact, these companies will frequently lead the sell-off; they are the easiest to sell, and professional investors being forced to sell often sell what's easiest first.

This creates a classic baby-out-with-the-bathwater scenario. Market selloffs are the best time to selectively and prudently go shopping. Prudent investors use these opportunities to buy the stock of companies whose prices are usually too high for their taste. This is different than just blindly doubling down, as the gamblers

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REVIEW *of* ECONOMY

The 3rd quarter 2018 GDP growth came in at 3.4 percent which was after a 4.2 percent number the quarter before. The final quarter of the year is estimated to be a little slower, but this is the best sustained growth we have seen in the U.S. in a very long time.

The official unemployment rate is 3.9 percent in August. This is the longest sustained under 4 percent rate since the 1960s. Wages are growing at more than 3 percent, which means real wage growth.

Inflation is 1.9 percent based on the latest consumer price index report. That is a lower rate than earlier this year. Put all together, this is simply the best economy we have seen in my professional career. +

REVIEW *of* MARKET

Markets plunge. For the quarter the S&P 500 finished down 13.52 percent and small company stocks represented by the Russell 2000 index were down 20.20 percent. Value actually did a little better than growth but not by much. There was really no place to hide.

Bonds did rally as stock prices fell. The Barclays U.S. Aggregate Bond index ended up 1.64 percent. High yield bonds however were down 4.64 percent.

International stocks suffered as well. The EAFE index finished down 12.50 percent while the MSCI Emerging Markets index ended the quarter down 7.40 percent. +

MARKET *forecast*

Eventually markets must reflect reality. The economy is great and stocks sell off? That cannot last forever and we suspect that stocks will rally in 2019.

Small company stocks should do better as should value stocks. Emerging markets still look attractive and has outperformed on a relative basis this past quarter. That bodes well. International stocks may carry more risk as the economies are not as strong in Europe and developed Asia.

Bonds are doing their job and reducing volatility by remaining stable in the downturn. Yields have dropped once again and are likely to go back up as stocks rally. +

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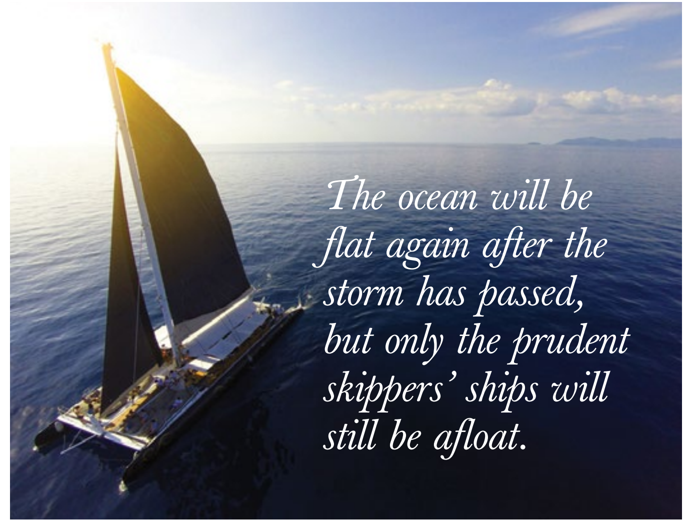
would say. There must be careful analysis done to assure that these companies and their business are as strong as thought. One also has to be careful not to get too excited too soon. Selloffs can last longer than expected, and it is difficult to know when they are over. Prudent investors will buy little by little, building their investment over time. Downturns are opportunities.

Ok, I know what you are thinking: This is great for those people who have a long-term horizon, but what about the investor nearing or already in retirement? When one gets into this phase of her investing life, the goal changes from growing assets to producing income. With our retirees we run an income-oriented strategy, which can be complicated to pull off but is very simple in concept. We want to produce the income needed through actual income payments while taking the least amount of risk possible. The importance of this strategy comes to light when markets go down.

Bonds are the typical example of income-producing investments. Bonds are simply loans, and the interest payments on those loans represent income to the bond-holder. Many types of stocks also produce income through dividend payments. These income payments are often referred to as a percentage yield, but they are promised dollar amounts. They remain constant as long as the business itself remains sound.

When a market downturn occurs, a portfolio using this strategy will drop in value. The income strategy, however, will continue to produce the same amount of income, assuming we have done our job well in selecting safe companies. The values of these stocks will rebound over time, as will more growth-oriented investments; but more importantly, the needed income continues.

Many investors fret over the sudden market drop right before they retire. What happens if one was to retire in January of 2019? Everything looks great and then suddenly a bear market hits. All is not lost. If she follows our advice



and builds an income-producing portfolio, the income yields have risen as stock prices dropped. If an investment worth $1,000 pays $50 per year in income and then drops in value by 20 percent (a full bear market drop), then that same $50 can now be produced with an $800 investment. In investment speak we say the yield went from 5 percent to 6.25 percent.

No one likes it when the market goes down instead of up, but it is the way investing works. We take three steps forward and two back. The secret is weathering the downturns well. The prudent investor doesn't just sit there passively with his head buried in the sand; He uses it as an opportunity and deals with the actual circumstances at hand, for prudent investors know that no matter how one defines long term, that it is really just every short-term period added together. The ocean will be flat again after the storm has passed, but only the prudent skippers' ships will still be afloat.

Warm Regards,

Chuck Osborne

CHUCK OSBORNE, CFA *Managing Director*