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MORE THAN YOU PROBABLY WANT TO KNOW

Although valuations are less troubling today, the current landscape feels like 1999 (the end of the dot.com bubble). Because we are concerned about the sustainability of valuations, the risk part of WIC's risk-return equation is now being weighted heavier than the potential future return part of the equation.

INTRODUCTION

The old saw *you would never eat another hot dog if you saw how it was made* is apt here. For decades, I have practiced the discipline of writing to think. The majority of my writings are contained within WIC, but occasionally I convert them to a public version. Beginning with my thoughts on "animal spirits" published in the commentary section of WIC's website, I have written a lot internally about the changing investment landscape wrought by the Trump presidency and how valuation is increasingly stretched, leaving less and less margin for error.[1] Most of WIC's investment committee discussions, and countless conversations in The Lab, are internal debates and explorations of multiple possible paths. This memo shares with our clients a summary of what we have been thinking and the crosscurrents we are wrestling with – knowing full well that herewith we run "hot-dog-risk".

WE HAVE TO CONSTANTLY REMIND OURSELVES THAT WE DON'T KNOW

A common thread that runs through our investment decision-making debates is constantly reminding each other we simply don't know. Most of what we need to know to make investment decisions is unknowable. The future path of the economy, Federal Reserve policy, interest rates, inflation, PE multiples, tax reform, foreign policy/isolationism, companies' earnings direction, disruptive forces (e.g., being *Amazoned*), and especially investor sentiment and behavior - all these future paths are <u>inherently unknowable and therefore unpredictable</u>. Seasoned risk management starts and ends with that reality. That reality is especially difficult now.

When we combine this "unknowable reality" with the understanding that much of what we do falls in the realm of art and science - making judgments with incomplete information - we find decision making in the current environment particularly challenging. This memo provides an overview of some of the *crosscurrents* we are dealing with and the judgments we are making.

[1] Proper risk management requires a margin for error or room to be wrong. For example, we often use below analyst consensus margins and higher discounting rates than most to purposefully "undervalue" companies we are evaluating. Said differently, we do not assume company management will hit on all cylinders; we are skeptical.

CROSSCURRENTS

To be clear, investment decision-making is always characterized by many factors that are inherently unknowable. The following crosscurrents and issues make the current environment particularly perplexing:

- The very different and unusual management style of President Trump
- Congress seems to be splintered more than ever making major legislation doubtful
- Expectations of reduced government regulation, tax reform, Obamacare reform, and infrastructure stimulus may be overly-optimistic; if so, as time goes on with little progress on these matters perception could become increasingly negative
- *Trump fatigue* could take hold if the perception becomes he is all talk with little results; confidence could dissipate and negative perception could gain the upper hand
- The foregoing points could result in the beneficial *animal spirits* of the last eight months reversing course and becoming a detrimental force
- Valuations are stretched, even considering the beneficial effect of low interest rates on discounted cash flow and PE math; therefore the *margin for error* is becoming worrisomely narrow; but valuations are notorious for remaining stretched for a long time (another reason market timing is usually counter-productive)
- Foreign policy miscues are always possible; they may be more so now with a President who seems to naturally speak/tweet before he thinks or considers counsel
- Isolationism risk seems to be growing; tariff and trade war risk follows
- Investor complacency including many forms of "reaching for yield"
- A relatively small number of stocks are driving the market; similar to 1999
- The unwinding by central banks of years of expansive monetary policy

Again, these type crosscurrents – where one can logically argue both sides of the issue – are always present; this is not a new or unusual circumstance. Because our responsibility includes risk management as well as return generation, **we are increasingly concerned about the foregoing points – especially valuation risk and the narrowing margin for error**.

POSSIBLE PATHS

One way to think about risk is to envision a range of paths, a range of outcomes. When thinking about risk this way, it is important to think about what is now widely believed and expected and how various paths might lead to significant disappointment versus those beliefs and expectations. When unexpected negative developments unfold causing a reassessment of widely-held beliefs and expectations, or at the margin there is less of a continuation of a positive trend than expected (e.g., *Trump fatigue*), markets often unravel. We believe one does not have to know when an errant match or lightning bolt will ignite a dry forest; rather one only needs to observe, and respect, the forest is dry. Increasingly, we believe conditions are "very dry and flammable".

We know the following might appear simplistic, but we believe it is almost futile to attempt precision or probabilities when developing possible market direction paths. Four possible paths (among many) over the next 12-18 months:

- Path A. Market continues on a strong upward trajectory mainly powered by Netflix, Facebook, Amazon, Apple, Google, and other popular tech stocks.

- Path B. Market continues upward but stretched valuations constrain forward progress; the upward advance from here is only 3-6%.
- Path C. Market changes little.
- Path D. Market turns down, perhaps significantly so; 10-20% should be expected as such market downturns are within the norms of market history.

Assuming Paths A-D capture a reasonable range of possibilities, applying art and science, we believe the odds of Paths B-D outweigh A. If so, there is little to lose at this juncture with giving more weight to risk management and capital preservation than to near-term potential gains. Plus, our valuation discipline won't allow us to pursue Path A. Therefore, we are continuing to tilt our clients' portfolios to a more defensive posture. There is one more risk I want to touch on.

ANOTHER RISK - EVERYONE IS NOW AN ETF ALLOCATOR

Perhaps an exaggeration, but there is an undeniable trend away from conventional bottoms-up company research where seeking to understand companies is becoming passé. For years, but now with accelerating momentum, it is increasingly considered unnecessary to think about or research the companies owned in a client's portfolio. It is almost like the company is irrelevant; and irrelevant to risk management. Now, many, if not most, portfolio managers believe the way to construct and manage portfolios is to allocate their clients' capital among many ETFs and/or index funds and bet on getting the allocation right. Each ETF or index fund owns many stocks that have particular characteristics or factors – the phrase "factor bet" is the widely-used buzzword. The new norm is to rely on factor bets which tilt the portfolio toward certain factors or characteristics or sectors, and essentially eschew company-by-company examination. Is there herding risk here? Is there a fundamental problem, a fundamental risk, with caring less and less about the companies in which one is invested? Is the company's management irrelevant too?

I believe the studies that question the efficacy of constantly changing allocations among various funds/strategies.[2] Given the nature of tactical asset allocation, I suspect the average ETF investor holds a given ETF for a short period of time before moving on to another slice of the portfolio pie (studies indicate the average holding period is only ~200 days). Short holding periods with the widespread ETF allocation strategy; plus the fact this tactical allocation is simply another form of market timing; plus that which *everyone* embraces usually ends badly; plus common sense dictates one cannot manage risk if one does not know what he/she owns[3], all lead WIC to believe this ETF allocation trend has increased risk in the marketplace and insidiously increased risk for many investors. WIC does not follow the crowd. Hopefully, by now, you know that.

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For more commentary, we invite you to visit our website at www.wicinvest.com.

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[2] Davis, Kinniry, and Sheay; *Vanguard's* "The Asset Allocation Debate: Provocative Questions, Enduring Realities".
[3] Howard Marks; *There They Go Again …Again; July 2017.*