

QUARTERLY UPDATE

1st Quarter 2020

January 15, 2020

I want to provide you a different perspective on a traditional market commentary. I believe equity valuations are stretched, global central banks (in particular the Federal Reserve) have pushed too much liquidity into the market, and the flavor of the day for 2020 is going to be the true health of the US Labor market and inflation. We also believe that the US/China “Phase 1” trade deal, perhaps has been executed more for political posturing during 2020 rather than actual benefits to either country. We remain pessimistic the remaining tariffs on \$250 billion in Chinese goods will be reversed during 2020.

We continue to overweight large cap US Equities relative to mid and small cap stocks due to the lower leverage and higher profitability, which should add to reduce volatility if a market correction occurs. Our philosophy is unchanged since last quarter, which is to invest client assets at a risk level commensurate with their long-term tradeoff of risk and reward, and their ability to take financial risks.

We look at three measures of the labor market, which are unemployment rates, payrolls, and unemployment claims (lagging, coincidence, and leading indicators, respectively).

While unemployment is at a historical (50-year) low, unemployment claims recently ticked higher and this typically leads other indicators, potentially signaling that the health of the



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labor market might not be as good as it appears anymore.

We expect wage growth to stall, unemployment to rise, and unemployment claims to increase during 2020.

The Federal Reserve’s three rate cuts in 2019 loosened conditions substantially relative to 2018, which led to US Equities ripping through 2019 for returns on the S&P 500, NASDAQ, and Dow Jones Industrial Average of 28.9%, 35.2%, and 22.3%, respectively.

The Fed loosening also led to a significant drop in treasury yields, pushing returns on 10+ year treasuries into the 15-16% range, and the broad market index for fixed income (Barclay’s aggregate) returned 5.5%.

All in all, it was a great year for both equities and longer-duration fixed income.

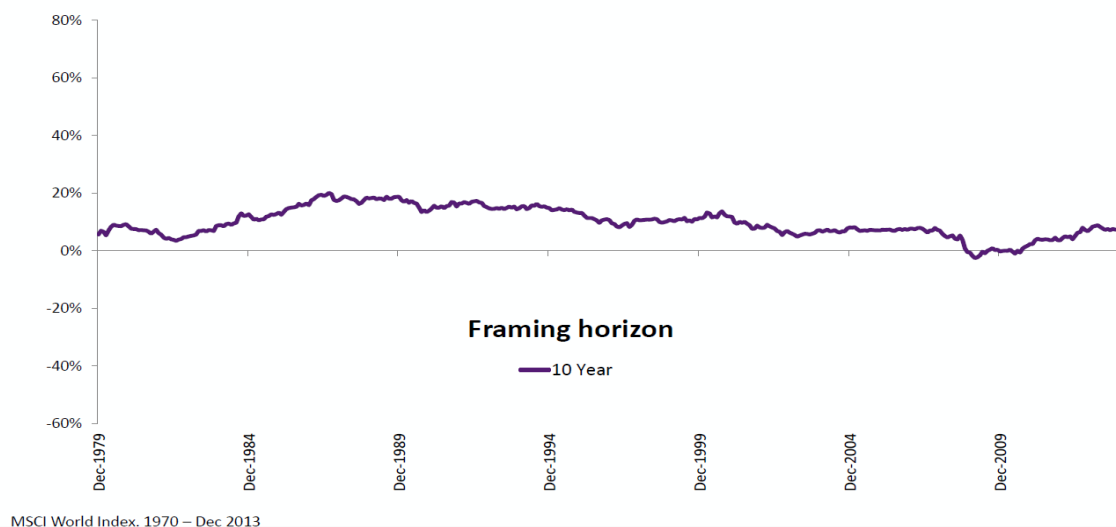
History tells us, however, that mean reversion to the average long-run rate of return on the markets is undoubtedly present. It is more likely than not that over the next 5 years we see below long-run average returns on Equities.

Additionally, the Fed generally cuts rates by 5 percentage points in a recession (which we believe will occur over the next 2 years) but with rates below 2% they will come to a point where they will have their number one policy lever essentially flat-lined, limiting their ability to stimulate growth during the next downturn (and potentially prolonging the recession).

Extended equity valuations, limited Fed power during the downturn, and lower than average equity returns going forward provide perspective on where we could be headed. While the information provided here might be useful with respect to knowing where we might be headed and what has occurred in the past, readers of these updates know that I believe frequent publications of what markets are doing, where they are headed, and “opinions” are a counter-intuitive exercise as we try to coach our clients through their financial journey to achieve their goals.

In a presentation titled “Investing with Ulysses; Better Decisions Through Behavioral Design”, Dr. Greg Davies showed the following:

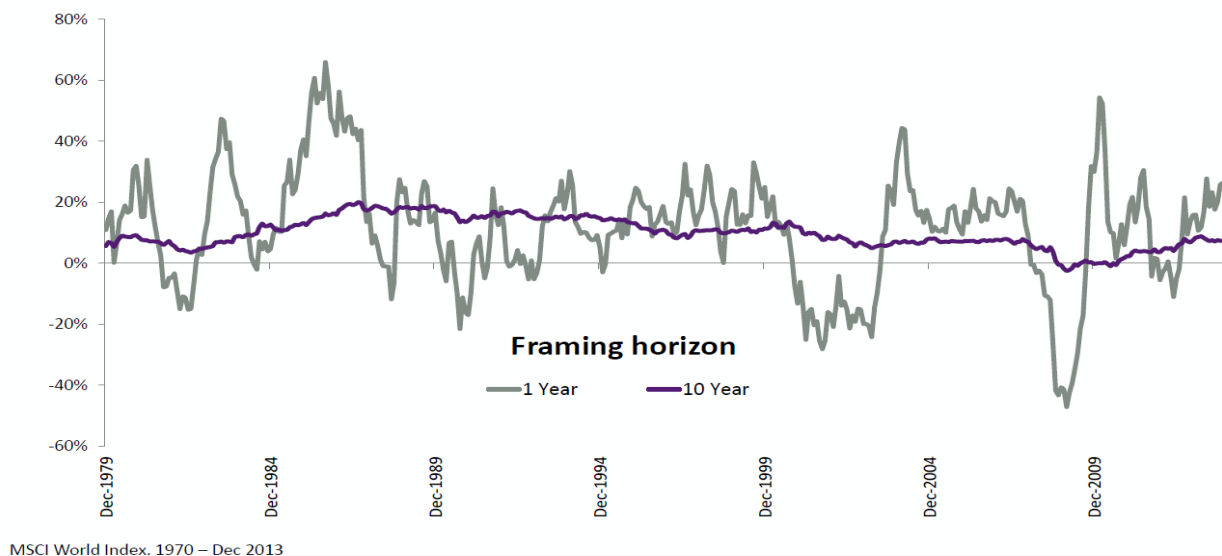
The information we *should* base decisions on



What this shows is that an investor in a globally diversified equity index (The MSCI World Index) only had one period (the 2008 financial crisis) since 1979 with negative total returns if they bought and held that investment for 10 years. For example, the data point for December 31, 1994 is the total return on the MSCI World Index for the period December 31, 1984 to December 31, 1994 (10-year hold period).

For investors with time horizons longer than 10-years, this essentially shows the power of investing for the long-term, and the importance of aligning portfolio actions with long-term goals. Unfortunately, with instant financial news notifications, normal investors find this challenging. The financial media pushes big red headlines of “**Dow Jones suffers largest point drop in history**” (which, tells you nothing in terms of the actual percent loss an investor would recognize), and constant articles, blogs, and commentaries being released to clients of “what is currently happening”. As human beings it is engrained in our biology to become fearful and react out of emotion, as the logical part of our brain is overridden by the emotional side when we see or hear this type of information. This instinctive (emotional) reaction helped us survive as we evolved and helped us avoid being eaten by tigers. But for investors, this information and associated emotional response works to our detriment, leading to poor financial decisions and sub-optimal investment outcomes. The next graph provides perspective on that notion:

The information we *do* base decisions on



Same time period, same equity index, but overlaid on top of the 10-year rolling returns are 1-year returns (an investor buys the index at the start of the year, and then sells it at the end of that year).

Most investors make decisions based on this short-term “noise” in the markets, leading to the classic investing mistake of buying high (fear of missing out) and selling low (loss aversion). I attribute these two behavioral reactions to short-term information we consume, as mentioned above.

Institutional investors, portfolio managers, and money managers that are actively managing portfolios (including our investment team) should care about the short-term news cycles, economic data, and the like. We use this information to evaluate potential short-term hedging actions to mitigate downside risk in our public equity portfolios. However, we still implement a systematic process that helps to eliminate human bias from the decision-making process. We also need to understand this information and its role in the models in order to ensure we have calibrated it correctly, and it is producing reliable signals. But long-term investors should not be presented with this type of information unless their investment horizon is, in fact, short term. The type of information an investor consumes should be commensurate with their investment time horizon and long-term goals. This is extremely difficult in the world we live in today, as most financial news broadcasting every day is focused on the present, and largely centered around big, bold, fear-stoking media that attracts viewers.

Nobody is isolated from these emotional biases. Advisors, CEOs, CIOs, Portfolio Managers, investors, me, everybody that is human is subject to these same flaws (some more sensitive than others). So, what can we do? We can create tools (which Dr. Davies coins as “Decision Prosthetics”) to help us make decisions ahead of time, to prevent our emotions from manifesting into actual investment action. This is the reason why we implement systematic strategies, with clearly defined trading rules and checklists, much like a surgeon follows a checklist during open-heart surgery. The checklist is there to prevent mistakes that could cost someone his life. And although investing is not life-or-death, it does dictate the level of financial flexibility we will have in retirement to do the things that make us happy, which in my opinion, should be approached with clients no differently than a Dr. approaches an open-heart surgery.

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