Monthly Commentary

November 18, 2014

SELECTOR
Real-Time Money Management

"Good investors gather information, put that information into current and historical context, then make sound decisions."

What a difference from just one month ago! For a quick flashback, major equity markets had just dropped approximately 10% from their September highs. It was the fourth and most severe equity market correction of the year. The large cap DJIA and S&P 500 Indexes had surrendered all of their gains for the year. The S&P 400 Mid Cap Index was down -12.35% from its September high and down -4.52% YTD. The S&P 600 Small Cap Index was down -12.78% from its July high and down -8.14% YTD. International equities were posting even worse results. If I had told you on Friday, October 15th that equity markets were going to reverse their decline starting on Monday, and go straight up for the next two weeks, totally recapturing all of their declines over the previous four weeks, you would have thought me crazy. But that's exactly what happened. It was almost unbelievable. But here we are in mid-November, once again setting record highs for the S&P 500.

Bond markets were surging higher one month ago as capital poured out of equities, looking for safer homes. The equity market's recovery rally allowed bond prices to fall back to more reasonable levels, but high quality bond sectors stabilized at attractive levels and continue to represent safe haven from excessive volatility. High yield bonds, which dropped sharply with the equity market decline, also recovered rapidly but have a more mixed technical picture, remaining below their previous highs. The Barclays Aggregate Bond Index is now up +5.10% YTD. The iBoxx High Yield Corporate Bond Index is up +2.87%. The very volatile (and very surprising) Barclays 20+ Year Treasury Bond Index is up +20.20%!

We opted for caution last month, pending further developments. Our most optimistic scenario had equity markets recovering from their declines over a period of four to eight weeks. Needless to say, the two week resurgence was quite unexpected. We don't want to look a gift horse in the mouth (knowing there is no such thing as a gift horse, they eat several times their price over time) and are happy with the vastly improved environment for domestic equities. That being said, the equity markets' race higher was even more aggressive than its decline, which is unusual. On a short-term basis major market indexes are over-extended and could use a breather. A mild pullback and a positive test of the breakout level would be picture-perfect and resolve the concerns of institutional investors, and me. Normally, I wouldn't even consider such a perfect scenario, but after the fairy tale recovery we just witnessed, anything is possible.

A primary question at this juncture is whether it is worth suffering double digit volatility for single digit returns? Many investors would say, "No", and implement a risk management strategy that better manages volatility. For us that means including more bonds into managed portfolios, recognizing that you forfeit a portion of equity market returns, whether positive or negative. It is late in the calendar year. Investors may prefer to be realistic about their expectations and results for 2014, a year when equity markets experienced four corrections (so far), and start measuring their prospects for 2015.

"This is a fast market that is surprising the experts"

An alternative approach would be to shrug off the race to the finish of the calendar year, focus on the historically good seasonality factors, and position oneself to take advantage of the positive momentum. Thoughts would include recognizing that while the calendar marks the laps, the investment race is a marathon and not a sprint. Additionally, when positive volatility trumps negative volatility, opportunities may become more rewarding to the risk-taker. Essentially, neither approach is categorically wrong but best determined by the investors own investment objectives and their chosen management style. That is why we offer a range of management styles and encourage investors to periodically review them in the light of their own expectations.

One thing is for certain, volatile markets are best managed by experienced professionals. This equity market is not 'easy' any longer. This is a fast market that is surprising the experts. Equity market breadth has been narrowed to domestic equities, with international equities in workout situations. Bond markets are becoming more selective and more precise. At the same time, the pot is richer as our aging Bull Market raises the stakes late in the game.

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Sources: Bloomberg, Marketwatch.com, StockCharts.com