SELECTOR
Real-Time Money Management

Monthly Commentary

October 20, 2014

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

Equity markets aren't pretty any more. The last few days of September equity markets behaved badly, but things got pretty ugly in October. The S&P 500, as well as mid cap and small cap equity markets, declined sharply the first trading day of October. They had a brief recovery the following Thursday and Friday, then dropped five of the next seven trading days, culminating with an intraday decline on October 15th that had the S&P 500 down -9.8% from the September highs. We had not seen a 10% correction in over two years. Historically, they occur approximately once every eleven months. After a moderate correction in January of 2014, followed by two mild corrections in April and August, this is the fourth equity market correction of 2014. This correction is the most severe and essentially wiped out all of the gains realized year-to-date for the DJIA and the S&P 500.

From a technical perspective, the latest correction broke several support levels for U.S. equity markets. This is problematic on several fronts as the U.S. equity market has been the global leader. International equity markets, which dropped sharply in September, are approaching Bear Market territory. Even the more resilient emerging markets equity markets pulled back in October. From a global perspective, even before our current correction, U.S. equity markets were standing alone. This is not a desirable situation. It is fine to be a leader when you have followers, but U.S. equity markets have no followers. Much of the capital flows into U.S. markets had been the result of dismal international equity performance. If U.S. equity markets cannot quickly regain that leadership role, those capital flows could dwindle.

High quality bonds are 'golden' during an equity market correction and this one is no different. The leadership roles remain with long-term U.S, Government and high quality bonds. Equity-related bonds such as high yield and convertibles that had enjoyed their affinity to equity markets have really been feeling the pinch in the last three weeks. During a minor, short-term correction, we normally stick to our equity guns and do not make significant changes to managed portfolios, but this is not a minor correction. It would be highly desirable for equity markets to rally back like champions and reclaimed their long-term moving averages and trend lines in the near future. Even that impressive action would require a 'basing and resetting' phase that could encompasses several weeks. That is our preferred outcome, as we are still primarily 'long' equities and would love to see higher prices.

The prudent move, and our move, is to prepare for volatile equity markets. We have taken defensive action in the last week that decreases our exposure to the weakest sectors such as small cap, mid cap, and international equities. We continue to hold large cap equities and selective sectors including real estate, utilities, and health care. The key will be how far those sectors rally back towards long-term moving averages that were broken the past couple of weeks. Should long-term trendlines and moving averages be recaptured, we would expect to see favorable price action from this very mature Bull Market. Should long-term trendlines and moving averages fail to support prices, we could be in for a 'market winter', and an ensuing Bear Market that is consistent with historical market cycles.

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We believe it is prudent to be cautious and protective over the near term. Should equities rally successfully, we expect that it may take a couple of months to rebuild a proper base before prices could continue to push higher. This is still considered to be a very mature Bull Market, currently five and a half years old. It is impossible to accurately predict how far it will run, and historically some of the best rallies occur at the very beginning and the very end of a Bull Market cycle. In other words, it is usually worth the wait, as long as you can tolerate the increased volatility. The antidote for increased volatility is to increase bond exposure with an emphasis on high quality government and corporate bonds, and we have initiated that action. We continue to maintain exposure for additional upside, and if equity markets are able to reestablish a positive trend we will be participating. At the same time, it is important to be realistic about the technical damage that occurred in October. If equity markets are unable to stabilize, additional defensive action would be warranted. We expect to see this situation resolved one way or the other in the next 30 days.

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