NAPATREE
CAPITAL

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A December of Extremes

This September, my partners and I sat down for lunch with a successful real estate investor. Candidly, we were pitching him on becoming a client. He asked something to the effect of, "if I were to invest $X million with Napatree Capital today, what are some of your best ideas?" Without much hesitation I responded, "well, it's boring, and something that is not being talked about much, but I would build a short-term treasury portfolio for the near term. I haven't seen this compelling level of short-term, risk-free rates in a very long time." I went on to contrast that with equity prices that didn't seem too attractive.

We haven't landed that client. (Yet.) Though he agreed with me: it was a boring answer.

My reaction was informed by my experience with real estate investors, who generally like cash and liquidity. It was a calculated attempt to land a client, but it was also representative of how we view risk. The treasury market was starting to take the shine off of stocks.

Finding the Silver Lining
The market started to turn shaky in early October. We put out a note (found here) at that time stating our belief that things would probably get worse before they got better for stock investors. This recent sell off however, was *much* more severe than we had anticipated. Here is how the major U.S. averages have performed since their recent peaks (through the December 20, 2018 market close):

	2018 Peak*	December MTD	YTD
S&P 500	-16.0%	-10.5%	-7.7%
Dow	-15.0%	-10.3%	-7.5%
Nasdaq	-20.0%	-10.6%	-5.4%

**S&P 500, and Dow Jones peaked October 3, Nasdaq peaked in late August*

Some current data points will provide perspective during this market turmoil. In times of extreme volatility, the markets trade on emotion. Anxiety runs high, causing humans to make irrational decisions. There is no refuting that. However, the question to answer is whether investors have panicked *enough* to put in a meaningful bottom in stock prices. The following is a highly technical analysis comparing some measures of fear to the backdrop of other turbulent periods in history. Let's examine.[i]

- Investors pulled $46 billion from equity mutual funds last week; the most in 15 years and a good indication of extreme fear.

- The recent sell-off has sent nearly four out of every ten stocks in the S&P 500 and the Nasdaq to 52-week price lows. Since 1965, this has happened 33 times. The market had a strong tendency to bounce back in the very short term, though less consistently in the medium term. Longer term (6-12 months), however, the market was positive 81% of the time with an average return of 23%. Looking just at the last bear market in 2008, stocks consistently hit new lows on five separate days in October and November of that year. If you had bought stocks on four of those five days, a year later the average return was about 22%. The one loss was less than 1%. This is during one of the worst market meltdowns since the depression.

- Investors' use of hedging techniques to protect against losses generally increases near market bottoms, which is another excellent indicator of extreme fear. One of the commonly discussed measures is the number of put options bought. Put options are akin to buying insurance against stock losses. The number of those puts purchased hit an extreme on December 20, the most since October of 2008. This is another indication of fear and is a contrarian indicator.

- The Russell 2000 (a small company index) is down more than 20% from its peak (September).
    - There were 13 other periods in history where small caps declined so dramatically after a peak; apart from one period, all others showed gains 12 months later, for a median return of 15%.
    - That one exception, however, was 2008.

By now we are aware of the issues causing the agita:

- Geopolitical: issues with a Brexit deal, trade war with China, pockets of concern in Europe, Russia
- Fear of a weakening economy
- Dysfunctional environment in Washington, DC
- Elevated levels of debt, both sovereign and corporate
- A flattening yield curve (bad for banks)

By many measures one could label this a bear market. Some strategists define it as a 20% pullback from a market peak. But that doesn't automatically mean that we should shed our stock holdings completely; research suggests that we may be through the worst of it at this point.[ii] Still, remember that most of these issues are priced into the market. Any sign of relief should help stocks.

Being Disciplined

Managing money is about preparation and discipline. When we sit with clients we establish a long-term objective. It is a critical element of investment advisory. We also take into consideration our thoughts on the long-term potential of the markets when we allocate to each asset category within an objective. This allows us to make adjustments at extreme periods. In fact, we are currently looking at raising clients' equity exposure where prudent. But that has yet to be fully determined.

Preparing for market volatility allows us to make decisions *during* the market volatility that should benefit our clients and having the discipline to continue to invest based on our process is crucial. Adhering to our discipline - continually looking for value, analyzing the relative risk of different asset classes (i.e. stocks vs. bonds), and thoroughly examining the current technical and behavioral conditions in a historical context – keeps us informed and able to make sensible decisions. If we have set your objective appropriately, your portfolio should weather this storm. It is a dynamic and ongoing process.

The Road Ahead

The meeting we had with that prospective client illustrates how we viewed risk near the end of last summer. If we sat down for that same lunch today the answer would be different. I would say, "let's start investing in value stocks. Let's take advantage of days where there is volatility, buy into weakness, and be patient." We don't know how long the bear market, weakness, volatility – insert whatever label you like – will last. But we know that throughout time, not yielding to our anxieties and being patient has paid off.

Maybe we'll go try to land that client now. It has certainly gotten much more interesting.

Jeff

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[i] Data provided by Sundial Research (www.sentimentrader.com), Y Charts, Trading Economics, Yahoo! Finance

[ii] https://sentimentrader.com/users/report/2018/sentiment_report_20181217.pdf