SLOCUM, GORDON & CO. LLP
INVESTMENT COUNSEL • EST 1978

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From 1978 to 1989, Ed Koch served three terms as Mayor of New York City. A colorful character and a successful Mayor, he would occasionally stand at street corners greeting passersby with the slogan "How'm I doin'?" He probably received a variety of responses depending on the particular point of view or political slant of the local citizen, but it was his way of testing the water for potential mid-course corrections.

If we were to adopt that polling technique with our clients now that the new year and new decade have arrived, responses would no doubt have significant variances depending on the client's: 1: time frame in question; 2: relative comfort level with risk; 3: respect for historical precedent the client has from past investing experience; and 4: how well the notion of full-cycle investing is understood as it influences expectations for returns from invested assets. In general, our clients, both individual and institutional, enjoy a successful long-term relationship with us because we strive to keep an equilibrium of investment exposure whereby returns are generally consistent from one year to the next without extending levels of risk beyond prudent limits. We have empirical evidence that our clients tend to participate fully in bull markets, but with lower implied risk levels in their portfolios. We also tend to lose far less when the markets turn lower over time. We call that risk management, but that strategy is more difficult to appreciate when the investing environment moves into euphoric overdrive as it has in the last months of 2019.

We had adopted a more cautionary stance in 2019 based solely on the economic data that kept corporate profits under pressure with four consecutive quarters of flat to down earnings. In most market environments, that would result in lower stock prices. However, as we have been saying for years now, we are in uncharted territory with these extreme levels of central bank manipulation. The Fed showed its colors by flinching when in the 4th quarter of 2018 the stock market nearly cratered with the Fed's "normalization" efforts to bring interest rates up to equilibrium from the zero-bound it had experienced in the immediate aftermath of the Great Recession. Late in 2018, Fed Chairman Powell dramatically changed course, along with pressure from the President, to reverse his interest rate plans in order to propel stock prices back to the upward trajectory they had been on for the better part of the last 10 years.

In other words, the major factor influencing the stock market in 2019 was not earnings growth or expanding profit margins, but rather the fact that the Fed provided yet more excess liquidity in the system which, predictably, found its way back into stock prices rather than the general economy, pushing stocks higher purely by momentum and not fundamentals. In many ways, this new round of easing has been characterized as Quantitative Easing 4, contradicting the earlier pronouncements from the Fed that QE was over once and for all. "Never" is a word the Fed shouldn't ever use!

As we all know either by experience or by absorbing the literature of the markets, stock prices can be influenced by a variety of factors: the direction of corporate profits, availability of borrowed money, wars, politics, innovation, corruption, demographics, immediate news headlines, and sheer momentum (up and down). In markets where the direction has been largely one way (up) for an extended period of time, complacency sets in and risk can develop slowly, then all at once. Risk management strategies serve to offload some of that risk by changing asset allocation or altering the industry groups represented in a portfolio from aggressive, economically sensitive to defensive, recession-resistant investments. It may mean

increasing cash or bonds in a portfolio to mitigate volatility, or it may mean doing the opposite when markets are suffering from a bear spell by increasing equities just when no one wants them. Nothing is predictable in the stock market, and the best that an investor can do is to be aware of risk at all times and take advantage of contrarian opportunities when they appear. Buying stocks when they are low provides what Benjamin Graham (and Warren Buffet) call a margin of safety in an otherwise risky world.

Recent commentary from investment strategists suggest that the traditional balanced portfolio of 60% stocks and 40% bonds will not produce competitive returns in coming years. The reasons vary, but largely center on the fact that interests rates are historically low and stock prices are historically high, providing little room for error. Regardless of the prevailing economic environment, history has shown that a portfolio with bonds reduces overall risk and volatility. The table below illustrates the historical annual returns of a portfolio that is 100% invested in stocks versus one that holds 60% stocks and 40% bonds.

Investment results vary from account to account depending on the unique mix of assets and securities tailored for each client, but in general our risk management actions provided better-than-market returns in 2018, and while we trailed the benchmarks in 2019, it was by all measures a superb year for returns from invested assets. On a risk-adjusted basis, given our predilection to reduce risk, these returns look even better. Where it all goes from here is a tougher challenge because of the unpredictability of politics, international relations, trade disputes, growing tendencies to eschew globalization in favor of nationalism

Annual Returns: 8/31/1976 through 8/31/2019

	S&P 500*	Balanced**
Annual return	11.2	10.3
10-year beta	1.0	0.5
Worst 1 year	-24.4	-9.7
Worst 3 years	-11.4	-2.6
Worst 5 years	-2.7	1.6
Worst 10 years	-1.8	2.2

* Includes monthly dividends

** 60% S&P 500 / 40% BBG Barclays US Agg Index

Source: Mauldin Economics, American Funds Hypothetical, Thomson Reuters

An important conclusion from the data in this chart is that since 1976, the balanced portfolio has returned 91% of the stock market with only 47% of the risk. Further, the balanced portfolio never had a 5-or 10-year period with negative returns, something that cannot be claimed with a 100% stock portfolio over this period.

and populism…all factors that will bear on corporate profits and investment returns over the next year or two, or possibly longer. Our job of seeking compelling returns with the least possible risk gets harder the further we go into the post-Great Recession recovery, now 11 years old, but this is not our first rodeo and we will find the right path by using tried and true strategies that have benefitted our clients over these last 41 years of our firm's business.

We wish everyone a prosperous New Year.

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