Slocum, Gordon & Co. LLP
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We hope many of you had the chance to watch our recent video presentation from June 19th, *The Fed and The Cycle,* where we provided an update to our macroeconomic outlook and investment strategy. To summarize, we believe the likely rate cuts beginning in the third quarter will do little to offset the current slowdown in bottom-line growth across most corporate sectors, driven by higher wages and debt service costs, flat top-line growth, and tariffs.

In spite of the disconcerting message from global fixed income markets, where roughly one-half of all sovereign bonds are now trading with negative yields, US stocks have moved higher anticipating a re-ignition of risk-on behavior in response to a new program of Federal Reserve easing. Although we have no way of predicting the limits of investor irrationality in response to easy money, we are reluctant to add risk solely based on TINA ("There Is No Alternative") ten years into a bull market and in the face of a global economic slowdown.

The synchronous dovishness from the Fed, the European Central Bank, and the Bank of Japan to us should not be a reason to celebrate, but instead taken as a warning that the series of rate hikes since 2015 have choked growth and exposed the excessive indebtedness of the corporate sector. In such an environment we look to further reduce our exposure to cyclical stocks and increase our bias towards income-generating securities from defensive issuers.

When markets are in an upward trajectory,

as we've seen since 2009, risk-control at the manager level is either invisible, non-existent, or simply unimportant. Yet as we all know, good times can quickly turn into difficult times, and only then does it become apparent who was prepared, or as Warren Buffett puts it: "it's only when the tide goes out do you discover who's been swimming naked."

In light of several trends in the financial advisory and investment management businesses that have taken hold since the Great Recession, namely the explosion of various low-cost, indexed investments, we thought we'd take this edition of *Viewpoints* to address the most important four-letter word in our business: risk, and present a case against turning over one's investment decisions to a computer.

To put the dramatic growth of asset flows into algorithmic investment vehicles in context, it's important to first examine the predecessor: the actively managed mutual fund, which began to capture the public's attention in the bull market of the 1980's as a means of achieving diversification (holding a large basket of uncorrelated securities) the average American would have otherwise been unable to afford. The fund industry exploded, with star managers like Peter Lynch and John Neff becoming household names, and hungry retail investors poured their savings into funds through their brokers. With a rapidly expanding universe of funds to choose from, retail advisors could easily switch client assets to whichever fund had the strongest recent performance, with their clients largely unaware they were paying not only fees and commissions to their broker, but also asset management fees, 12b-1 marketing fees, soft

dollar costs, record keeping fees, purchase & redemption fees, etc to the underlying mutual fund. It wasn't until the Dot-Com bubble and a number of academic papers began circulating did it become widely recognized that the average fund manager, net-of-fees, was underperforming his or her benchmark over most time horizons. Much of this was driven by the need for managers to maximize short-term performance to prevent outflows to whichever "hot" competitor fund had been leading the rankings in recent periods.

In the aftermath of the Great Recession, money was cheap and capital sought yield (TINA), but skepticism around the mutual fund fee factories as well as advancements in IT set the stage for the passive index fund and ETF to become the new fashionable approach to portfolio management. Assets invested in index funds have in fact eclipsed the amount invested in actively managed funds, and the trend is showing no sign of abating. JP Morgan estimates global ETF assets will grow to $10 trillion by 2022, up from ~$5 trillion today.

With established financial service companies and Silicon Valley startups alike looking to capitalize on the surging demand for low-cost investment vehicles, the number of market indexes that one can passively invest in now actually exceeds the number of US stocks! In our view this creates an entirely new set of risks that will likely remain invisible until a correction occurs. A growing share of these passive funds utilize leverage, futures contracts, swaps, and other derivatives that depend on liquid markets and solvent counterparties, without actually owning any physical securities. Moreover, the more vanilla ETF's also have issues of their own. $SPY, which has over $270 billion in assets and tracks the performance of the S&P 500, is not advertised as a momentum-driven strategy, yet as the stock of Amazon, for example, increases in price, the more of it $SPY must buy in order to reflect the market-cap weighting of the underlying index.

As ETF providers have developed a suite of funds tailored to nearly every imaginable investment style, robo-advisors have emerged as a way for investors to outsource the increasingly difficult task of fund selection to an algorithm. These automated advisors take the premise that a person's financial situation, goals, and appetite for risk are static and can be reduced to a statistic, and then apply that measurement to an algorithm to determine the "optimal" asset allocation for the individual.

In good times, the notion of tracking the averages for a minimal cost is satisfactory for most. In sharply falling markets, however, tracking the indexes could be crippling. Most of you have heard our mantra of striving to invest in such a way that we can make money when everyone else is, but lose less when markets fall. The low-luster, ignored, or out-of-favor securities we invest in will rarely sit at the top of the heap in roaring bull markets, but should instead prove their value with consistency over the course of a cycle. It isn't easy to appreciate the value of risk control 10-years into a bull market, but we hope you can sleep well at night knowing your portfolios are currently structured with preservation of capital as the foremost priority.

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