

# 1<sup>st</sup> Quarter 2020 Market Commentary

## Premise Investors,

At the time of writing our last quarterly commentary, the events in these last three months were unimaginable. We had just finished the year at all-time highs, and the biggest concerns were a trade dispute with China, an impeachment process with a seemingly foregone conclusion, and the upcoming Presidential election all the way in November. In the new year, we began hearing about the virus, but initially the equity markets continued pushing to new highs even as the news was progressively negative. The market has seen virus scares in the past few years with sell-offs for SARS and Ebola, but **what would happen to the markets next was unprecedented in terms of speed and scale.**

Unfortunately, this created a perfect storm for any trend following system. We have always said that sudden drops from highs after a strong up-move are the weakness in any trend following system, as the time it takes for the signals to reverse are increased, and the quickness of the move could cause large drawdowns from the previous highs. In our research, we saw that possibility in the crash of 1987, and for that reason, we made the deliberate choice to never position the portfolio riskier than the comparable strategic diversified basket. We also recommended that advisors use our models to set the maximum risk at the risk tolerance of the client. This was a departure from anyone else that was in our space, as most tactical managers would concentrate risk in very few classes and use other techniques such as leverage to juice returns in the upward markets.

We knew that trend following systems are at risk in these sudden drops. So, the risk level of what you are holding in the proverbial 'bomb drop' scenario is how you should measure the risk of the portfolio. In other words, in market drawdowns, we don't want investors to retract more than an equivalent strategic portfolio. We also know that the faster the indicators get you out, the more wiggles you will experience in up markets making the entire process less beneficial. A system built to "participate" in market uptrends has to make trade-offs in certain types of market downtrends.

In fact, running the numbers of the diversified models from 2012 until February of 2020, we were able to post returns very near the comparable diversified models that come from Dow, S&P, and Morningstar. We are able to show that even after several wiggles since our inception, using the models as intended would have a very small cost to the upside, in exchange for the benefit of removing market risk at times where things could deteriorate into life changing sell-offs.

That seems to be where we are again. In the eight years we have run these portfolios, this is only the fourth time we have moved to a full risk-off decision. As stated earlier, the drawdown is larger than anyone wanted to see because of the previously strong market and the quickness of the sell off, but **it is not unlike the type of market movement in 1987 that we had seen and accounted for in our research.** It is not a new and unexpected market occurrence, but something we always knew could happen and warned that the system would not protect against.

When we talk about 'prolonged' down moves, we are speaking of multiple quarter, but particularly multiple year, market sell-offs that are usually accompanied by recessions, depressions, or other serious economic problems. Look at the long term monthly chart of the S&P 500 below. For a long time, the S&P 500 exhibited characteristics of an exponential growth chart, but it is obvious that the down moves that started in 2000 and again in 2008 do not follow that pattern. The chart, which usually moves along an upward sloping pattern, has



these two bumps that are clearly different. These are sell-offs that take place over multiple years and cause considerable damage to a portfolio. These are the 'prolonged' down moves we are addressing.



Let's put this into some perspective. From both peaks, the market sold off near 50% and took multiple years to get back to even. In the case of the year 2000 down move, and as a result of the 08 sell off, it took over 12 years to get back to even. That means the index in 2000 would not see a positive return until after 2012. You had a negative return for 12 years. Many people expect 7% returns per year from their equity portfolio but buying the S&P 500 index in 2000 would have been a loser for the next 12 years, and investors would have seen their account get cut in half, TWICE! When investors are asking why they aren't keeping up with the S&P 500, we would say to look at that history and ask yourself if you want to keep up with it. Those are the facts of a buy-and-hold portfolio, and you never know in advance when that might occur again.

From a financial planning perspective, most people really start earning money later in life and can only begin to accumulate large investment balances after funding for homes, college expenses, and other goals. If it takes you until age 50 to save up a \$1 million dollar nest egg, would you be able to see it get cut to 500k two times? Would your financial plan still work if at age 62 you showed zero return on the portfolio for the last 12 years? Or would your plan work if you are 65 and you see no return for the next 12 years? When you want your portfolio to match the return of the S&P 500, you must take the good and the bad. If it happened before, it can and probably will happen again. We could be at the beginning stages of one of those moves right now.

When the market dropped at the end of 2018, we exited, and the market fell another 10%. We didn't know whether it would turn into a large prolonged drawdown, but we did know that volatility was up and the potential for a large loss (50%) was possible. When the potential for a large loss is high, we move some money off the table. In this sell off, we exited when the S&P was near 2540. So far, the low has been 2190. That is over 12% from our exit. We don't know if it will continue down, but many pundits are saying the virus could have a long reaching effect on the economy and that a test of the lows is probable. Just as in 2018, we do not know what will happen, but when there is the potential for life altering drawdowns, we are the part of the portfolio that is trying to protect capital, not the part that aggressively tries to time the short term market movements. There may be a place for the latter in some portfolios, but that is not our role.

You must set up a portfolio for the possibility of what might happen, not afterwards when looking at what did happen. That is why our first priority is to diversify the portfolio into global asset classes which include equities and fixed income. In 2000, the equity sell-off saw fixed income increase, but in 08, they both went down. Over the last 4 years, the S&P 500 beat all the other classes, but you would have been a fool for only holding the S&P from 2000 to 2015. **Since the future is unpredictable, you need to set up a portfolio that can accommodate many potential outcomes.**

From the standpoint of using tactical management, the decision is also to spread the risk around. Our models have both a tactical and a buy-and-hold (strategic) component because each will have a time that they outperform the other. Our tactical model has a wider range of equity exposure, so it is meant to be used with a buy-and-hold (strategic) component to adjust to a maximum and a minimum level of desired equity exposure. The long term goal is to marry these different return streams in order to give the investor a somewhat smoother ride and to decrease the impact of negative events on their financial plan.

So now we have 4 major market moves since, and including, the crash of 1987. From our research, we told everyone that an 87 type crash was unavoidable because of its sudden drop from the highs which is what the 2020 sell off looks like, so far. We also can see that trend following tactical management has the potential to help limit down moves that act like the 2000 and 2008 sell offs, which are slower to develop and last for longer periods of time. While the 2020 sell-off started like 1987, at this point we cannot say if it will have a lasting effect or bounce back quickly. As we stated before, we are the part of the portfolio that opts for removing risk, not taking it in these times.

We also can look back at the risk-off moves we have made since we started in 2012 and note that all three risk-off moves before this 2020 sell were negative from a trading standpoint on the S&P 500. Yet we were able to post returns comparable to the equivalent risk tolerance models provided by S&P, Morningstar, and Dow Jones. This shows that we were out in some pretty scary times, but it did not have a material cost on the portfolio. We are not trying to make good trades per se. If that were the case, then after we exit equities and the markets continue to go lower, we would simply buy back, thereby locking in outperformance. While we would beat the market, we would also be sitting ducks for the potential further down move that could occur like in the paths set out in 2000 and 2008.



What we are doing is allowing investors to spread the bet around on whether this pull back bounces back quickly, as it did in 2018, or continue downward as the virus' effects echo into the future. Our piece is the tactical piece that removes some of the money from the table. Obviously, if the market breaks the lows and turns into a prolonged bear over the next few years, you will wish you had more, but if it bounces, you would wish you had less. Overtime, we have seen that while the last three trades went against us from a pure trading standpoint, they did not destroy value from an otherwise diversified account at a similar risk level. The result of the fourth trade is still yet to be determined, but at the darkest point so far, as the market crossed below 2200, we were not invested in equities which gave a sense of relief to investors that may otherwise have panicked and sold everything.

A portfolio created beforehand that takes all these uncertainties into account is an important tool that allows investors to hold course in these scary times. The problems could affect equities and not fixed income. They could affect US equities and ignore international equities. They could be short lived sell-offs that quickly bounce to new highs, or prolonged bear markets as the economy moves into a depression. Spreading the risk around to many asset classes, as well as exposure to both strategic and tactical strategies is the best way to account for the unknown path that the returns will take. Having a tactical portfolio that does not drag too far behind a buy-and-hold (strategic) portfolio through most of the possible outcomes is a bonus.

What happens next? Are we out of the woods? We think not. Expected volatility remains elevated to levels we have not seen since the global financial crisis. We could see the market rise and fall daily, whether it's hopeful news about containing Covid-19, or it's disappointing news on the longer term affects on the economy. Markets might get boosts from government aid or Fed infusions. However, if those are seen as merely "band aids on a bullet wound", we are bound to see lower levels. We could see a V-shape recovery, or a W, or a hockey stick, or a Nike swoosh. We won't try to predict. We are careful not to make that call, but rather rely on a proven, repeatable process to help us navigate these volatile and unusual times.

We are glad to be in good health as we share this update with you. We sincerely hope that you and your loved ones are safe and getting through these tough times. We are all in this together. Stay Healthy and Hopeful.

The Premise Team

