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INVESTMENT MANAGEMENT

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There have been recent discussions, internally and externally, surrounding the potential for a cyclical top in the equity market. In response to the numerous emails I have received lately, let me share my thoughts. In short, one's interpretation of and perceived need to react to the call of a *"cyclical top" largely depends on: 1) investment timeframe, 2) threshold for pain, and 3) ability to move in and out of the market.*

To begin, the piece I published at the beginning of the year, *"Remain Calm and Carry on"* [1], was all about reversion to the mean:

> *"From financial history and from my own experience, I long ago concluded that regression to the mean is the most powerful law in financial physics".*[2]

What was ripe for reversion to the mean this year?

VOLATILITY

Here are some stats on volatility:

1. Since 1960, the S&P 500 has moved up or down 1% or greater 53 out of the 257 days the stock market is open, on average, per year or **21% of trading days.**[2]
2. Last year, the market moved + or -1%, 8 days or **3% of trading days.**[3]

   Hellloooooooo. Reversion to the mean, here we come in 2018!
3. Through April 17th, we have experienced 1% moves 29 out of 71 days or **41% of trading days.**[3]

   Voila. Reversion to the mean. Here it is.
4. And no advanced math is needed to understand, in order for the market to regress over the last two years back to this 20% level, *the market will largely need to remain this volatile for the rest of the year.*

*The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See Disclosure section for index definitions.

The problem with this higher volatility is it comes in a year where I doubt the market will make much progress overall. As I wrote last month:

> *My conclusion, from the February 2016 low to the January 2018 high, the S&P 500 has rallied 57% for a 25% compounded return over that two year period. That's a lot. Maybe we are due for a breather year……still positive but the rate of ascent needs to temper.*[3]

If the market is up single digits on the year, but it were to move over 1% during 40% of trading days, that is a ton of volatility around that anemic base case. Therein lies the problem. *Markets do not move in a linear fashion.* If they did, I would not have grey hair, and I would have more of it!

And that is where "cyclical tops" come in. In 2010, the market was up on the year, but the worst peak to trough drawdown was down -16%. In 2011, the SPX was up on the year, but the worst peak to trough decline was down -19%. In 2015, the SPX was up on the year but the worst peak to trough decline was down -12%.[4] Get my point?

Could we experience another one of these peak to trough declines that could be referred to as a *"shallow correction within a secular bull market"*[5] as has been written recently? (aka, a "cyclical top") Absolutely. I suspect that will be the story line of the year. I do not believe this is the end of the secular bull market but rather a pause coming in a year ripe for increased volatility. And that makes for a dangerous combination.

But there is a potential silver lining. In 2017, who needed to pay for professional advice with the market chugging along every day? Everyone was an investment expert. The tide never went out. An 800 number was good enough.

But when there is increased volatility, professional counsel is much more important.

Thus, the second **reversion to the mean** this year:

THE VALUE OF INVESTMENT ADVICE.

As I wrote in the 2018 January outlook piece:

> *We think there is a high likelihood that the spread between how the equity markets does and how investors do should widen considerably in 2018. Why? Investors tend to overreact more in volatile markets.*[6]

Increased volatility tends to lead to worse investor timing behaviors. And the data has again begun to support this. In early January, as the market peaked, the retail investors' confidence index peaked at over 70%. Bad timing. The S&P 500 dropped 10% shortly thereafter. Unfortunately, the index bottomed as the market did in early February at 27%.[7] The result? In early February (at the lows), retail investors pulled $51 billion from US stock funds.[8] I am confident that when we close the books on 2018, the data will suggest that cumulatively more selling was done close to the lows than buying, and more buying was done close to the highs than lows.

An 800 number does not serve to talk panicked investors off the ledge. I suspect (though I have no data to prove it yet), that most of the recent most inopportune liquidations came from self-directed trading.

So in conclusion, when the dust settles on 2018 and the books are closed, I think that both the secular bull market proponents ***and*** the cyclical bear market advocates will be able to declare victory. At times, painful drawdowns followed by relief recoveries and as long as investors do not chase returns on the upside or overreact on the downside, 2018 will not be all that bad. And that, to me, will be where financial advice will be so important.

Stay calm and carry on. Or as my friend John Raphael says in the rocky times, "man your battle stations, this is not a drill!"

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[1] 2018 Equity Market Outlook. Remain Calm and Carry On. January 2018

[2] Global Reflections: Nick Savone. April 2018

[3] AEA February 2018 Commentary

[4] Source: Bloomberg

[5] Global Cross-Asset Strategy: The Great Cycle Debate: Morgan Stanley. April 2018

[6] 2018 Equity Market Outlook. Remain Calm and Carry On. January 2018

[7] Sentiment Trader. April 2018

[8] CNBC. February 2018