2017 Q4 OUTLOOK

Traub Capital Management

October

Overview

Equity markets continued their solid performance in the third quarter of 2017 adding another 4 1/2%, including dividends to the gains in Q1 and Q2 for a YTD gain of 14%. As discussed in the previous quarterly review, the media is awash with scary headlines about coming corrections and bear markets. However, we don't see any reason to panic. Earnings growth continues to be good. The European and other international economies are growing slowly but steadily, with most major non-US markets still supported by ultra-loose monetary policy and generally lower valuations than their US counterparts. Unemployment continues to trend downward and inflation continues to be low – much lower, in-fact, than the Fed (Federal Reserve Bank) seems to think would be appropriate for the US economy at this point in its economic cycle.

The yield curve remains positively sloped and with low inflation expectations; the 10-year Treasury rate will continue to be fairly low. The Fed has announced a very slow unwinding of the Quantitative Easing program which it began during the 2008 recession. The unwinding is planned for a period of ten years or so, where maturing obligations held by the Fed would simply not be reinvested when they mature.

It is widely expected that the Fed will raise short term rates by 0.25% later this year and will have three to four more small rate hikes in 2018. Given the low rate of inflation we are expecting, we would not be the least bit surprised to see only two or three rate hikes in 2018.

All the above considerations continue to support gains in equity values and we do not foresee an end to the current bull market, although a "correction" of 10% or so is always possible at most any time and for no particularly good reason. These small corrections do not generally last for prolonged periods and our recommendation is simply to ride them out.

We could end our Q4 outlook here simply by saying our outlook has not changed from the previous quarter. We believe the environment is positive for equity investing and we could very well see further gains to the end of the year. However, when there is no change in the economic outlook it does give a bit of breathing space and it is good to use that breather to look at an aspect of investment planning that is frequently ignored, but often at the top of people's worries.

Planning for a Downturn

We can pretty much guarantee that there will be a notable downturn in equity markets at some time in the next few years. As in most of life's endeavors, it is way better to have a good plan than to just hope any particular situation simply does not happen. For the next downturn, there are seven possible ways to cope, some of which you could combine, and some which more apply to retirees. None of these is without flaw, so it would be good for each of us to plan which path to take. All are discussed below.

Ride It Out

Generally, not a bad plan assuming you do not need to take any money out of your portfolio but if you do need a source of income during the downturn, this plan may not fill the need.

Get a Job if Not Working (or delay retirement if nearing it)

Again, not a bad plan. Having a source of income will let you implement the “Ride It Out” plan with a bit more confidence. We have completed numerous analyses of individual’s and family’s retirement funding, and it becomes very clear that earning even some income in retirement is one of the best ways to make the funds you have last. For a sort of typical couple, a Social Security income of somewhere around $50,000 per year and annual spending of $100,000 per year leaves a gap of $50,000 per year to be funded from retirement savings. A very modest job (even part time) earning $30,000 per year fills in a large portion of the income needs and extends the life of retirement assets markedly. However, the “Get a Job” plan does not meet everyone’s need, particularly when a market downturn generally means that more people are losing jobs than are gaining them. If you intend to implement this approach, it would be good to find a position when the economy is stronger.

Carry a Sufficient Cash Balance if Retired and Drawing on the Account

Most students of equity markets conclude that having sufficient cash to last for two years will generally be sufficient to implement the “Ride It Out” plan mentioned above. However, carrying a large cash balance all the time will certainly lead to lower returns most of the time, so this plan is not without its problems.

Correctly Forecast the Downturn and Position the Portfolio Accordingly

A great plan, yet one with real difficulty in implementing, particularly since setting up a defensive portfolio and then seeing a market gain will leave you out in the cold and dramatically hurt your returns. It is unfortunate that a large number of investors choose this program, which is why the portfolio return for the average investor is often less than half of the return for most any broad stock market index. The average investor just “feels” that the market is ready for a downturn and prepares a defensive position only to see the market rise instead. We at Traub Capital spend a large amount of time analyzing macro-economic trends and other factors that may cause a downturn so that we can minimize losses. This is a full-time job and if you want to do most anything else with your life, you are not likely to have a sufficiently correct process for identifying the downturn. Even if you are continually analyzing economic trends, it is most likely that you will not have sufficient resources to consistently forecast correctly. Virtually no professional investor can honestly claim to have forecast the previous five downturns without missing any of the upturns. Any one process may be the one in a million, but we have not included a “win the lottery” scenario for a reason. The odds are really against it.

Hold Lots of Bonds

The value of bonds tends not to decline as much as, nor as fast as equities (if they decline at all). They are a good defensive holding, which is why most portfolios are constructed with some portion of both stocks as well as bonds. Over the last 30 years interest rates have generally been coming down which has led to generally increasing prices of bonds helping to provide a decent return to the portfolio that holds lots of bonds. At the moment, with interest rates about as low as they are likely to go, bond returns are likely to be well below where they have been over the last decade or two, so holding a large bond portfolio has its drawbacks.

Sell Assets as Necessary (for retirees who are drawing on the investments)

If your historic returns have been good and your portfolio is sufficiently large, you may be able to simply sell assets as necessary to cover any funds that you may need. The drawback to this approach, however, is that you will be selling “low” during a downturn. But if you sell consistently over time to fund retirement, sometimes you will sell low, and sometimes you will sell high.

Borrow What You Need if Drawing on Funds in Retirement

The drawbacks of the previous six plans lead to this seventh plan that for some should be considered. That seventh plan is to borrow what you need and pay it back when things improve. This approach is consistently either ignored or not even considered due to the risks of borrowing. The primary advantages are 1) you can avoid selling “low” and 2) you can avoid taking a tax hit if selling taxable assets at a gain to raise cash, or selling IRA assets beyond the required minimums. On face value, borrowing what you need appears to be unattractive and somewhat risky and yet, if you are disciplined, it may very well be worth considering.

There are several sources of funds to borrow. These would include borrowing against financial assets (such as margin), borrowing against the value of your home or taking out a reverse mortgage. There are, of course, costs and detailed considerations for each. The Home Equity or Reverse Mortgage avenues generally would have lower interest rates than a personal line of credit or a loan against financial assets.

Looking at the loan approach on a very cursory basis does show some merit to this approach. To do so, you would need to make an assumption about your portfolio returns on a long-term basis. You could use most any number here from about 4% and up to 8%. Conceptually, if you can borrow at less than the long-term return rate of your portfolio, you would be well advised to do so. The problem is nobody knows what their long-term rate of return will be.

To effectively implement the borrowing approach would take some discipline to secure a favorable interest rate and to repay the loan when market conditions improve. In some cases, it would also require that the borrowing capability be set-up and established well in advance of any need. Generally, a year or two in advance would probably be just fine. For lines of credit you might want to access a small amount of the loan within some short period after taking it out, just to be sure it is fully functional when you need it.

Conclusion

We believe this quarter you can tune out the headlines with a very good probability of keeping or growing the gains in the equity markets this year. Use the time to begin setting up a plan you can use the next time the markets turn down. As always, we are here to help and can work through your particular scenarios on an individual basis. Just give us a call to set up a time to discuss.

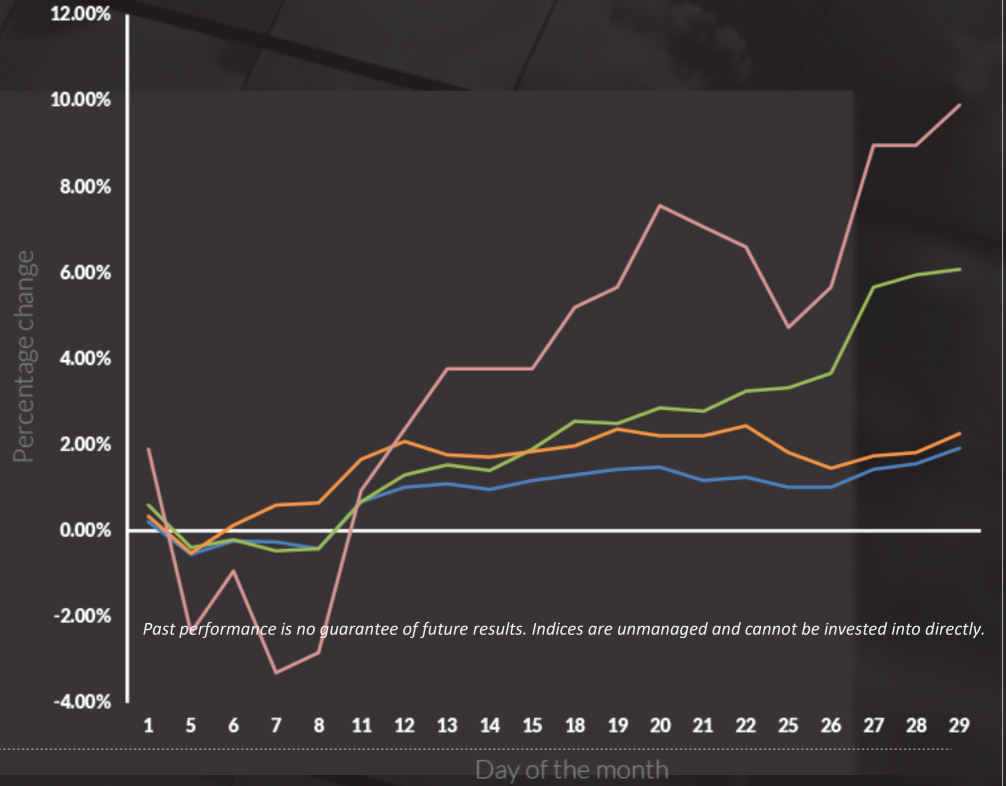
The market at a glance
September

U.S. Large Cap
(S&P 500)
2,519.36 (1.93%) ▲

U.S. Mid/Small
(Russell 2000)
1,490.86 (6.09%) ▲

International Large
(NYSE International 100)
5,643.00 (2.25%) ▲

U.S. Treasuries
(U.S. 10-year Treasury yield rate)
2.33 (9.91%) ▲



The market in action

- In one of the biggest data breaches of all time, Equifax, one of the three major credit reporting agencies in the United States, announced that more than 143 million individuals had their information compromised. The hack reportedly occurred from May through July of this year.
- The devastating hurricanes that impacted much of the Americas in August and September continue to impact millions of people. Estimates indicate that, between Hurricanes Irma and Harvey, total combined damage could exceed $400 billion.
- Controlling stake in the storied music publication company Rolling Stone has been made available by Wenner Media LLC. Acccording to Kreisky Media Consultancy, the stake could go for as much as $80 million.
- Amazon is looking to expand its operations to a second headquarters office. Amazon estimates that, from 2010 through 2016, their main headquarters impacted Seattle's economy to the tune of roughly $38 billion. Amazon expects to announce their decision sometime in 2018.
- Nordstrom is set to implement a line of stores that will have no merchandise for sale. Starting in early October at locations in California, these "Nordstrom Local" stores will have items that can be tried on, but not purchased. Instead, inventory will be gathered from other stores and from its own website. These stores will also have "bars" that offer juice and wine.
- In a promising sign for working-class families in the United States, middle-class income for Americans in 2016 rose to the highest it has ever been. In relation to this news, the poverty rate dropped to 12.7 percent, roughly returning to pre-Recession levels.

Keep reaching for your financial goals

Few things are able to motivate us like self-improvement; however, despite initial enthusiasm, our personal goals can seem like impossible challenges after just a few days.

Financial goals are particularly difficult to accomplish. Spending money is inherent in modern life, and financial goals can easily get lost in other money issues. What's worse, the feedback from financial goals is blunt and immediate. As soon as we get started, our finances begin to define our success with clear positives and negatives. Financial goals also remember our mistakes. A one-time slip-up, like a costly purchase, can disrupt progress towards a goal for months or even years.

The success of a goal often comes down to the strategies and tools used to support them, but valuable techniques are often abandoned as soon as a little bit of progress is made. Use some of these steps to help make your goals a reality:

Be reasonable – It's always important to be realistic. In regards to financial goals, it is essential. If you make your goals too extreme, you set yourself up for frustration and disappointment. It's better to have an attainable goal you can more easily reach than an impossible goal that discourages you and could lead to giving up on the goal entirely. Once you have a little success, you can raise your expectations.

Set solid milestones and celebrate them – Milestones are a great way to track progress and boost your morale, but you need to make them an important part of your life. If you've made it halfway to your goal, celebrate in some way and give yourself a taste of what success will feel like. Stay positive; milestones are meant to show you how far you've come, not how far you still have to go.

Find some accountability – Telling someone else about your goals and having them check up on your progress can massively boost your discipline. Even if your confidant only asks for occasional updates, being accountable for your actions can provide a lot of encouragement to stick to your plan.

Automate what you can – Constantly trying to make the right choices can wear down your motivation. Automating your target savings or debt payments can help you avoid the potential mistakes and will allow you to save your energy for other challenges.

Break and build habits – It's often said that it takes 21 days to break a habit or build a new one. While the psychology isn't exact, it's clear that our habits are a lot easier to change than we usually imagine. If you can force yourself to stick to a plan for just three weeks, progress should become much easier.

Limit the number of goals – Reaching goals can be difficult, so don't try to accomplish several of them simultaneously. Only start one or two financial goals at a time, and don't create new ones until your current efforts have become second nature.

Bend so that you don't break – Interruptions are inevitable. Much like setting a realistic goal, it's important to have realistic expectations for your progress. If there is an unavoidable problem, adjust your goal accordingly and keep trying. Don't give up on a goal just because of an unplanned setback.

Reaching goals is a skill that takes practice and experience. In accomplishing one goal, you learn which strategies work best with your personality.
Even when you fail, you've learned more about what it takes to reach success. The important thing is being willing to try again.

Heydon Traub
h.traub@traubcapital.com
(781) 453-3929

97 Chapel Street, Suite 7
Needham, MA 02492