Market Musings

Volume I
2018

Victoria Capital Management, Inc.

June 1, 2018

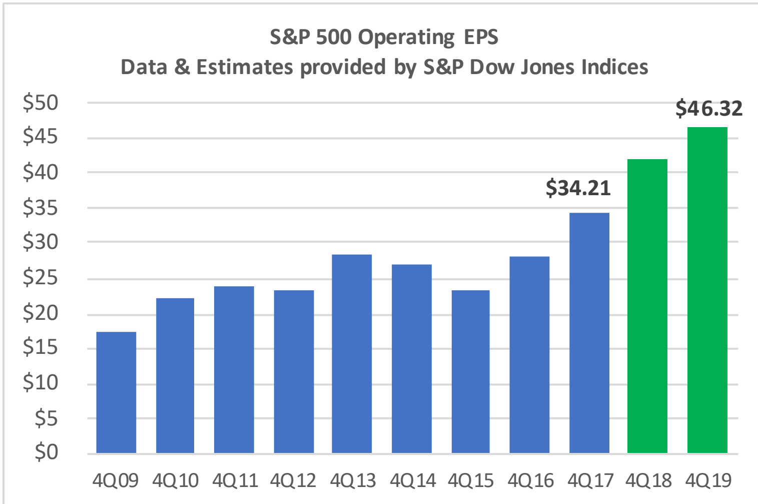
Market Musings

Victoria Capital Management, Inc.

A newsletter brought to you by Victoria Capital Management, Inc.

VOL. 1, ISSUE 1

Corporate profits (shown right) remain strong and continue to grow. The S&P 500, a broad U.S. market index of large companies, operating earnings per share is estimated to be $46.32 in the 4th quarter of 2019. A 35% increase from 4th quarter 2017.



"An investment in knowledge pays the best interest."
Benjamin Franklin

Market Commentary

Not all stock market investors are benefitting from an improving economy. Several large companies dominate their industries and have recently come under scrutiny. Two of these market leaders include Amazon and Facebook. With a combined market cap of $1.2 trillion, these two companies are larger than the 600 companies that make up the S&P 600 Small Cap Index. When companies this large have headlines striking fear in investors, it has profound effect on the entire market and the indexes in which they are constituents.

Financial Market Whirlwind

The first quarter of 2018 was characterized by violent swings in equity markets after a solid gain in 2017. We call it the Charlie Brown quarter as seen in the zig-zags in his t-shirt. January started out with continued gains in equity prices as most major market indices eclipsed previous records. Optimism over the president's tax cut plan and rising corporate profits provided the story behind the "Goldilocks Economy" and expectations for even greater stock market gains through the end of 2018.

February turned out to be a reversal of the gains of January as a hawkish Federal Reserve policy, fears of a North Korean nuclear confrontation and political turmoil turned investor optimism to pessimism and broad market indices retraced most of January's gains.

As the fear of a North Korean confrontation dissipated, markets rallied again taking the NASDAQ index back to record highs in mid-March. President Trump then made the surprise announcement about steel and aluminum tariffs and the market turned down again. To complicate matters, two "Modern Day Disruptors" (see below) came under pressure, prompting fears of government intervention and increased regulation.

Many market observers view recent swings as a sign of a consolidation/correction in a continuing long-term bull market in stocks. The fourth quarter revision in real GDP to 2.9% up from 2.5% indicates that the underlying economic fundamentals are intact.

Investors are mesmerized by the recent wide swings in the stock market. Back in the day, (and we won't say what year) a ten point move in the DJIA during a session would be considered an eye-opening event. Today 100, 200, and even 500-point swings are within a "normal" daily range. These price fluctuations are accelerated by traders and large financial institutions that trade on smaller market moving events. Market volatility was low for most of 2017 but has returned with a vengeance in 2018.

The fundamental underpinnings for a continuation of the bull market in stocks remains intact. The short-term problem is that there have been several one-off events that have triggered increased trading volatility and wider stock market swings. Short-term reactions such as these justify being a long-term investor.

Compared to the 55% of people 35 and older that were invested in the stock market in 2002, only 35% of people are invested in the stock market today.

(source: Gallup)

VICTORIA Capital Management, Inc.

Market Musings

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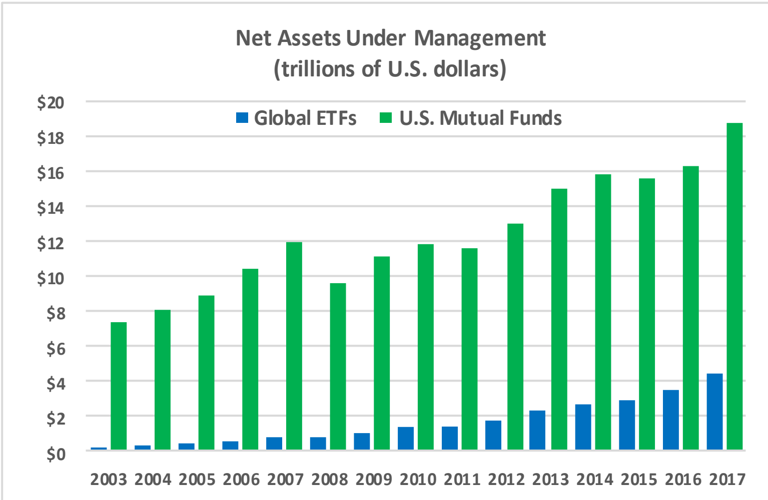
VOL. 1, ISSUE 2

The chart to the right shows that the assets under management of global exchange-traded funds (ETFs) are growing. However, the net assets of global ETFs are still approximately 426% less than the assets under management of U.S. mutual funds



The Challenge of Saving for Retirement

An increasing number of working Americans are beginning to realize that they may not have saved enough money to finance a reasonable standard of living in retirement. Depending on how old these Americans are, there are several alternatives that might be able to help those individuals reach their goal. However, the answer is not simple and requires an analysis that consists of a variety of alternatives depending on the shortfall in estimated savings. In some cases where there is a large shortfall in savings, alternative savings strategies may require taking additional risk. The ultimate risk is that, given a low level of savings and a short-savings horizon, there may not be a viable savings strategy that can achieve an individual's retirement goals.

There are important components of the savings plan that will determine the probability of achieving retirement savings goals. The basic assumptions in designing a plan include:

1. Current savings value and liquidity;
2. Income now and in the future;
3. Assets and liabilities now and in the future;
4. Expected contributions to the savings plan;
5. Expected rate of return on the portfolio;
6. Required rate of return on the portfolio; and
7. Flexibility in the retirement date.

There are many difficulties in developing a plan since the future is unknown but setting out what appears to be a viable plan is one good way of setting the wheels in motion to achieve a viable retirement.

Another difficulty is recognizing that a plan must continue during retirement years and care must be taken that the plan allows for flexibility in investment decisions and plan distributions.

"Imagination is more important than knowledge."

Albert Einstein

Market Commentary

Among savings plan components, the rate of return on investment can make or break a plan. One tradeoff is short-term price volatility for long-term growth. One advisor has emphasized this tradeoff by indicating a shortfall in savings can be "brutal" in retirement. Further complicating matters are reactions to short-term price volatility and the impact such decisions can have on long-term returns. These decisions could force reconsideration of the plan resulting in hard choices to catch up from errant knee jerk reactions to market events. In other words, don't get off the train.

The U.S.'s current economic expansion is in its 107 month, the second longest in history since tracking the data began 164 years ago.

(source: National Bureau of Economic Research)

August 1, 2018

Market Musings

Victoria Capital Management, Inc.

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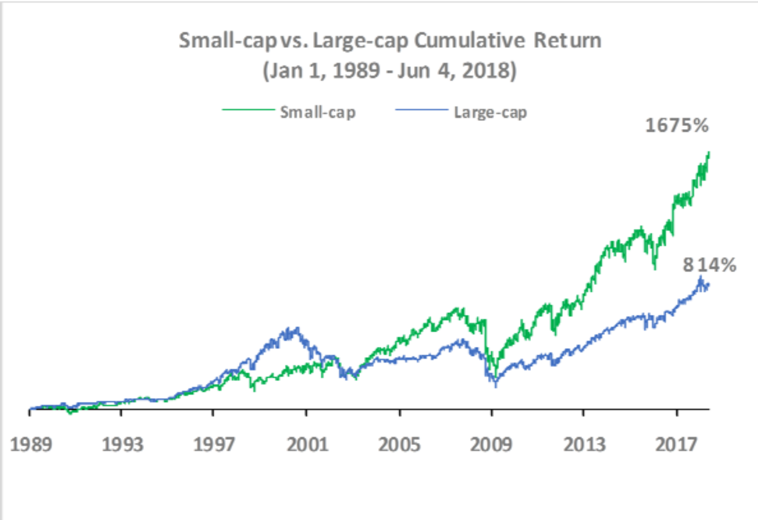
VOL. 1, ISSUE 3

Returns of small-cap companies compared to their larger brethren, as described by the S&P 600 small-cap index and the S&P 100 large-cap index, (shown right) is substantially larger over time. From 1989 to June 4, 2018, small-caps out-performed large-caps by 105.75% or 2.71% annually.



It's a Small World

Academic research and historical data show that small-cap stocks, companies with a market capitalization between $300 million and $2 billion, have outperformed larger companies and produced greater total returns over time. While there isn't consensus as to why this phenomenon exists, there are a few theories that attempt to explain the outperformance. Some of the arguments include the higher risk associated with small companies, the lack of coverage by analysts, the inability of large institutions to invest and the growth available to smaller companies. Another argument backing small-cap stocks' historical outperformance is that there are regularly new companies in which to invest as small companies grow, provide a return and move out of the small-cap universe.

Another important thing to keep in mind is that small-cap stocks do not always outperform. There are certain environments in which smaller companies can thrive and many of the economic aspects currently occurring may favor small companies. A few examples of conditions that favor small-caps are tax reform, regulation cuts and the recent tariff / trade war talks. To explain these topics it is important to understand that many small companies derive a substantial portion of their sales within the U.S.; that makes tax reform more beneficial to these companies than those generating profits globally. Furthermore, as tariffs and trade war talk effect international companies, those operating mainly in the U.S. will not see as dramatic an effect on their earnings. Finally, cutting regulation is generally good for all businesses. However, when considering compliance a fixed cost, larger businesses can sustain during periods with a high regulatory burden. As this regulatory burden decreases, small companies can compete and grow, and reap substantial benefits to their bottom line.

"The first stocks to double in a bull market will usually double again."

Michael L. Burke

Market Commentary

Over the last decade we have witnessed the rise in popularity of systematic rebalancing. With the enormous increase in the number of lifecycle portfolios and target-date funds the problem is growing. In most cases these funds contain a rebalancing clause: a commitment to rebalance a portfolio to a pre-set asset mix on either a quarterly or annual basis.

The proliferation of rebalancing actions has created the potential for a recurring market-moving event. The only precondition is a calendar quarter in which asset classes show a divergence in performance. When this occurs, the stage is set at the beginning of the following quarter for a major rebalancing "event."

For the first time since 2006, when no U.S. banks failed, there were no banks that failed during the first 5 months of 2018. Since 2007, however, 48 banks a year have failed, 531 in total. (source: FDIC)

Market Musings represents the views and opinions of VCM and does not constitute investment advice, nor should it be considered predictive of any future market performance. Data is from what we believe to be reliable sources, but cannot be guaranteed.

Victoria Capital Management, Inc.

Market Musings

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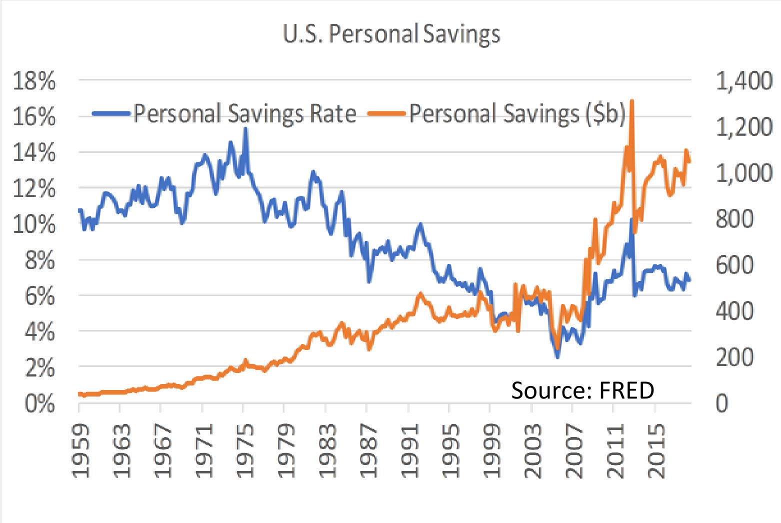
VOL. 1, ISSUE 4

The chart shows that the savings rate of U.S. households has fallen during the past five decades to 6.8%, but the value of those savings is near all-time highs at $1.05 trillion - thus increasing the net worth of households and non-profits to an all-time high over $100 trillion!



"There's nothing wrong with cash. It gives you time to think. "

Robert Prechter, Jr.

Market Commentary

As the market continues to hit new highs, many naysayers are being forced to buy or be left in the dust. You only have to consider what happened in previous instances when the S&P 500 (SPX) broke out above previous upside consolidation patterns.

When the SPX broke out of the 14-month upside consolidation in 2016, it gained~35%. This move was reminiscent of the upside consolidation between 1994 and 1995 when, after the breakout, the SPX gained some 40%!

Just watch out for triple-witching in September!

Larger Investors, Fewer Investments

Institutional ownership consists of large entities that manage funds on another's behalf. Examples include mutual funds, pensions, foundations, investment managers, insurance companies and endowments. Because many of these institutions are relatively large, they make up a good portion of public equity positions and trades. Furthermore, the composition of public equity holders has changed over time; with institutional ownership doubling its share of the equity market during the last decade of the 20th century. In fact, it is estimated that institutions currently hold approximately 80% of outstanding equities.

While institutional ownership was been growing, the number of public market equities has decreased by more than half; from more than 7,500 in 1997 to fewer than 3,700 in 2017. This shrinkage is due to several reasons, including increased regulation and a low interest rate environment. For example, the 2002 Sarbanes-Oxley act added to the reporting and liability burdens of public managers and during a low interest rate environment, companies are more likely to use the debt market to raise capital than through an initial public offering. As the number of available public equities continues to decrease, crowded trades can be more prevalent as the amount of capital committed to a particular security or strategy increases.

Market participants have tried to identify crowded trades using several indicators or formulas. One such useful measure of crowdedness is asset centrality; which is meant to identify assets with relatively higher volatility and assets that are more connected to each other. This equation generally identifies crowded trades because it measures volatility and connectivity, which are expected to increase when substantial capital is deployed toward a security. Crowded trades have both benefits and costs. However, understanding if the crowded trade is causing inflationary or deflationary pressure on a security is a much more important factor.

During retirement, "out-of-pocket" health care costs cost the average American household $197,000. This amount DOES NOT include the cost of any nursing home care costs (source: Webb & Zhivan).

October 3, 2018

Victoria Capital Management, Inc.

Market Musings

A newsletter brought to you by Victoria Capital Management, Inc.

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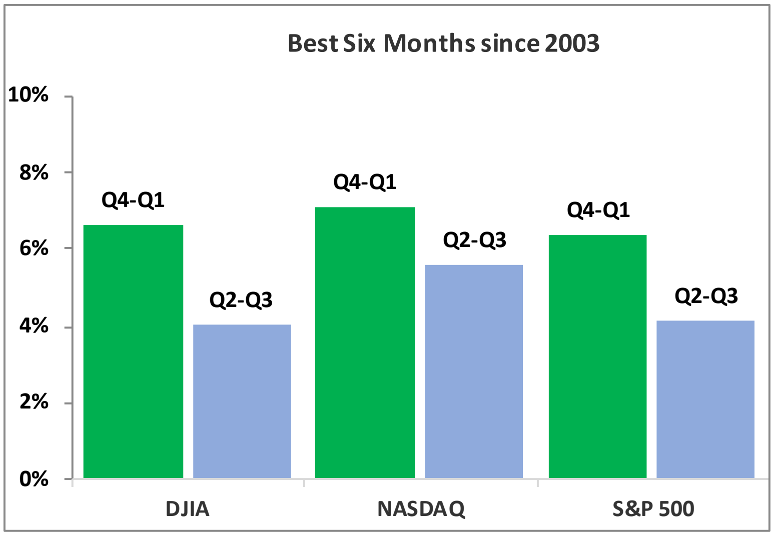
**The chart to the right demonstrates that the "Best Six Months" for being invested in the S&P 500 index is the fourth and first quarters of each year.
Even though we don't know what will happen this year, history tells us that this phenomenon could likely occur again.**



"Better do a little well, than a great deal badly."

Socrates

Fourth-Quarter Stock Market Magic

According to the Stock Trader's Almanac: Examining market performance on a quarterly basis reveals several intriguing and helpful patterns. Fourth-quarter market gains have been magical, providing the greatest and most consistent gains over the years. First-quarter performance runs a respectable second meaning that the beginning of October marks the "Best Six Months" of the year. And after record market gains in snarky September, maybe the best is yet to come!

Typically, positive market psychology hits a fever pitch as the holiday season approaches, and does not begin to wane until Spring. Professionals drive the market higher as they make portfolio adjustments to maximize year-end numbers. Bonuses are paid and invested around the turn of the year.

Moreover, presidential election years tend to produce high drama and frenetic campaigns. Can this be the reason for the bullishness that seems to occur in the five days before and three days after midterm Congressional elections? We don't think so. With so much negativity around, maybe investors are looking for a change for the better and unleashing their inner bullishness!

The market's sweet spot in the four-year cycle begins in the fourth quarter of the midterm year. The best two-quarter span runs from the fourth quarter of the midterms year through the first quarter of the pre-election year, averaging 14.6% for the Dow, 15.4% for the S&P 500, and an amazing 22% for NASDAQ.

Market Commentary

After a booming 2017 when the S&P 500 index rose 21.8%, more than twice its historical rate of return, the gain so far this year through September 30th of this year has been 10.6%. History also tells us that the fourth quarter is usually a good quarter for the stock market so we could see another above-average growth year for the S&P 500. Looking a lot better this year is the S&P 600 SmallCap index that is up 18.3%. Comparing these positive returns with mostly negative returns for bonds and foreign stock markets indicates that diversification can reduce volatility.

In the first half of 2018, capital spending by S&P 500 companies totaled $341 billion—up 19.2% from the first half of 2017. If companies maintain the current pace, it would mark the fastest growth in capital spending in at least 25 years.
(Source: Goldman Sachs)

November 1, 2018

Market Musings

A newsletter brought to you by Victoria Capital Management, Inc.

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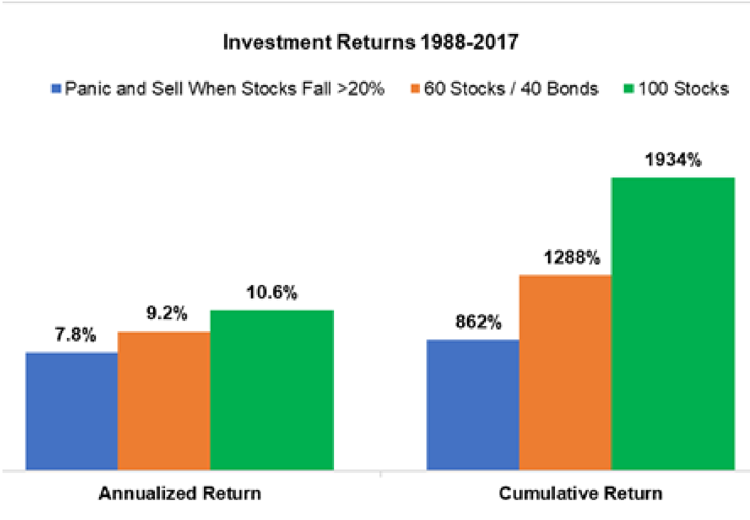
The chart to the right shows the annualized and cumulative returns for three portfolios from 1988—2017. Note the dramatic difference in returns from the portfolio that sold during substantial equity market declines compared to the buy and hold portfolios.

(Source: AAII)



A Bull Market is a Bull Market

Recognize that this bull market in stocks is the longest in history; from a low point of 6,547 in March of 2009 to a September high of 26,828. The market, as measured by the Dow Jones Industrial Average, rallied some 20,281 points - equal to a 310% gain. During this nine-year market advance, we have experienced four declines of 10% or greater. The current market decline from October 3rd through October 24th is 8.4%, the second large decline in 2018. The first decline was called the "February Flop" and was 11.6% to the downside, all of which was made back by September 20th.

Coinciding with the 8.4% decline, which has been coined the "Powell Plummet," was the announcement by three large hedge funds (Tourbillion Capital Partners, Criterion and Highfields) that they were in the process of liquidating and returning capital to shareholders. When a sudden avalanche of stock sales (such as those generated by liquidations) occurs there is likely an overall market decline; with the biggest stock declines in those stocks being liquidated and associated selling from "frightened" investors. Since many stock market speculators use margin to leverage their portfolios, higher interest rates coupled with margin calls could have triggered additional selling. According to the eVestment Hedge Fund Asset Flow report, almost $15 billion of assets were redeemed from hedge funds in September alone leaving third quarter net flows in the red. These redemptions continued in October and is likely the result of another under-performing year for hedge funds.

The bottom line is that the trend is your friend. Investing during turbulent stock market times takes a strong stomach and a disciplined process. When the fundamentals say, "Bull Market", short-term declines should not scare investors out of their positions. Instead, investors need to understand how much value is lost when they overreact and sell. Stay the course until the upward trend reverses and the market confirms an end to the bull run.

"They say you never grow poor taking profits. No, you don't. But neither do you grow rich taking a four-point profit in a bull market. "

— Jesse Lauriston Livermore

Market Commentary

Could 2018 witness the best Thanksgiving ever? According to the Federal Reserve Bank of St. Louis, real median household income for 2017 ($61,372) is the highest ever recorded in the U.S.—besting the previous record ($60,309) set just the year before in 2016. Before that year, the peak was $60,062 set in 1999—some 19 years ago.

Additionally, consumer confidence has surged since November 2016. With increased optimism naturally comes a desire to increase spending and/or investment.

Watch Black Friday!

Personal consumption by consumers represents 70% of the US economy and just 39% of the Chinese economy.

(Source: Business Week)

December 1, 2018

Capital Management, Inc.

Market Musings

A newsletter brought to you by Victoria Capital Management, Inc.

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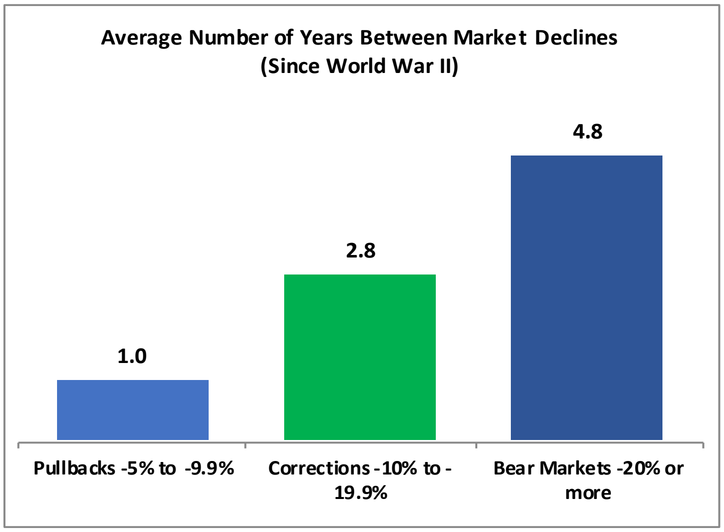
The chart to the right shows the average number of years between stock market declines. According to history, it will take nearly three years for the next correction to take place after the October correction in the U.S. stock market.

Source: (AAII & S&P Dow Jones Indices)



Get on the Train

Some say that equity investors take the escalator up only to take the elevator down—an interesting way to look at the way stock prices move and an allegory that leaves investors nervous about future elevator rides down. However, one thing that often is overlooked in this allegory is that when the elevator does come down, an opportunity opens for those waiting to ride the escalator up and a more appealing "place" to get on. Another important aspect of this example is that the escalator ride may be slow and boring, but pays handsomely, with the average rolling annual return from US equities above 12% since 1970.

So, what is it about that scary elevator that keeps investors from getting on knowing that the ride is profitable? Recency bias. Most investors, whether correct or not, rely on their "gut" to make decisions. When a recent event such as a large sell-off occurs, the brain's natural function is to be more biased towards this event because it occurred more recently than other events. Therefore, even though most people know that the stock market is generally a good place to allocate capital, investors miss opportunities to "get on the train" when short-term volatility creates anxiety. Frightened by headlines and market gyrations, the brain goes foggy, vision is impaired and bodily functions seize up—indications of being "scared to death." Fear keeps investors out of the market. After a while, the brain eventually forgets, or is less stunned, and the investor gets into the market at new highs. As professional investors we know that timing the market does not work and that avoiding a "gut" reaction is key to successful investing. We also know that returns over short periods of time have been typically unpredictable. But markets tend to become less volatile when the time horizon is five years or more using rolling returns. Keep focused on the long-term plan and look at short-term swings for what they typically are, short-term swings.

"The time to buy is when blood is running in the streets."

Baron Nathan Rothschild

Market Commentary

Never count the Fed out. Market commentators spend hours discussing the impact of a ¼% increase in the Fed funds rate. Yet, at the end of November when Jerome Powell hinted that the Fed is taking a slightly dovish attitude about raising interest rates, the stock market, as measured by the DJIA, surged by 618 points. The surge in consumer spending on "Black Friday" of a record $7.8 billion also shined a brighter light on continued economic growth. At the same time, oil prices appeared to stabilize around $50 and President Trump and Chinese President Xi entered the G20 meeting hoping to get a trade deal ironed out. The outlook is improving!

More than 10,400 people are estimated to turn 65 every day in 2019, with the number rising every year for the next ten until 2029, when 11,500 people are expected to turn 65 each day.

(Source: Gov't Accountability Office)