MARKET MONITOR

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The Rules of Portfolio Management Don't Change in Bear Markets

BY: MICHAEL ALEXENKO, CFA

There's nothing like a global pandemic to make you question everything you once believed to be indisputably true. The last crisis that compares in magnitude to Covid-19 was the 2008 financial debacle. Who would have thought that in a little more than a decade we'd see free market/small government fans once again renouncing their belief in market-based solutions and spend so much taxpayer money it would make Karl Marx blush?

The financial whoopin' that we've all gotten a taste of was suffered the worst by no other than the Oracle of Omaha himself: Warren Buffett. When you see the legendary investor raise the white flag, it's easy for everyone to get more than a little rattled by a natural disaster depression. Yes, that's correct – a depression. When you have economic activity contract at a pace we are currently seeing, then it is a depression. You don't need economic statistics to tell you that you're in a depression, a few weeks ago all you needed to do is go into any grocery store, Target or Walmart and it was like being transported back to 1967 Soviet Union; the shelves were bare.

The good news is that they are getting better. Maybe a new economic metric dubbed as the toilet paper indicator (TPI) will be adopted because of the pandemic? Once there are normal supplies of toilet paper back on the shelves, we'll all know the worst is behind us. The TPI isn't flashing the green light yet.

We are all equipped with the best weapons against an assault like Covid-19: Diversification and asset allocation.

All joking aside, the reaction to the nightmare being experienced in the airlines by Warren Buffett may be a fascinating future case study for either chronicling the last great sly maneuver of an aging wizard, or an example of what happens when you don't know when it's time to put a bow on a storied career. I believe it will be the latter.

Buffett had sworn off the airlines long ago. He once stated that, "if someone had shot down the Wright brothers' plane, they would have saved investors billions of dollars." Maybe he wanted to prove his point so that's why he decided to invest over $9 billion in four major airlines in late 2019, only to now bail out at a price point that you have to believe to be near a generational low. As stated, only time will tell whether Buffett knew when it was time to cut losses, or if he violated the elementary rule committed by the amateurs he professes to mentor by buying high and selling low.

Buffett's problems might run deeper than just his reaction to the pandemic. His results since the financial crisis have been poor at best. Since 2008, he has woefully underperformed the S&P 500 which is the benchmark he's boasted about beating since 1965. What's caused this to happen?

Investments in financial companies like Wells Fargo and the floundering Kraft-Heinz, along with carrying excessive amounts of cash in a year when the market earns 31.5% might explain why a great investor gets forced into more errors.

Motivated to make up for past losses or underperformance, investors can get themselves sidetracked from the rules that they once knew to be true. Especially if they feel like they are running out of time.
Asset allocation and diversification remain the cornerstones of wise portfolio management. It doesn't matter whether you're in a recession, depression or stagflation, a portfolio needs to be constructed with the foundation of asset allocation and diversification. We are all equipped with the best weapons against an assault like Covid-19: Diversification and asset allocation.
It's understandable that we become tempted to look for new methods to combat the financial causalities we sustain during an ugly bear market, but the laws of investing are not repealed in down markets, rather they are validated.
There are two basic feelings that pull at our financial heartstrings at times like these that conflict with one another:

1. We have the desire to stop the bleeding, which is accomplished by raising cash.
2. We have a curiosity about which investments will deliver the greatest profits.

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Implement Proven Portfolio Management Techniques

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Picking a winner is a more difficult task to execute, but both have the potential for sizable gains or losses.

Consider this headline from a May 15th Wealth Advisor article **-** *Vacation real-estate markets are 'toast' because of the pandemic as Airbnb owners rush to offload their homes, Redfin CEO says.* Depending upon your point of view or your particular situation this headline might either scare you to death or pique your interest. If you're in the market for vacation property this might be the best news you've read in a while, or if you own a vacation home that you have on the market you feel like Covid-19 just gave you another gut punch.

Buffett was a brilliant value investor, but this is another reason for his lousy twelve-year run. Value as an investment style has been routed by growth stocks for the last ten years but periods like that happen as it did from 1990-2000. Value investing is the ultimate buy low, sell high discipline and that's why it's so surprising to hear Buffett selling. Maybe he'll have the last laugh and he's waiting to buy until after the final round of capitulatory selling? The more likely scenario is that value stocks might be due for their time in the sun and selling investments at depressed prices rarely works in your favor.

If you're a value investor you might want to start looking into vacation homes if you've had some thoughts about buying one. Likewise, when we implement proven portfolio management techniques, then we at times benefit from when the market forces us to buy low. If long term investors weren't buying in March/ April 2020 then maybe they'll also be having the last laugh with Warren or having regrets about what they should have done.

Market Snapshot:

Market Has and Will Continue to Anticipate Strength of Economic Recovery

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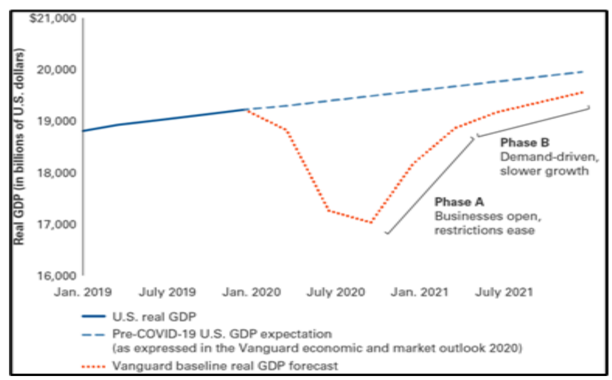
Although there is a great deal of interest in studying where we've been or what has happened, the time used to do so has little value unless we're able to use the analysis to help us figure out where we're going. That's why for long term investors the current crisis should be viewed as an opportunity rather than a calamity from which there is no recovery. We have enough history to know that markets do recover and if your time horizon is long enough you will benefit from the recovery. There are countless opinions available about how soon our economy and markets will begin to recover from Covid-19and at what speed. The markets as they usually do, have already answered part of this question and the view expressed and depicted in the chart created by the folks at Vanguard might offer as good of a prognostication as any other.

Possible Path for Future GDP Growth



Source: Vanguard

You'll notice that Vanguard has our economy continuing a bottoming phase until late July and then it has a two phase recovery thereafter. Keep in mind the market will anticipate economic movement about three to six months in advance which is what it is doing now. It's possible that the market will mirror a return pattern similar to the economic pattern in which case we may have already passed our "V" shape surge and we'll have a slower path from here with some periodic trouble spots. Or the question may come down to something as simple as, "Do you think the market will be higher or lower a year from now?" I vote higher!

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1576 N. FIFTH AVENUE SAINT CHARLES, IL 60174

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