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Investing INSIGHTS from Evanston Advisors

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Happy New Year! 2017 flew by didn't it? This time a year ago we had just elected a new President—an untried, political novice with grand plans and no Washington connections with which to get those plans accomplished. He was quickly tested by a failure to get Obamacare repealed, hurricane devastation, strife within the administration, and tensions with North Korea (among other nations). Whereas Obama had "a pen and a phone", Trump has a Twitter account… and he uses it, much to the chagrin of just about everyone. However, he did manage to convince the markets that his plans to be "business friendly" were more than just campaign posturing and rhetoric. And the market loved it.

"In other words, the market was not just positive last year, it was decidedly so."

S&P 500, Value, and Growth Year 2017

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The chart on the front page shows the closing value of the S&P 500 each day of 2017. I've added two additional lines: the 50-day moving average, and the 200-day moving average.

What about "moving averages"

I've discussed moving averages in the past, but here's a brief refresher: a moving average is the average of the closing values of the prior x days. In our chart above, x is alternately 50 and 200 days. At the end of each trading day, a new day's closing value is added into the average, and the oldest day drops off, thereby the average is "moving" through time. A moving average gives us an indication of where the market is versus a trend. Typically, the 50- and 200-day time periods are used for intermediate and longer-term trends, respectively.

When the market line is above the 50-day moving average line, it is said to be in a positive intermediate trend. Crossing below suggests that the trend has turned negative. Similar inference can be made with the 200-day moving average.

Recent trends in moving averages

Over the past 20 years, the market line has been below the 50-day line about 34% of the time on a calendar year basis. In other words, the market spends about 1/3 of the typical year in an intermediate-term negative trend. Moreover, on average it spends about 28% of the year below the 200-day line (this typically occurs during a correction).

In 2017, the market spent a mere 14 days below the 50-day line. At no point in the past 20 years did the intermediate-term trend stay so positive for an entire year. The market did not even come close to falling below the 200-day moving average last year. While this is not quite as impressive (intermediate trends shift far more frequently than longer trends), this phenomenon only occurred one other time in the past 20 years, in calendar year 2013. In other words, the market was not just positive last year, it was decidedly so.

The rising tide more or less lifted all boats, though not to the same degree. In prior letters last year I discussed how the Growth orientation was outperforming Value. This was true for much of the year, but as summer ended things started to shift. In September, Value returned over twice what Growth did. October swung back toward Growth, and then the final two months went strongly Value again.

Managing portfolios is different

I am often asked: "why did you buy ABC Co., when it's been such a loser, and not more of DEF Co., which has been such a winner?" The reason is simple: we are managing a portfolio, which is different than simply purchasing a collection of interesting securities. In portfolio management, we are tasked with a multitude of things to pay attention to at once. These include but are not limited to potential capital return, potential income generated, tax profile, risk profile, and correlation. If we only had to worry about the first three, the task of investing would be much simpler. The last two items however, is where the magic happens.

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Risk and correlation

Risk and correlation go hand-in-hand more often than not. Correlation speaks to the manner in which items behave related to each other (think co- and relation). Two risky assets that are uncorrelated have a much lower risk profile in combination than either does individually. Conversely, risk is not mitigated at all by purchasing an asset that is perfectly correlated to an asset you already own. For example, let's pretend you owned stock in Facebook at the beginning of 2017. You want to reduce risk in your portfolio, so you look at stocks you could purchase to diversify. Alphabet (Google) seems like a good company, and hey, they aren't in the same industry, so I'm diversifying, right? Well… not really. Despite them being in different industries, they are very highly correlated, meaning the stock prices move in similar manner (for much of last year it was almost in lockstep). That's great when they both are going up, but the idea of diversification is risk reduction, not increased return.

It's about longterm expectations

In portfolio management, we fully expect that some securities will decline, even in an up market. We are interested in long-term ownership (that's the tax profile part I mentioned earlier) of good companies (the capital return and income part), are not over-priced (value orientation, risk reduction), that, when viewed as a portfolio are not overly correlated. Our expectations for companies in our portfolio are based on the long-term, and we are cognizant there may be stumbles along the way. However, because we are diversified, while one stumbles, others gain. In a portfolio with strong companies but poor diversification, when one stumbles, the whole portfolio is more likely to suffer.

Happy to be wrong

And now we come to the part where I once again get to say, "I was wrong". This is two years running by the way, and in each case, I couldn't be happier to have been wrong. By the end of the second quarter of last year I had revised my return expectation for the stock market from double digits down to high single digits. This was based on the fact that the market had gone quite some time without a correction, and was at valuations that had not been seen since the dot-com bubble of the late 1990s. The correction still has not materialized, and gains in the S&P 500 were far stronger than most expected. The gains were, however, rather concentrated - almost 1/3 of the gain in the S&P 500 last year can be attributed to five companies: Alphabet (Google), Apple, Microsoft, Amazon, and Facebook.

Is a correction due?

So where do we go from here? I am still firmly in the camp that the market is frothy and well overdue for a correction. That said, the new tax bill has resulted in a number of publicly traded companies stating that they are going to give raises and bonuses to large numbers of employees. In addition, beginning in February workers should see an increase in their take-home pay as the lower tax withholding levels kick in. On the corporate side, reduced corporate taxes will increase after-tax profitability and potentially spur growth. Also, the repatriation of overseas profits should see a large influx of cash coming back into the United States. More money in consumers' pockets and more cash in circulation both bode well for the economy and the stock market.

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What about the Fed?

I believe that in the absence of any economic or geopolitical crisis, the Fed will continue to raise rates this year. The pace at which rates are raised may pick up if the economy starts to heat up too quickly. In general, increasing rates and inflation are typically detrimental to the stock market.

A final word

In short, I believe we may see a correction, followed by new highs, but my view through the crystal ball is pretty hazy on the timing because of the competing factors of strong corporate growth prospects and overvalued equities coupled with pressure from rising interest rates and the potential for inflation.

If you have any questions, please feel free to contact us.

Nathan K. Snodgrass, CFA, CFP®
Chief Investment Officer

EvanstonAdvisors

Evanston Advisors
1300 E Woodfield Road
Schaumburg IL 60173

847 397 3000
evanstonadvisors.com

Confidence for your future.