November 15, 2016

“I am as mad as hell, and I’m not going to take this anymore.” Network, 1976

One of the first things that came to mind the morning of November 9, 2016 was the quote above. While I did not recall that it came from a 40 year old movie, the phrase effectively captures the sentiment of many voters in last week’s election. Furthermore, I think it is interesting to note that 1976 was about the time that many working families, in what came to be known as the Rust Belt, began to believe that their lives were becoming more challenging and their future less certain. There can be no doubt that President-elect Trump effectively tapped into the understandable angst of many voters who are increasingly feeling left behind and frustrated. Indeed while once, most Americans expressed confidence that their children would enjoy an increased standard of living; today a majority of Americans no longer share that view.

With this backdrop, it is quite clear that 2016 constitutes an important ‘change election’.

“The Times They Are a-Changin’” – January, 1964 by Nobel Laureate, Bob Dylan

I recall enjoying Dylan’s songs from ‘back in the day’ as a teenager in Youngstown, Ohio and I have been a fan of his ever since. While some no doubt scoff at the notion that Dylan will soon be a Nobel Laureate, I think he is one of the geniuses of our time. Moreover, when I reflect on how the world has changed over the past 50, 40, 30 years, I am struck by both the magnitude of economic improvement for many people here and abroad, but also by how little improvement and actual devastation many communities, industries and the people tied to those places and segments continue to experience. We live in an increasingly dynamic world with an enhanced divergence among those who are fortune and others who are much less so. These ever-evolving conditions have important implications for investors.

In the aggregate, I believe man has reason (but by no means certainty) to expect that things will continue to evolve in a favorable fashion. However, it is abundantly clear that not all people, segments, regions, industries, etc. have been doing well over the past 15, 25 or even 40 years. Some large segments of our economy and the good people tied to them have encountered disruption that will be hard to overcome. Sadly, I don’t have a prescription for how we can fix what many understandably deem to be broken. Nevertheless, I do want to offer thoughts on two important questions. First, how should investors allocate their capital? In addition, how should we seek to implement changes along the way?

While there are myriad ways to be successful and sensible with respect to investing, I believe some of the most effective strategies are underappreciated and underutilized by many investors. One school of thought with respect to successful investing suggests confining one’s holdings to a finite number of businesses that you know and understand. I appreciate the appeal of concentrating one’s investments, but there are some important risks that are inherent in this approach. First, virtually all stocks go through periods of underperformance, and when they do, the resolve of even long-term oriented investors is challenged. Sometimes the tide changes such that former stalwarts turn into so-so businesses and stocks. Ideally investors want to identify and react before the long slide occurs. However, sometimes the perception of a diminished outlook proves temporary and the best course is to remain steadfastly committed. Mark Twain famously commented on reports of his death that, “The rumors of my demise have been greatly exaggerated.” In other words, decisions to stay the course or ‘cut bait’ can prove costly depending upon subsequent performance and the decision the investor makes. Another challenge lies in maintaining perspective amidst notable changes elsewhere. For example, even die-hard ‘value’ investors had a tough time refraining from investing in ‘tech and telecom’ companies in the late 1990s. Capitulation by buying near the top or selling near the bottom of any cycle can also be hard to resist but also costly. We believe an effective means to lessen (not eliminate risk) is to broadly diversify.
Home Bias is the Norm, but is it Sensible?

It is not uncommon for U.S. residents to hold the vast majority of the equity holdings in U.S. companies. Over the years I have worked with clients who steadfastly express little, if any, appetite for owning ‘foreign’ stocks. There are two primary reasons, namely 1) the desire to invest in companies that are familiar and 2) the belief that ‘the U.S. is best’ so it simply does not make sense to invest elsewhere. To be clear, I believe that investors can do well if they confine their ownership to U.S. only companies. However, history reveals (and I have shared the related data) that there are extended periods of time when the returns for the U.S. market are well below those of other countries and regions. Sadly toward the latter portions of extended runs (or even after the fact) many investors discover the benefits of international markets at what prove to be inopportune times. That said, as the table below reveals, a ‘home country’ bias is not unique to the U.S. investors as this preference is fairly typical.

There is no Place Like Home

<table>
<thead>
<tr>
<th></th>
<th>U.S.</th>
<th>Canada</th>
<th>U.K.</th>
<th>Australia</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global Index weight</td>
<td>50.9%</td>
<td>3.4%</td>
<td>7.2%</td>
<td>2.4%</td>
<td>7.2%</td>
</tr>
<tr>
<td>Investor holdings in domestic equities</td>
<td>79.1%</td>
<td>59.0%</td>
<td>26.3%</td>
<td>66.6%</td>
<td>55.2%</td>
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Sources: Vanguard, based on data from the IMF’s Coordinated Portfolio Investment Survey (2014), Barclays, Thomson reuters Datastream, and FactSet.

When you consider the fact that Canada’s economy and markets tend to be influenced a great deal by commodity prices (e.g. their economy and markets are far less diversified than ours), it strikes me as imprudent to invest the lion’s share of his/her wealth in Canadian stocks. Similarly, the Japanese stock market has lagged the returns for the U.S. and other major markets for nearly 30 years so a lack of diversification into other markets has been costly for Japan-centric investors. The alternative to owning highly concentrated, potentially ‘high octane’ portfolios is to diversify and then exercise patience. However, one reality I have often encountered over my career is the desire for many investors to try to time the transition around some particular occurrence (which may or may not unfold). One of our chief responsibilities is to help you understand and avoid some of the common behavioral biases that tend to hamper results over time.

“People seldom do what they believe in. They do what is convenient, then repent.” – Bob Dylan

In my experience, lots of investors ‘get it’ (the benefits of diversification); they just have trouble getting around to doing it. There are few absolute ‘rights and wrongs’ when it comes to investing. That said, I have seen several things that while understandable from a psychological perspective do not necessarily strike me as terribly prudent. For example for about two decades now, I have had the privilege of advising people who hold highly concentrated positions (e.g. well more than 20% of their wealth is in a single stock or perhaps well more than 50% of their liquid wealth is allocated into to just a single sector). More often than not, conversations reveal they know their stance entails considerable risk and many acknowledge the merit of diversifying. However, I often hear things like, “I want to sell XYZ, but not until the stock gets back to its all-time high”. That makes sense if you believe that the particular stock will for some reason go up say 30% while everything else you would want to own with the proceeds will somehow stay at or near today’s price. Importantly, we advocate exercising patience after one has adopted a properly diversified strategic allocation.
Over the course of my career, or even in the span of the last 20 or even 10 years, there have been developments that command attention. For instance, former behemoths like Citibank (C), Transocean (RIG), U.S. Steel (X) are shadows of their former selves, while companies that weren’t even conceived of like Netflix (NFLX), Facebook (FB) and other tech and biotech companies have emerged to become some of the best known and admired companies with ‘mega-cap’ stock market values. Clearly folks who have owned too much of the former and not enough of the latter have suffered financially and vice versa. Often recent past trends lead many of us to expect more of the same. However in our dynamic, ever ‘times they are a-changing’ world, new technologies emerge, consumer preferences change and sometimes beleaguered companies and industries come roaring back to life.

“It’s hard to speculate what tomorrow may bring.” – Bob Dylan

Diversification here and abroad, in sectors that are performing both well and poorly, among both large and small capitalization stocks and including both ‘growth’ and ‘value’ stocks can help reduce the volatility of the return stream. As we have frequently shared, diversification helps ensure that we have meaningful exposure to the segments and individual companies that prove to be the best companies and stocks in the future while at the same time helping to ensure that we are not excessively concentrated in segments and companies that disappoint. If you are interested in ‘swinging for the fences’ and ‘living on the edge’, by all means concentrate and hope for the best. However, if you share our view that the first priority is to help safeguard against the unacceptable outcomes that are truly part and parcel of every concentrated approach, then diversify with confidence. In doing so, you are taking a leap of faith and you are giving up some comfort of owning the familiar in favor of the ‘foreign’ but we believe this is the sensible approach to successfully navigate the unknown future. Indeed two more quotes from Bob Dylan seem appropriate. Specifically he said, “There is nothing so stable as change” (e.g. change is the constant), and “Yesterday’s just a memory, tomorrow is never what it’s supposed to be.”

As always, I hope this letter brings some comfort to you as we contemplate the unknowns that lie ahead. While it is too early to tell what changes lay ahead, I know that most of you, regardless of whom you voted for, want to see improvement in our economy, country and the lives of fellow citizens. We have little doubt that we will continue to see and face challenges, but we are optimistic that collectively those challenges will be addressed. Sadly this does not mean that the future for all people or all investors is bright. We have a long way to go before that is the case.

On the cusp of Thanksgiving, please know that we are grateful to have the opportunity to serve you and we sincerely appreciate the trust you have placed in us. We are committed to act in your interests to the very best of our ability. One of chief responsibilities is to help you adopt and adhere to a sensible plan that is tied to your particular goals and objectives. We share our perspective in our client letters in order to help you have the confidence to ‘stay the course’ and maintain discipline during the thick and thin market environments that likely lie ahead.

Happy Thanksgiving to you and all of your loved ones!

W. Richard Jones, CFA
Senior Vice President, Investments
When asked if “Life for our children’s generation will be better than it has been for us” fully 76 percent of respondents said they do not have such confidence. *The Washington Post*, August 12, 2014.

I first quoted Dylan in one of my client letters back in February, 2001. I have recopied the caption and the entire paragraph pertaining to that reference below –

**Bob Dylan – Market Strategist & Wall Street Visionary?**

There is considerable debate over the direction of the economy and interest rates over the short to intermediate term. One can make a plausible case that the decline in the economy and corporate profits is going to be greater than is generally perceived and that the financial markets are ‘not yet out of the woods”. Personally, I am inclined to agree with the strategists on Wall Street who believe that easing by the Federal Reserve (lower rates & increased liquidity) combined with the likelihood of tax relief will help ensure that any downturn in the economy is likely to be rather short lived and mild. There is little doubt that future earnings disappointments lie ahead, but the markets may already be reflecting most of the bad news. In my judgment, valuations (price to earnings ratios) for many fundamentally sound companies are reasonable (not compelling) and the long-term outlook for the economy and corporate earnings is favorable. Furthermore, today’s concerns pale in comparison with prior challenges including World War II, the Cold War and the stagflation of the 1970s. The economy and financial markets showed their resilience in prior periods and I am sure concern about interest rates and near term earnings will dissipate over time. Therefore, I believe long-term investors who remain committed to high quality mutual funds and individual securities (stocks and bonds) will be rewarded. In the words of Bob Dylan, “What looks large from a distance, up close ain’t never that big.”

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