Those who don’t remember the past are condemned to repeat it. – George Santayana

As I have shared before, we truly do not know where the economy and markets are headed in the short or even intermediate term. Nevertheless, we think it is likely that we will continue to experience growth over the long term. That said we do think it is a good idea to consider the range of nearer-term outcomes in the context of a much longer-term history. Indeed history provides a means to avoid the natural tendency to merely ‘live in the moment’ without perspective about how investors can survive periods of euphoria and extreme pessimism that can derail many investors. To be clear, we believe the range of outcomes in the near to intermediate term is always large. However that doesn’t mean we are forecasting a large price change. *Rather it means we think that a sharp move down or up is always a possibility and therefore investors should mentally prepare for those possible outcomes and ask whether they feel comfortable with their current positioning.*

As you might reasonably presume, we spend a significant amount of time trying to stay abreast of current events here and abroad and attempting to discern what may lie ahead. Indeed we think it would be irresponsible to do otherwise. Nevertheless we are always mindful of the common tendency (which we are not immune from) to ‘know’ what the future holds, because that often moves investors away from sensible plans to achieve their life goals. The other risk that comes from knowing what will happen is it will cause us to embrace data and opinions that conform to our views and ignore information that calls our views into question.

**We have met the enemy and he is us.** – Walt Kelly

Wikipedia states that “Cognitive dissonance (CD) is the mental discomfort (psychological stress) experienced by a person who simultaneously holds two or more contradictory beliefs, ideas, or values.” Please see the link to Wikipedia here – [https://en.wikipedia.org/wiki/Cognitive_dissonance](https://en.wikipedia.org/wiki/Cognitive_dissonance) for more on this subject.

When we live in the moment of the news cycle for economy, markets or politics it can be easy to become either very optimistic or concerned depending upon one’s point of view on current events. It is natural to make sense of events and then develop a view of what will happen next. I find that as an investor, I am actively grappling with CD. On the one hand as stated above, I think there is ample reason to believe that the long-term prospects for the economy and markets are favorable. In the short-to-intermediate term, I believe the direction of the markets is largely unknowable and therefore it is impossible to easily predict near-term movements. Furthermore, I also believe that most of us cope with cognitive dissonance by consciously or sub-consciously seeking out data, news and opinions that conform with our view while avoiding or dismissing information that lies in opposition. I believe this is a challenge that all of us face, and like so many other things related to investing, *how readily we seek out the potential ‘other side of the argument coin’ (e.g. what can go wrong) is really important (but not very easy).*
Are mega trends and reversals easily identifiable? We don’t think so.

There are some who believe the markets foretell what they will do. Technical analysis is premised on the notion that you can use prior price history to [reliably] forecast the magnitude and duration of the market’s future direction. Therefore, proponents of this approach believe the future is all written on the charts (or perhaps in the stars) if you just know how to read them. While I know there have been extended periods of favorable (e.g. bull) markets and vice versa, I don’t believe that means we can confidently predict the magnitude or duration of future market cycles. Rather while I think it is important to have strong familiarity with market history (in order to have context and perspective about how much prices can move), I believe it imperative to recognize that each era has important differences that also need to be considered. For example there are some similarities between today’s market environment and the late ‘90s tech-fueled market. There are also important differences in the underlying darlings of that period compared to today. Specifically for the most part the mega cap darlings of today tend to have much greater sales, earnings, and cash flow today per $1.00 of market cap than in the prior period. Beyond those particulars there are other important considerations like, inflation, the level of interest rates, Federal Reserve policy, relative currency strength, the balance sheet of consumers, measures of productivity, tax rates here and abroad, the degree of geo-political harmony or discord that all can impact the duration of economic cycles and stock market cycles. To think otherwise strikes us as potentially dangerous thinking.

As you know, we advocate broadly diversifying capital across all of the major segments of the markets (e.g. large, mid and small cap stocks, U.S. and international, developed world and emerging markets). We do this because we believe this is a prudent way to pursue risk reduction against a backdrop of an unknown future. Indeed our experience and empirical data have taught us there are other advantages to our approach. For instance, in the Wall Street Journal on June 16, 2017 Jason Zweig wrote about how a handful of ‘superstocks’ have accounted for the lion’s share of the markets gains since 1926. The question ‘how does one go about ensuring ownership of these most rewarding stocks?’ is a challenge for both individual and institutional investors alike. Citing research on this important subject Mr. Zweig wrote – “Traditional advice on diversification says you should own at least 15 to 30 stocks in order to reduce your risk. But, in a sequel research paper, Professor Bessembinder found that a portfolio of 25 stocks still had a 64% chance of underperforming the total market. Superstocks are so scarce that you need to hold hundreds, even thousands of companies to be near certain of matching the market’s return.” Because of CD and myriad other factors, our experience has been that many investors either tend to hold on to stocks even after there is substantial evidence that the business’ outlook has fundamentally deteriorated or in the alternative, they can lose patience and sell too quickly due to price declines that prove temporary. In other words, fortunes have been lost holding on to many former darlings that never recover their mojo and/or by failing to have sufficient long-term ownership of the companies, sectors or market segments that really ‘ring the bell’ over the long term. We believe broad ownership can help alleviate the real pressure to act (or refuse to act) that can cause both buyers’ and sellers’ remorse.

We’ve come a long way and likely we will move ahead from here

When I think about developments over the past 10, 20 or 40+ years, I marvel at how much progress has been made. Indeed I remain confident that there will be favorable developments in the future such that global wealth will continue to increase over time. On the other hand, I also recognize that many former titans that dominated their respective industries have either lost their mojo or the industries themselves have been largely eclipsed by new entrants, new preferences, etc. While developments are easy to see in hindsight, it is well to remember that was not the case beforehand (or the stock prices would not have risen and then fallen so much).
Audacious – An apt description of those who forged our new nation

A few weeks ago, I read a favorable review of David McCullough’s newest book, The American Spirit: Who We Are and What We Stand For. For the most part, it is a collection of various commencement addresses and other speeches he has made over the past 20+ years and I found each to be interesting and indeed comforting. He eloquently brings history alive so that we can see that many of today’s challenges pale in comparison to those that our forefather’s faced in their day. I found these essays to be so stimulating that I then read his books, 1776 and John Adams.

Without question our nation and indeed the world faces very significant and potentially destabilizing challenges today. But history clearly shows that this is often the norm and yet collectively we have thus far been able to adapt and overcome serious threats to our way of life. Indeed I found Mr. McCullough’s book John Adams to be particularly compelling as the events that led up to The Declaration of Independence, the Revolutionary War itself and then the years and decades that followed were fraught with uncertainties and hardships ranging from health epidemics, to potentially devastating hostilities with strong nations and truly intense infighting among strong willed adversaries in the U.S. who had very different views about how we should move forward. Imagine for instance trying to implement foreign policy when there were often 3 and 4 month delays in communications between the President, Congress and our diplomats in France, England and elsewhere. Imagine that today as then, that Donald Trump is our president and Hillary Clinton as the number two vote getter is Vice President. Further imagine having one’s cabinet openly hostile to your policies and very prone to taking its grievances directly to a press that strikes me as more partisan and willing to go on the attack as they are today. That pretty well characterizes the environment that John Adams ‘enjoyed’ as our second president.

Let us know if you think we need to talk

While we don’t know what the near term direction of the markets will be, we remain confident that mankind will continue to make progress at least in terms of aggregate global and U.S. wealth. Against this favorable long-term backdrop we remain vigilant with respect to guarding against linear thinking (our own and others) as we firmly believe economic, market and geo-political challenges will be part and parcel of the future as has been the case throughout history. Moreover, we believe that accounting for biases and controlling one’s emotions is inherently difficult, so patience and adherence to a long-term strategic allocation can aid our pursuit of long-term investment success.

History informs our belief that sharp movements in the financial markets are common and should be expected, but they are nevertheless not easy to predict. Indeed just since the early 1970s, the S&P 500 has sold off by roughly 50% on three separate occasions and there are many more top to bottom corrections of 20% or 30%. Some major market indices here and abroad as well as sub-indices have experienced even greater peak to trough declines. Therefore even 50% declines are not ‘hundred year flood’ occurrences and they tend to arrive when they are least expected and few investors find them anything but harrowing. Our fear is not that gut-wrenching declines lie ahead as we believe they do. Rather our concern is how you will respond in the face of adversity because the ‘comfort of holding cash’ causes many investors to deviate from sensible long-term plans. In these instances, the declines and permanent loss of principal become very real as investors effectively ‘lock-in losses’ and remove the possibility that all or most of their principal balance will be restored due to the absence of market exposure during subsequent recoveries. One objective in sharing these observations is to help raise awareness of your own market experience and behavior in the context of market history so that you can avoid the costly timing decisions that adversely affect many investors.
If reading this letter prompts you to think we should revisit your asset allocation, by all means let’s have a thoughtful conversation soon. As mentioned above, we do not think bull and bear market cycles are easy to predict or quantify by magnitude our duration. Each will be affected by the prevailing economic, political and market conditions themselves (e.g. rate of change in corporate earnings, interest rates, inflation, etc.). That said, history teaches us that the longer a ‘bull phase’ persists, the more likely it is for valuation and investor confidence to become dangerously elevated on the high side and vice versa. For this reason, we will do our best to stay attuned to these variables and to communicate our observations. Indeed while subject to change in response to changes in GDP growth, corporate earnings growth, changes in interest rates and inflation, we believe U.S. stock market returns will likely moderate down from the rather robust returns we have experienced since the market began to turn up from the March 2009 lows.

Unfortunately, surprises including those that trigger sharp price declines in market value across all or most major market segments are often due to new developments that many deemed unlikely to occur. We likely won’t anticipate or time these movements particularly well, so it is important to prepare in advance (through sand bagging) and also recognize that for the most part, broad market declines will prove temporary. Lastly collectively we investors are prone to repeating common mistakes of the past. Our goal of course is to share perspective that will hopefully help you avoid costly timing mistakes and enable you to achieve desired outcomes.

Warmest regards,

W. Richard Jones, CFA
Senior Vice President, Investments

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\(^1\) Recently I returned home from vacation and told my partner Travis Rice how much I enjoyed reading *John Adams*. He said did you see the miniseries when it was on HBO several years ago? Sadly, I did not, but it too was based upon Mr. McCullough’s book. In any case, it is available on HBO NOW and I have included the Wikipedia link to the miniseries below.