Third Quarter Report 2019

LUCIEN, STIRLING & GRAY ADVISORY GROUP[SM]

"Smart Decisions About Serious Money"

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A MESSAGE FROM THE PRESIDENT

Thomas G. Twombly

Warren Buffett once commented that *"the most important quality for an investor is temperament, not intellect."* Think about that for a moment. In other words, it's not how smart you are or how quickly you process information that makes the biggest difference in the long run. What ultimately counts is how measured you are in your thoughts and how deliberate you are in your behavior.

Our behavior, what we discipline ourselves to do – and even more importantly, what we discipline ourselves *not* to do – when provoked by perfectly natural human tendencies to act out, is a far greater determinant of our long-term financial success than any other factor. It's greater than our intellect, our timing, the quality of our research, our investments, and our luck. Behavior vanquishes all.

The trouble is, we're living through a time now when skepticism, even cynicism, towards each other and towards the institutions that undergird our society is reaching new heights. Trust is at a low point. Congress is dysfunctional. Political polarization is more extreme than at any period in our lifetimes. The social and political tension is palpable.

Add to this the facts that interest rates around the world are near their lowest levels in recorded history; income and wealth disparity between the "haves" and the "have-nots" keeps widening; and U.S. stock markets are close to all-time highs, while many obsess about an impending recession. So many things seem unstable and subject to sudden change. How can one invest confidently in this environment?

The huge conundrum, and indeed the greatest temperamental challenge that all long-term investors must wrestle with is that the future we invest in and for is inherently <u>unknowable.</u> It always has been, and it always will be. And yet, **we must move forward anyway.** On one hand, the great goals of life, like funding a solid education for children or grandchildren; ensuring our financial security, dignity and independence throughout a three-decade retirement; or building and leaving a legacy for those we love, take decades of dedication and discipline to accomplish. But on the other hand, the only guarantee we have during that time is that *everything will change*. All those intervening years (and indeed every day that comprises them) will be full of uncertainty and ambiguity. We will *never* have all the information we want before having to make important decisions. We'll *always* be unsure of something, and often we'll be unsure of many things. Other times, the things we <u>are</u> sure of will suddenly change.

Exhausted and under stress because of these conditions, human being reflexively resort to simplistic binary distinctions – fight or flight. *Feeling* instead of *thinking* becomes the path of least resistance. And then we act out – temperamentally. **Don't do that.**

As hard as it is to do in this maelstrom of emotions, a successful investor absolutely must overcome this temptation towards reactivity. In an environment like the one we're experiencing now it's ever more important to think, plan and act *purposefully* – based on principles like patience, discipline and a hard-nosed faith that, in due course, things will work out. It's also very important to examine the unconscious word definitions you attach to the various assets you're investing in, and to frame your decision-making in ways that are appropriate for the objectives you're trying to achieve.

For instance, many people quickly associate the words "risk" and "volatility" with stock investing. They subconsciously think of other words like "blue chip", which they quickly associate with gambling. Or they succumb to the financial spectacle of television shows like Mad Money that propagate a high-stakes, short-term trading mentality: "Buy, buy, buy! Sell, sell, sell!"

Re-framed in a more deliberate, long-term perspective, however, owning stock simply means you've become a long-term shareholder in a business. In the case of investing in publicly traded equity markets, you're becoming an *owner* of some of the most successful, well-financed, dynamic and profitable businesses ever conceived in the United States or the world. These enterprises produce innovative products and services that are sought after by millions, and sometimes billions of consumers around the globe. They are run by experienced, highly adaptive management teams who are well-compensated to mind the interests of shareholders. They innovate relentlessly, adapt constantly to ever-changing environments and can demonstrate a history of successfully weathering any number of past recessions. Defined this way, equity ownership almost becomes an entirely different concept, doesn't it?

There is nothing easy about exercising patience and discipline. There is also nothing easy about maintaining perspective. They all take diligence and effort – and regular inoculations against our own worst proclivities. It's so much easier to get swept up in the urgency and anxiety of the moment than it is to look far ahead and allocate capital based on time horizons of 10, 20, or 30 years. It's so much easier to sell when the crowd is fearful and prices are falling, than it is to stalwartly allocate new money to an asset class (or several) when it's out of favor and the news is gloomy. It's so much easier to believe that the solution to our investment needs lies in finding some new, different, cutting-edge fad than it is to stick to a diversified buy-and-periodically-rebalance philosophy that utilizes time-tested but boring investment strategies. Remember: the purpose of investing isn't to generate excitement, it's to fund and endow the most important financial goals of our lifetimes - this is serious money.

If there is one truth I've learned about successful investing and investors in the last thirty-five years of my career as an advisor, coach, counselor and leader it's this: You play this game *chiefly against yourself*. *Your biggest opponents are your own worst instincts*. You must recognize and curb those reactive instincts.

Successful investors are goal-focused and guided by a meaningful long-range plan. They've gained a clear view of what's important to them, what their philosophy is, and what their unique challenges and opportunities are likely to be. With our help, they've also thought proactively about how they intend to respond to shifting circumstances. They're temperamentally resilient, practiced at handling tough setbacks, and well-prepared to make any number of personal changes and course corrections along the way. That's the *only* way one can invest confidently in this environment, or in any other for that matter.

Thank you, again, for your confidence and trust.

Thomas G. Twombly
President

Investment Commentary

The third quarter of 2019 took on a much more ambiguous tone than either of the first two quarters of the year as a distinct mood of uncertainty has begun to work its way into the psyches of investors and business leaders around the globe. Much of this uncertainty is emanating from political as opposed to purely economic conditions, but the net effect has nevertheless resulted in a broad-based slowing in the global economy. Major equity markets across the globe showed very muted or even negative results for the period. Bond markets, on the other hand, continued to attract substantial asset flows despite offering current yields that leave very little room for investors to prosper over the long run.

In the U.S., large-cap stocks rose +1.7% for the quarter, while mid-cap stocks fell slightly by -.09% and small-cap stocks declined by -2.4%. Developed market international equities also imposed a drag on results, falling by -1.07% during the quarter, while emerging market equity allocations declined by -4.3% in response to on-going tariff and trade war anxieties.

As we write this on the 3rd day of October, after a bumpy start to the new quarter, it's informative to note that the S&P 500 is, at the moment, only .5% higher than it was at its peak 21 months ago in January of 2018, following the big run-up from the Trump administration's corporate tax reform. This apparent inertia, however, has been anything but calm for anyone who has been paying attention on a regular basis. Not only did we witness substantial downside volatility in February and March of 2018, and then an almost -20% decline in the final quarter of last year, but this year has offered a bumpy ride as well. In fact, on the way to a +20.6% gain so far, much of which was a rebound from the sharp selloff at the end of 2018, we've seen two declines of -6% or more. The third quarter saw the index drop more than -2.5% three separate times in August, as well as seven rallies of 1% or more that eventually pushed the index (in September) to within points of the previous all-time high.

Bonds, on the other hand, have moved substantially since January of 2018. The yield on the 10-year Treasury, at 1.68%, is now more than 100 basis points lower than where it stood then, and there is now approximately $15 trillion dollars in *negative yielding* debt around the world. This unprecedented situation has spurred substantial asset flows into so-called "bond proxies" in the equity world. Utility stocks and Real Estate Investment Trusts are each up more than 20% since January of 2018, and experienced respective gains of +9.3% and +7.7% in the third quarter alone. Traditionally considered conservative, these are now among the most overvalued sectors of the overall market - with price to earnings ratios that currently exceed 20, compared to long-term averages of 14.3 and 15.4 respectively.

Looking forward, we think it's especially important for investors to try to maintain a long-term view, and to judiciously allocate capital with a view toward what's likely to happen over the next five years, as opposed to the next twelve months. The short term has always been unknowable, and this is particularly true as we head towards an election year in an especially fraught geo-political environment. Over that longer term, we believe it makes good sense to maintain solid allocations to international equities, despite (or, in fact, because of) their more recent struggles compared to U.S. equities. We also believe very strongly that allocations to emerging market equities will eventually pay off, though no one can say for sure exactly when. The relative price-to-book ratio of the MSCI Emerging Markets Index vs the S&P 500 is now more than 30% below its long-term average, and it sits at a low point we haven't seen since early 2002, when the world was still in a deep recession due to the dot-com crash. Meanwhile, long-term demographic growth trends in those countries look quite compelling over the coming decade.

As we made a point to mention in the first half of this report, it's not easy to maintain a long-range perspective. Neither is it easy to exercise patience and discipline. They both require regular reminders of where economic conditions stand in their extended-term context, and periodic booster shots against the natural reactivity that grows so quickly in uncertain and murky environments. If you believe you could benefit from one of those booster shots, or if you'd simply like to discuss our perspective, we would welcome the opportunity to sit with you and talk. Please give us a call.

Lucien, Stirling & Gray is...

Moving!

As of October 31st, 2019 we will be leaving our long-time offices on Guadalupe St.

Please make note of our new address:
7800 N. Mopac Expressway, Suite 340
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General Market Results

	3rd Quarter	YTD	One Year	Three Year	Five Year	Ten Year
Barclays Agg Bond	2.27	8.52	10.30	2.92	3.38	3.75
S&P 500	1.70	20.55	4.25	13.39	10.84	13.24
DJI	1.83	17.51	4.21	16.44	12.28	13.56
S&P 400	-0.09	17.87	-2.49	9.38	8.88	12.56
Russell 2000	-2.40	14.18	-8.89	8.23	8.19	11.19
NASDAQ	0.18	21.54	0.52	15.88	13.51	15.49
MSCI EAFE	-1.07	12.80	-1.34	6.48	3.27	4.90
MSCI EM	-4.25	5.89	-2.02	5.97	2.33	3.37

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