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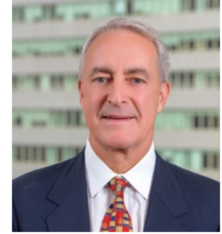

Thoughts for Investors

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Worried about a Market Decline?

APRIL 2017

"Markets can remain irrational longer than you can remain solvent."

– John Maynard Keynes, economist

STATE OF THE MARKET

"Recently we have been receiving calls asking whether we believe the stock market is now too high (or being told, unequivocally, that it is) and whether stocks should be sold. Of course, I was asked that question around the time of the election, last year and the year before that. This year, an exchange-traded fund of the 30 Dow Jones Industrial Average (DJIA) stocks has become very popular, pushing up the valuation of the index and all 30 stocks within it. So, would I buy an ETF of the DJIA today? In a word, no. In my opinion, quite a few of these stocks and others are overvalued, and I share investors' concerns about that. Yet, as the Keynes quote above wryly points out, overvaluation and the ability of the market to sustain a certain level or go higher are not the same thing.

The great value investor John Templeton described the difference another way. He reminded us that most often, bull markets end on euphoria rather than skepticism or any specific (PE) ratio. Are you euphoric? Furthermore, I think it is interesting to put this recent bull market in perspective. Most everyone vaguely recalls the Crash of 1929 and the Great Depression. They often link the two when thinking about their investment plans, yet many historians now believe the crash, while possibly a trigger, was mostly not responsible for the depression. Instead, they believe the depression was caused by a series of bad economic decisions by people, business and government. Fortunately, we've learned a few lessons since then.

Could the culprit for the Crash of 1929 be the 500% rise in the stock market from 1920-1929? The severe bear market of 1973-1974 came after a 19-year bull market from 1954-1973. To paraphrase Keynes, in the long run, one can go broke betting against the market. Some recent research suggests that just because we have had an approximate 300% stock market rise since the low about eight years ago does not automatically mean a recession and a market decline is more probable today (valuations aside, for the moment).

In this newsletter I will explain what to do if you think the market is too high or in the event of a market decline.

REMAIN INVESTED AND PATIENT

"Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."

– John Maynard Keynes

Conventional wisdom continues to tell us that the stock market is too high. For the sake of reputation, many investment professionals dare not dissent. They are often as guilty of following the herd as investors. Even in these times, an investor's most important job is to be patient. It is tempting to believe that one can be nimble enough to sell and get back in if a decline happens. That's the promise of asset allocation, the algorithms of robo-advisors, and the masses of published economic media and conventional wisdom. I can assure you, this

is virtually impossible to do, even though, for the advance of their reputation, many investment professionals try and many investors buy into the theory that you can sell and get back into the market later. If at some point you intend to compare your performance to that of a stock market index such as the S&P 500, it is important to remember that the index never sells. The index is 100% fully invested in stocks — all the time — even if they are overvalued — even in a bear market when the index is going down and you are losing money. In essence, the index goes "full speed" all the time, even up to and into recessions. Unfortunately, it is my experience that many investors believe index funds or ETFs are somehow less volatile and less risky. That is not so, as they will find out in the next bear market. Furthermore, buying an S&P 500 index ETF today means buying into the overvaluation of any of its components (if you believe any are overvalued). Are companies like Amazon and Google overvalued today? Only time will tell. If you want the return of an index fund, you have to own it through thick or thin.

DOES THE STOCK MARKET HAVE TO GO UP? TECHNICALLY, YES!

"The speculator's primary interest lies in anticipating and profiting from market fluctuations. The investor's primary interest lies in acquiring and holding suitable securities at suitable prices."

– Benjamin Graham

Are you an investor or a speculator? Investors understand that the stock market has to go up eventually. I believe remaining patiently invested can be easier if one understands why the stock market rises in the first place. (I) Only stocks that survive remain in the stock market. You don't have to worry about bankrupt stocks because they are gone, while declining stocks have a decreasing influence on market averages. (II) It is the stocks of growing companies that drive stock market averages. This happens because they have growing free cash flows, profit margins and ultimately earnings, not all of which gets paid out to shareowners. Some earnings are retained by the company and reinvested back in the business. If successfully reinvested, the growing cash flows, profit margins and earnings lead to more earnings. It is the compounding of these earnings that leads to higher stock prices and therefore higher market averages. It also helps the stock market if, in general, the economy at large is growing.

(III) There may also be a change in the "perceived value" of a given stock or the market as a whole. This is reflected through a higher PE ratio, which investors are willing to pay to own that stock or the entire market. While this could be considered "icing on the cake," investors like Keynes called it the "speculative" portion of the return. Be careful if this is the primary reason why a stock (or an index) is rising and why you are attracted to it. Changes in "perceived value" is code for emotion creeping into the valuation. Speculation can be dangerous when it gets out of hand. I believe "sector" ETFs, like biotech, real estate, energy and gold, to name a few, can go through periods of speculative fever. I have found that the more a sector ETF is advertised, the better the chance that it has reached over-valuation.

There is another factor at play in driving stocks, and the market, higher in the long run: company employees. Employees have a very selfish reason for showing up at work. They want to take care of their families and themselves by receiving a paycheck. Trying to grow and make things better at a company often makes things better for the stock as well. Knowing why stocks and the stock market rises makes market fluctuations an opportunity for the investor and the curse of the speculator.

HARNESS THE OPPORTUNITY

"All the money is made in the buying."

– Wall Street Proverb

As I said earlier, an investor's most important job is to remain patient, which means controlling one's emotions. I believe that is made easier if investors spend their time trying to identify good investments

rather than trying to decipher complex economic signals that are widely dispersed, irresistible to ignore, often incorrect or revised afterward and, most importantly, reflect what everyone else is doing or thinking. Our approach to identifying good investments can be found (here). The next most important job as I have mentioned (here) is to harness other investors' lack of emotional control. The best way to achieve this is to buy stocks correctly, and this is the point where valuation indeed becomes important. As the great value investor John Templeton advised, "To buy when others are despondently selling and to sell when others are avidly buying requires the greatest fortitude." Emotionally, this is a very hard thing to do. We have often said that in rising markets, people invest with their hearts and in falling markets with their stomachs. Our job is to help them use their heads. Even if you didn't buy at the very bottom, there's hope. Philip Fisher, perhaps the greatest growth stock investor, advised that good stocks should be given the opportunity to grow into their valuation. Just be careful on that front too. Benjamin Graham, the great value investor, said, "You can get into more trouble with a good idea than a bad idea," because you can make the mistake of falling in love with a stock. Audi Partem Alteram. Always Hear the Other Side.

"If the job has been done correctly when a common stock has been purchased, the time to sell it is – almost never."

– Philip Fisher

If you bought a stock near what you believe to be its value, don't sell if it becomes temporarily overvalued. Especially don't sell if it retreats back to that value and you get discouraged for having "round-tripped" it.

"Any man who is a bear on the future of this country will go broke."

– JP Morgan

If one looks at the great wealth that has been created by people like Gates, Buffett, Jobs, Bezos and others, there is a very noticeable and common thread. They almost never sell because they are investors, not speculators.

In summary, we may be near a market top. Then again, if the economy grows, we may not be near a top! The way an investor acts at both market tops and market bottoms — both of which can only be identified after the fact — ultimately determines their long-term success, because it is precisely those times that the most grievous investment mistakes are made. So whenever you believe we are at a market top, revisit this newsletter. Review your portfolio for any "speculations" that have crept in. These are stocks you "didn't do your homework on" but bought simply hoping someone else would buy them from you at a higher price. These should be sold. Don't worry about the true "investments" in your portfolio. Remain invested in these. Even if the market were to decline in the near term, your patience will likely be rewarded in the long run.

"The biggest investment mistakes I've made were the stocks I sold, not the ones I bought."

– Steve M.

AUDI PARTEM ALTERAM

Hear the Other Side

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