

## Survive The Volatility: “Simplify”

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*“The stock market is the story of cycles and of the human behavior that is responsible for overreactions in both directions.” - Seth Klarman, CEO Baupost Group*

2020 and 2021 were “risk on” years in the financial markets. Investors were flooded with opportunities in both innovation and speculation. The former could be found in electric vehicles, artificial intelligence, batteries, and therapeutics - to name a few. The latter could be found in SPACs, meme stocks, and crypto currency. The “gold rush” into these investment opportunities seemed to be more like entertainment than fundamental investing. As a result, valuations in the speculative side of the market reached unwarranted levels coming into the end of 2021.

Even in the more traditional segment of the market, valuations became stretched in the growth stocks that investors have come to view as relentless winners. Concurrently, interest rates began to move higher – seeking some degree of “normalization,” indicative of an economy that can function without endless monetary support. Given these elements, equity prices needed to come down, needed to cool off, to bring forward a more orderly and trustworthy condition. And so, they did.

Our view is that economic fundamentals remain positive, and not all corrections lead to a bad outcome. Warren Buffet is fond of saying, *“you pay a very high price for a cheery consensus. It won’t be the economy that will do in investors; it will be the investors themselves. Uncertainty is actually the friend of the buyer of long-term values.”*

We are focused on these few simple steps to help you and your portfolio survive the

volatility, and to find value for the next move higher:

1. Simplify the portfolio, look to reduce any unnecessary diversification.
2. Increase exposure to “wide-moat,” high free cash flow, blue chip companies with essential products and services. In other words, emphasize resiliency.
3. Increase exposure to the small and mid-cap portions of the market, which have significantly lagged a market more focused on the “comfort food” of large cap technology stocks (*see Page 3*).
4. Build and maintain a “sleeve” in the portfolio that will stand to benefit from an inflationary cycle: basic materials, commodities, real estate, and financials.
5. Leave enough cash to take advantage of good entry points into high quality investments, should the pull-back in stocks deepen.

As always, investors are confronted with both risk and opportunity, one does not exist without the other. We are concerned about geopolitical tensions, political dysfunction, and climate change. Yet, we are optimistic about the current economy, the adaptive nature of publicly traded companies to grow revenue, and the rate of innovation that will bring forward immense investment opportunity.

The volatility in the financial markets has grabbed all the attention lately. Over the short-run, the market is driven by forces over which we have little control and watching your portfolio daily can be counter-productive. On the other hand, you do have control over the choices that you make related to the essential components of financial planning.

Planning is the cornerstone of our practice, and we try to act on the aspects that are important to you, regardless of the state of the financial markets. Accordingly, we would like to take this opportunity to remind you of our core competencies, and a few of the planning tools that we make available to our clients. Please take a moment to read through the “menu” below, and make a note of any planning objective that you would like to pursue, or resource you would like to use, to improve your financial condition in 2022:

### Services

- Comprehensive written plans; covering all aspects of your financial profile and path, including net worth and income & expense statements.
- College Funding; savings strategies and cost modeling.
- Retirement Planning; our proprietary retirement income illustrator (RII) and funding strategies.
- Insurance: writing and reviewing life, health, disability, property & casualty, and long-term care.
- Tax Planning: tax return analysis, portfolio tax efficiency audit, tax-sheltered retirement plans, charitable gifting, and other tax-reduction strategies.

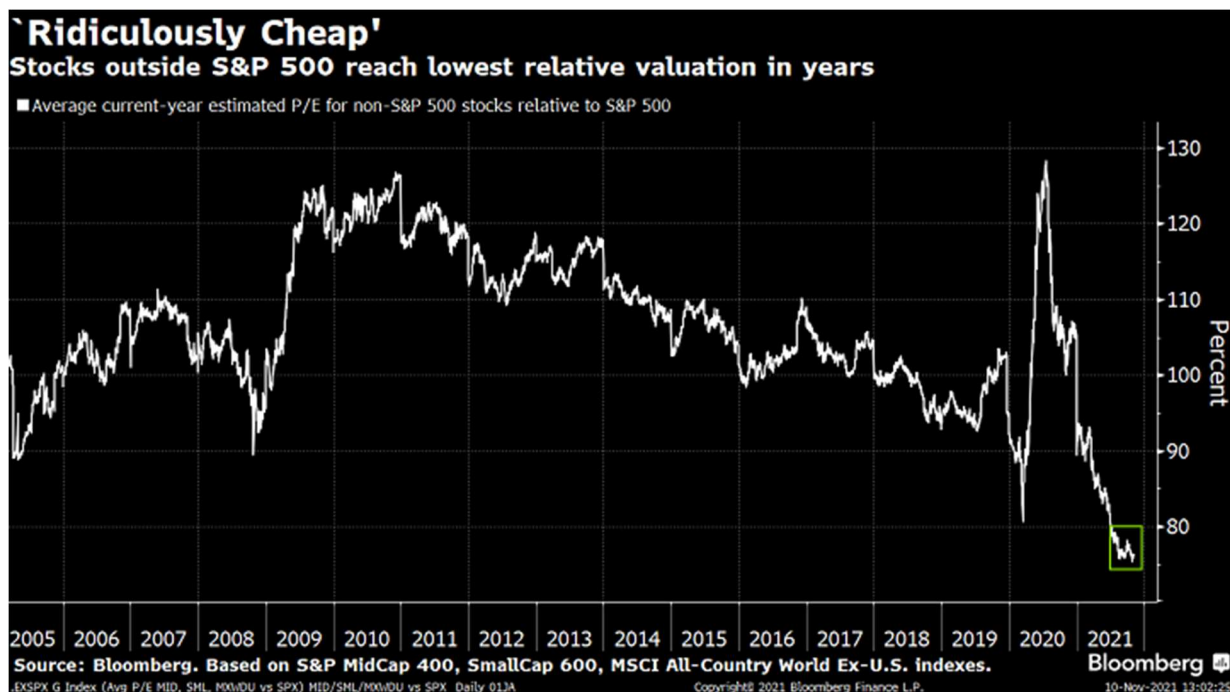
- Trust & Estate Planning: working with an accredited attorney to achieve the best possible outcome.
- Financial Literacy: educate and prepare your children to build a solid financial foundation.
- Company Sponsored Retirement Plans: review, design, and manage 401(k), Defined Benefit, and small business retirement plans.
- Succession Planning; business sales and intra-family business transfers.

### Resources

- E-Money: a comprehensive personal financial planning portal, available to each RFG household.
- Cambridge Statements: a portfolio performance tracking portal, available to each RFG household.
- Riskalyze: software to assess risk levels in your private and company-sponsored portfolios.
- Morningstar: research on mutual funds, ETFs, variable annuities, and equities.
- Schwab Bank: mortgage, home equity, and pledged-asset loans.

Was it “King Richard” Williams who said it first, or was it Benjamin Franklin before him? The message is the same now as it was then: “If you fail to plan, you are planning to fail.” Resolve to make 2022 the year in which you make the kind of improvement in your financial health that will last a lifetime. We will work with you every step of the way.

This blog article is for those of you that appreciate some degree of fundamental analysis, and the chart below tells a story that is very relevant to our investment models for 2022. This fall we started to see articles in the financial press addressing two important trends. The first is that the performance of the S&P 500 is increasingly dominated by a narrowing list of large cap tech stocks – to the point that these highly liquid tech firms have become the equivalent of comfort food for investors. The second factor is the extreme disparity in relative valuation between the S&P 500 index and every equity index outside the S&P 500. Dave Wilson of Bloomberg News captures this well in a segment entitled “Ridiculously Cheap.” In his report Mr. Wilson published the following chart, which illustrates the average estimated P/E ratio (one common measure of valuation) of the Mid Cap 400, Small Cap 600, and the MSCI International Equity indexes combined versus the average estimated P/E of the S&P 500.



As you can see, the relative valuation of the stocks in non-S&P 500 indexes (including small cap, mid cap, and international equities) are at historic lows compared to the stocks in the S&P 500, at least based on average P/E. And the degree of this “discount”, not seen in the last fifteen years, is an event that raises our eyebrows. While there are many good reasons to believe that large firms provide steady predictable growth and deserve a prominent weighting in any portfolio, one must stop to appreciate the opportunity smaller more focused companies may provide during an expansion of the real economy. When we talk about inflation, we are talking about economic expansion. When we talk about Fed tapering, we are talking about pulling back on the price supports that are provided most directly to the largest companies. The valuation comparison of the S&P 500 to international equities is more complex, but the economic expansion is a global event yet core international companies trade at substantially lower multiples. In view of all of this, it makes sense to us to evaluate this valuation gap and rotate more assets into small cap, mid cap, and international opportunities.