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PORTFOLIO WATCH

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Market Smarts

We've come to the last newsletter of the year and a lot has happened in just the last month, not the least of which is that we elected a real estate developer with no political experience to be the next president. You may think that was a good idea or not, but it's clear the victory by Donald Trump made a lot of pollsters look really dumb. The market reaction also made a lot of market commentators look dumb, but that's just what the market does. The stock market has a finely-tuned ability to make the maximum number of investors (and advisors) look stupid at any given time. If you have a truly diversified portfolio, then a part of your portfolio should make you look brilliant, and another part will make you look stupid. This is just a fact, but it's a big problem for those who manage risk.

Smart, Stupid, or Lucky

Most of us have heard of the studies that claimed a monkey throwing darts at a stock page in the 80's and 90's (for those old enough to remember "stock pages") could do just as well as a professional stock picker. Even though that was the case, stock jocks still seemed brilliant. It took work to find something that didn't make money. Then the dot-com bubble burst and all those same brilliant advisors suddenly looked stupid. The cycle did a rinse and repeat between 2003 and 2009, and we're in the middle of the process again. Owning stocks always looks brilliant when the market is going up, and stupid when the market goes down. Since few people are smart enough to time these ups and downs with any consistency, advisors simply hope they can survive the "dumb" period while waiting to be smart again.

Never the Smartest

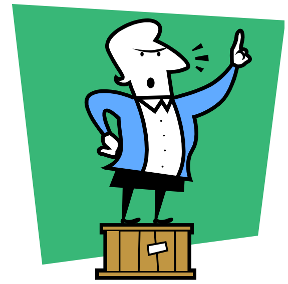
A well-diversified portfolio may be exactly what an investor should own, but the advisor who puts it

together will never look all that smart. I tend to use a lot of different investment types that attempt to make money in different ways, so there is always something that looks dumb and usually something that looks like a good idea. When stocks are going up, anything that's not a stock looks dumb. When stocks are going down the obvious question is why I wasn't smart enough to get out before they did that. And when stocks are flat, the income investments look brilliant but it sure is dumb having the other investments around that aren't doing anything. Research shows that the best portfolio is diversified, but that means something will always look like a mistake.

Delayed Smarts

Risk management has looked pretty dumb for almost the last 8 years. If only we could look backwards and then decide where we needed the risk management. Unfortunately, the only people who get to do that are money managers who advertise their back-tested performance. A solution to this is to use time to our advantage with hedging techniques. However, hedging (i.e. protecting from loss) requires a timeframe. An investment that can be sold at any moment can have no downside hedge. It's at the whims of the public's emotions. An investment that can be effectively hedged against market losses over, say, 5 or 6 years is certainly achievable, but it probably won't respond to every fluctuation of the market. When the market suddenly jumps because, for example, a reality TV personality gets elected president, the wisdom of a downside hedge will take a while to reveal itself, but it will look smart eventually.

Veripax News



Some fairly significant things in terms of new capabilities and tools will be rolled out in January, so watch this space next month. Veripax recently crossed the $100M milestone in assets under management, and that means we will need to transition from state regulation to federal (SEC) regulation next month. It's a sign of "growing up," but it will mean enhanced compliance procedures and more hoops to jump through. I'll be hiring a compliance consultant to establish new procedures and make sure we can get through an SEC audit without issues. I want to thank all of our clients who have helped this company grow from a start-up to now officially a "large advisory firm." It's been quite a journey, and I'm sure it will continue to be.

Market Comments

Well, I was almost right in predicting what the market would do in the event of Trump winning the election. I predicted that the market would jump around trying to digest the idea of a Trump presidency, and then it would go back to anticipating the next move of the Fed. My mistake is that I thought this process would take weeks or months. As it turned out, it took a couple of hours while the stock market was closed. The futures market dropped over 800 points when it looked like Donald Trump may pull off an upset. Shortly after that happened, traders started contemplating the idea of relaxed regulation on banks and even the possibility of a corporate tax cut, and stocks were off to the races.

Not everything is hunky-dory in the world of investments. Most people only hear about US stocks, and even more narrowly they hear about what the Dow Jones average is doing. This tends to be misleading because 10 stocks drive more than half the performance of the Dow: Goldman Sachs, 3M, IBM, UnitedHealth, Boing, Home Depot, McDonalds, Travelers, Chevron and Apple. General Electric, one of the largest companies in the world, is just 1.1% of the Dow. So with these 10 companies doing very well, particularly Goldman Sachs, it's easy to miss the fact that the Healthcare sector is down since the election, as well as foreign stocks and pretty much anything connected to interest rates or credit. This is another example of why a diversified portfolio will always have some areas that look dumb, and hopefully some areas that look smart.

I'm now cautiously optimistic about the next year or so. If the new administration is successful in lowering corporate taxes and creating a more business-friendly environment, there may be another leg left in this bull market. I still think there is a price to pay for printing $4 Trillion and staying at zero interest rates for so long, but the initial reaction of the market sure looked good. Although it's counter-intuitive, a market run like this is one of the most stressful times for advisors. If there is any cash laying around it needs to be deployed, but do you jump into the market after it's been going up for 5 days in a row? Pretty soon we stop waiting for a pullback and start buying as soon as there is a day or two of pause, and that's all we've been seeing lately. The market is just waiting for me to get all the cash invested before it makes every investor look stupid again. I wish everyone a very Merry Christmas and Happy New Year.