Lifeworks

Market Update

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A new bear market, the marshmallow test, and why waiting is hard.

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Dealing With Volatility and a Bear Market

At the time of this writing (Mon. 16th), stock market indices were down about 12% on the day and we have now entered into bear market territory with the S&P 500 down over 25% year to date. As scary as that sounds—and believe me, I know that doesn't sound very good—I'd like to take a step back and objectively assess what is going on.

I believe that the markets want what we all want…a less partisan, smarter, and more effective government...but I digress. What the market really wants is some understanding as to how bad the virus is going to get in the United States and what the impact will be on consumers and businesses. As I said in one of my previous updates, the market hates uncertainty. Unfortunately, it is likely going to be weeks and perhaps months before any clarity or certainty can be had with regards to the virus.

So for now, the market is bracing for financial turbulence and economic uncertainty. One thing we have been watching is that almost every asset class was pushed lower by broad and indiscriminate selling across most of the major markets. Equities, REITs, cryptos, alternative assets, commodities, and certain segments of the Fixed Income markets have all been hammered during this sell-off.

The Fed

Yesterday, in response to the coronavirus, the Federal Reserve slashed rates to near zero and bought $700 billion in treasury and mortgage-backed securities kicking off QE5 (Quantitative Easing, round 5). One of the Federal Reserve's key functions is to ensure there is liquidity available and that the markets operate as smoothly as possible.

For better or worse, we expect that the Federal Reserve will also look for other ways to inject liquidity into the markets in the form of buying commercial paper and/or corporate bonds as well as other monetary policy options.

Dollar shortages and modern-day bank runs are a possibility the Federal Reserve is also watching for as well.

We don't believe that stocks will recover based solely on the Fed's decision to cut rates and inject capital into the markets. For that to happen, we need to understand the extent of the coronavirus in the U.S. and that there is nothing the Fed Chairman can do about the virus itself.

Coronavirus

At this point in time, we don't know how many people are affected in the United States. Sure, government officials can throw out estimates, but the reality is we don't have sufficient testing to know how good or bad things actually are. We also don't know what the impact will be on our health care systems or facilities in the coming weeks.

We do expect this to change over the next 2-3 weeks as better data becomes available.

In the days and weeks ahead, news headlines for the virus are going to be scary. Remember, one reason for scary headlines is that it gets our attention and makes us click on the link. That translates into revenue for that website or media network. I'm not saying that this is a conspiracy or something unethical is going on. It is just a point that I make sure to remind myself and my team about every day—as the real world is generally never as bad as the news makes it out to be. Now, there will be lives lost and economic damage from the virus itself. But the real economic damage will be driven mostly by the government intervention into our everyday lives, into our markets and industries, and the lasting impact on the psychology of the consumer.

Viruses have been with us forever and will survive long past our time. We need to keep our wits, avoid panicking, and we will get through this together.

Oil

In the past week, we've also been watching the ongoing developing oil price war between Saudi Arabia and Russia. While reduced energy prices are generally good for industrial economies, the United States is now a large energy exporter, so this has had a negative impact on the valuation of the domestic energy sector. There is no reason to believe at this point that this oil price war will end any time soon. The Russians are attempting to economically squeeze the American shale producers and the Saudis are caught in the middle as they do not want to further cede market share to Russia or the U.S. Expect this storyline to continue being a driver in the global financial markets.

Waiting is Hard

As I was making some notes in preparation for this market update, I started thinking about some of the key qualities or skills we need in order to be successful long-term investors. One of the thoughts that jumped into my head was, "waiting is hard". As I wrote that, I was reminded of the experiment where a kid is in a room and an adult puts a marshmallow in front of the kid (The Marshmallow Test). The kid is then told that if they can wait for a period of time and not eat the one marshmallow, when the adult returns they can then have two marshmallows. The adult then leaves the room and we get to watch the kid wait. It's funny, cute, and a little painful to watch (just a little).

It's painful to watch because we get to be unattached, unemotional, objective viewers of the experiment. It is easy for us to see that if the little guy or gal can just hang in there for a few more minutes they are going to double their enjoyment and reward. As a father of four children, I am keenly aware of the universal axiom that all children know from birth: that two marshmallows are way, way, way better than just one! What makes it painful to watch the Marshmallow Test is that our vantage point combined with our unemotional position lets us clearly see that the time spent waiting is short and will eventually be the best decision the kid can make. We are rooting for the kid because we know that the reward will be worth it—if they can just hang on and wait it out.

However, for the four-year-old kid, waiting for 15 minutes to eat that sticky, sweet, sugary goodness is like a lifetime of waiting. And, waiting is hard for a four-year-old. Watching 4-year-old kids try to exercise patience and not eat the marshmallow is funny, frustrating, and maybe a little sad. Yet, perhaps it is similar to how we adults react when we know we need to be patient with our investments. We know that the reward increases if we can wait...but waiting is hard. It's not naturally in our DNA; we have to discipline ourselves to be patient.

Naturally, just like that little kid, we worry that the marshmallow in front of us could disappear, go bad, or that the adult who made the rules will return and change them on us. I believe that it is these fears and emotions that cause us to lose our objectivity and the ability to stay disciplined with our investments.

Depending on the research one uses, the average length (duration) of a bear market in the United States is about one year. Some have lasted longer than that while others have passed by much quicker. However, just as the kid felt like 15 minutes of waiting was a lifetime, it is easy for us to feel like the bear market is going to last forever. But, it won't. Your marshmallow will still be there and the rules of the game haven't changed.

The Lesson of 2008-2009

Warren Buffet once wrote, “When investing, pessimism is your friend, and euphoria is your enemy.”

He further outlined his strategy by saying, “A simple rule dictates my buying: Be fearful when others are greedy and be greedy when others are fearful.” I shared this in last week’s market update and will probably restate it a few more times over the coming months as this wisdom from the Oracle of Omaha is worth repeating.

Our team learned some important lessons from our experience of the 2008-2009 bear market.

One of those lessons we learned was; When you are in a bear market, it feels painful and hyper-volatile. But, on the other side, two is better than one. Meaning, the markets will present buying opportunities we may only see once in a decade.

When the dust settled and it was all said and done, the 2008-2009 bear market was one of the greatest buying opportunities for investors in history. Even with the recent market pullback, the S&P 500 is still roughly four times higher than the low of March 2009.

Last week, I briefly wrote about exchange-traded funds (ETF) and how they are mandated to mimic the market's performance. That means during days like today, those ETFs are forced to sell off holdings to match the market. Some of the holdings that the ETF must sell include solid businesses like Costco or Coca-Cola as an example. This can create a divergence between the price of the stock and the underlying value of the company. In grocery stores and wholesale stores like Costco, we have seen long lines and empty shelves. Year-to-date sales are probably up from last year based on observations and comments from those companies (we won’t know for sure until earnings are reported). However, in the equity marketplace we have seen ETFs and algorithmic trading programs that are forced to sell the stocks of solid businesses without regard for the underlying value of the company.

This divergence will allow us to be opportunistic and buy great companies at deep discounts due to the indiscriminate selling around us. When the market is fearful, when ETFs and algorithmic traders are selling off quality stocks without regard for their actual value, we will find buying opportunities that might only come along once in a decade.

We know we won’t be perfect with our timing—no investor is ever perfect there. We will focus on remaining disciplined during periods of euphoria and fear by objectively looking at business cycles and fundamental metrics, and then actively using that information to make wise decisions with where we invest capital.

The proactive act of being fearful during greedy times has helped us avoid large losses in our portfolios and has given us the advantage to be opportunistic during fearful markets.

Our team believes that over the next couple of months, we will likely see opportunities to build wealth by making investments in sound companies at great prices. We are prepared for this and plan to cautiously take advantage of buying opportunities going forward.

We will wait patiently for the second marshmallow and thoroughly enjoy the reward on the other side.

Live above the grind,

Ron S. Bullis
Founder & President

Derek Vermeulen
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Core Investment Strategies

Core Equity Strategy

Holding	Ticker	Percent
Schwab Short-Term US Treasury ETF™	SCHO	12.76%
First Eagle Overseas Class I	SGOIX	7.84%
VanEck Merk Gold ETF	OUNZ	7.35%
AMG Yacktman Fund	YACKX	6.86%
Primecap Odyssey Stock Fund	POSKX	5.88%
First Eagle Global FD CL I	SGIIX	4.90%
BlackRock Mid Cap Growth Fund	CMGIX	4.90%
DFA Emerging Markets Core Equity Portfolio	DFCEX	4.90%
Fidelity Advisor Real Estate Fund	FRIRX	2.94%
Fidelity Advisor Healthcare Fund	FHCIX	2.94%
Disney	DIS	1.96%
Amazon	AMZN	1.96%
Walmart	WMT	1.96%
Microsoft	MSFT	1.96%
American Express	AXP	1.96%
Travelers Companies INC	TRV	1.96%
Coca Cola Co	KO	1.96%
Home Depot	HD	1.96%
Dollar Tree	DLTR	1.96%
Cisco	CSCO	1.96%
United Health Care	UNH	1.96%
Apple	AAPL	1.96%
Pepsico	PEP	1.96%
Biogen Inc	BIIB	1.96%
Anthem Inc	ANTM	1.96%
Johnson and Johnson	JNJ	1.96%
CME Group Inc	CME	1.47%
Costco	COST	1.47%
Procter & Gamble Company	PG	1.47%
Exxon Mobil	XOM	1.96%
Cash	N/A	1.00%

Protected Portfolio

Holding	Ticker	Percent
ISHARES MSCI EMERG. MARKETS ETF	EEM	5.00%
ISHARES MSCI EAFE ETF	EFA	10.00%
ISHARES RUSSELL 2000 ETF	IWM	8.00%
SPDR S&P 500 ETF	SPY	16.00%
APPLE INC	AAPL	3.50%
AMERICAN EXPRESS COMPANY	AXP	3.50%
BIOGEN INC	BIIB	3.50%
CME GROUP INC	CME	3.50%
COSTCO WHOLESALE CORP	COST	3.50%
CISCO SYSTEMS INC	CSCO	3.50%
WALT DISNEY COMPANY	DIS	3.50%
DOLLAR TREE INC	DLTR	3.50%
HOME DEPOT INC	HD	3.50%
JOHNSON & JOHNSON	JNJ	3.50%
COCA COLA COMPANY	KO	3.50%
MICROSOFT CORP	MSFT	3.50%
PEPSICO INC	PEP	3.50%
PROCTER & GAMBLE CO	PG	3.50%
TRAVELERS COMPANIES INC	TRV	3.50%
WALMART INC	WMT	3.50%
SCHWAB SHORT TERM TREASURY ETF	SCHO	4.00%
CASH	N/A	1.00%

The Protected Portfolio also includes Put and Call positions on each individual holding that are targeted at 10% below and 10% above market value of the underlying position at the time of investment. This provides hedging to protect against major market swings.

Fixed Income

Holding	Ticker	Percent
DFA FIVE-YEAR GLOBAL FIXED PTF	DFGBX	28.00%
DFA INTERM GOVT FIXED INCOME I	DFIGX	41.00%
DOUBLELINE TOTAL RETURN BOND I	DBLTX	29.00%
SCHWAB SHORT TERM TREASURY ETF	SCHO	1.00%
CASH	N/A	1.00%

Disclosures & Footnotes

Lifeworks Advisors is a registered investment advisor.

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2. The SPDR® S&P 500® ETF Trust seeks to provide investment results that, before expenses, correspond generally to the price and yield performance of the S&P 500®Index (the "Index"). The S&P 500 Index is a diversified large-cap U.S. index that holds companies across all eleven GICS sectors. Launched in January 1993, SPY was the very first exchange-traded fund listed in the United States.
3. Past performance is not a guarantee of future performance. Your actual portfolio construction and results may vary from our portfolio models.