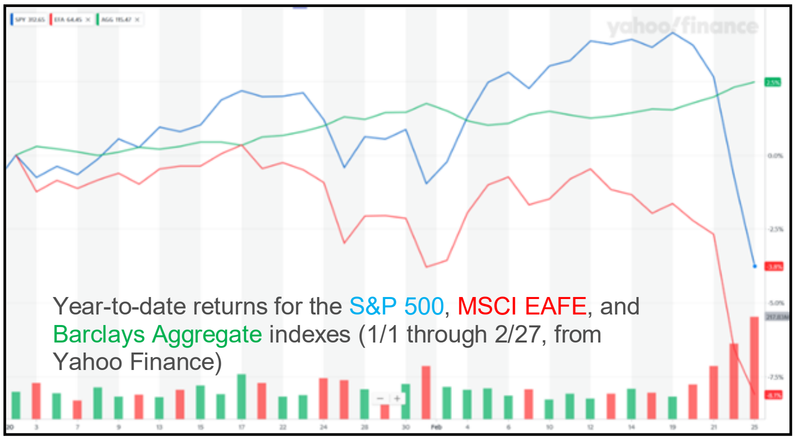
February/March 2020

Gore Capital Management

Our only client is you.

We started writing our first quarter newsletter about two weeks ago. Corporate earnings season was wrapping up with many companies delivering solid results, economic reports were good, and the S&P 500 index was up about 4% through the first 6 short weeks of the year. Amazing how much, and how quickly, a microscopic organism can change things.



Year-to-date returns for the S&P 500, MSCI EAFE, and Barclays Aggregate indexes (1/1 through 2/27, from Yahoo Finance)

Needless to say, we realized that our original newsletter copy was going to require some "light" edits as this week began to unfold. But rather than simply change some words and update some figures and charts, we decided to scrap the original text in its entirety and instead examine the roots of market philosophy and how it's evolved. The best way to combat fear is with education, and that's what we hope to provide in the next few pages.

We're now in the midst of a full-blown market panic, with the S&P 500 down more than 11% in just the past 4 trading days. The big questions on everybody's mind include, "how long will it take to get coronavirus under control," "what is the global economic impact of the outbreak," and "how much farther will the market fall before things settle down?" The answer to those questions, as well as most of the other ones people are pondering, is the same: we don't know yet. The good news is that market panics tend to follow a similar formula regardless of their cause. After all, the stock market is just an auction house of people haggling over the price of something (in this case, the value of a business).

While the market may still fundamentally be the same instrument it was in the 1600s, the forces behind it have changed quite a bit, especially since the turn of this century. There are now computer algorithms sophisticated enough to make trading decisions based on keywords in news stories. The computer "reads" the article, finds the keyword, and enters a trade all before a human can finish reading the headline. That's just one example. The sheer number of these different independent algorithms, each one controlling millions of dollars of capital, has created a recipe for a whole lot of trading volume on very little substance.

Humans themselves really haven't evolved that much despite the leaps in technology. We're still, at our core, emotional creatures driven to seek pleasure and avoid pain. Losing money is painful, but the ability to log on to a website and be reminded of just how much money has been lost on a minute-by-minute basis magnifies that pain. The 24/7 news cycle, the rise of social media, and the spread of misinformation across social media hasn't helped. Remember when account statements used to be delivered quarterly and the only way you could find out the price of a stock was to look in the finance section of the newspaper?

The primary consequence of all this is greater volatility, especially over a single trading day. DIY investors selling their index funds with the push of a button are actually selling hundreds, if not thousands, of stocks indiscriminately. The algorithms aren't any better; their high-speed trading networks can process and execute more transactions in a second than we could in a day.

Market Statistics	YTD (as of 2/27/2020)	2019	3-Year Annl.	5-Year Annl.
S&P 500	-7.61%	30.70%	13.85%	11.68%
Dow Jones Ind. Avg.	-9.36%	25.34%	15.15%	13.21%
Russell 2000 (Small Cap)	-10.13%	25.00%	6.85%	7.79%
MSCI EAFE (Foreign)	-8.09%	22.01%	7.76%	5.12%
MSCI ACWI (Global)	-7.48%	26.60%	11.03%	8.51%
MSCI Emerg. Mkts. Equity	-7.44%	18.42%	7.88%	4.48%
Barclay's Aggregate Bond	3.03%	8.72%	4.62%	3.01%
S&P GSCI Gold (Spot)	7.84%	18.87%	9.44%	4.42%

Source: Morningstar

Faster moves of greater magnitude are the new norm. Case in point, this week's decline of 11%+ is sharper and quicker than what the market experienced in 2008. Yes, *that* 2008 – the worst economic crisis since the Great Depression. Are we really willing to say with conviction that this virus outbreak is more serious than that? Market behavior so far says yes, but the fundamentals don't (again, so far).

On the flipside, short-term volatility and indiscriminate indexing can potentially create more opportunity for the rest of us. More volatility leads to an increased risk premium, the reward an investor expects to earn in exchange for tying his or her money up in the market.

You have probably seen a chart similar to the one directly below, created by Scott Grannis of the Calafia Beach Pundit blog. We like to include these graphics in our reviews and newsletters because they're great visual illustrations of how the market behaves over time. There are always reasons for investors to be fearful, but the market actually needs that healthy dose of skepticism to clear out weak hands and let rational investors control the trajectory over the long-term.

So where do we go from here? Market panics tend to follow the same 5-stage script. The first stage is the initial selloff, usually prompted by a piece of bad news. We saw this a few weeks ago when the first reports of the coronavirus outbreak emerged from China. The second stage is a period of calm as investors digest the initial reports, but most don't feel compelled to do anything because the reports are still thin. Stage 3 is characterized by increased selling pressure brought on by an onslaught of more bad news. In our case today, the virus has spread to the developed world, there are now real concerns over how it will impact global economic production, and people are starting to get scared... not just of losing money but potentially getting sick. From Tom Essaye of the *Sevens Report*: "The coronavirus's impact on the markets (and economy) may be entering a new, more significant phase, because of the risk of introducing fear into the economy, and that can essentially become a self-fulfilling prophecy that creates a slowdown (people don't go out for fear of the coronavirus, and the U.S. economy slows materially)." (Quote from *Sevens Report* published 2/28/20). Stage 4 is panic. Nobody knows what's coming, but they are *certain* it will be worse than ever before. Stage 5 is capitulation, the nadir of the decline. This is the point where the last group of weak hands say, "that's it, I can't handle it anymore, sell everything."

GCM's Top Holdings	YTD (as of 2/27/20)	2019	3-Year Annl.	5-Year Annl.
PIMCO Income (PONPX)	0.61%	7.94%	5.55%	5.71%
FPA Crescent (FPACX)	-4.49%	20.02%	6.44%	6.08%
T Rowe Price Blue Chip Growth (TRBCX)	-4.04%	29.97%	20.94%	15.77%
Vanguard Mega Cap Value (MGV)	-10.69%	25.73%	10.99%	10.77%
American Fds EuroPacific Growth (AEPFX)	-8.67%	27.28%	9.59%	6.42%
Litman Gregory Masters Alternative (MASFX)	-0.09%	8.52%	3.52%	3.32%
Baird Aggregate Bond (BAGIX)	3.07%	9.48%	4.94%	3.38%

Source: Morningstar

Capitulation is also the point of greatest potential gain for the steely-nerved investors who are able to identify diamonds amongst the rubble ("diamonds" being good companies selling at discounts to their fair value).

What are we looking for to signal capitulation? Nearly every day this week, selling pressure has been steady throughout the day, often with an increase in selling volume during the last hour or so of trading. From our experience, capitulation usually occurs during a sudden selling event near the middle of the trading day, followed by a slow tick upward towards the close as buyers begin to step in. It's important to keep in mind, however, that capitulation may signal the end of the panic but it's likely that the market will have to trend sideways for some time, perhaps many months, before most investors get the nerve to start buying again. It took about seven months for the market to rebound after the panic in late 2018. The one in November of 2015 took the better part of a year to recover. At this point, we have no reason to think this case any different from past ones.

@CharlieBilello	S&P 500 Corrections >5% since March 2009 Low				
Correction Period	# Days	S&P High	S&P Low	% Decline	"Stocks Fall On…"
2020: Feb 19 - Feb 27	8	3394	3047	-10.2%	Coronavirus, Global Slowdown Fears
2019: Jul 26 - Aug 5	10	3028	2822	-6.8%	Trade War, Tariffs, Yuan Devaluation, Recession Fears
2019: May 1 - Jun 3	33	2954	2729	-7.6%	Trade War, Tariffs, Inverted Yield Curve, Global Slowdown/Recession Fears
2018: Sep 21 - Dec 26	96	2941	2347	-20.2%	Rising Rates, China Slowdown, Trade War/Tariffs, Housing Slowdown
2018: Jan 26 - Feb 9	14	2873	2533	-11.8%	Inflation Fears, Rising Rates
2016: Aug 15 - Nov 4	81	2194	2084	-5.0%	Election Fears/Concerns/Jitters
2016: Jun 8 - Jun 27	19	2121	1992	-6.1%	Brexit Concerns, Pound Crashing, European Banks
2015/16: Nov 3 - Feb 11	100	2116	1810	-14.5%	China, EM Currencies, Falling Oil, Middle East, North Korea Nukes
2015: May 20 - Aug 24	96	2135	1867	-12.5%	Greece Default Concerns, China Stock Crash, EM Currency Turmoil
2014/15: Dec 29 - Feb 2	35	2094	1981	-5.4%	Falling Oil, Strong Dollar, Weak Earnings
2014: Dec 5 - Dec 16	11	2079	1973	-5.1%	Falling Oil, Strong Dollar
2014: Sep 19 - Oct 15	26	2019	1821	-9.8%	Ebola, Global Growth Fears, Falling Oil
2014: Jan 15 - Feb 5	21	1851	1738	-6.1%	Fed Taper, European Deflation Fears, EM Currency Turmoil
2013: May 22 - Jun 24	33	1687	1560	-7.5%	Fed Taper Fears
2012: Sep 14 - Nov 16	63	1475	1343	-8.9%	Fiscal Cliff Concerns, Obama's Re-Election
2012: Apr 2 - Jun 4	63	1422	1267	-10.9%	Europe's Debt Crisis
2011: Oct 27 - Nov 25	29	1293	1159	-10.4%	Europe's Debt Crisis
2011: May 2 - Oct 4	155	1371	1075	-21.6%	Europe's Debt Crisis, Double-Dip Recession Fears, US Debt Downgrade
2011: Feb 18 - Mar 16	26	1344	1249	-7.1%	Libyan Civil War, Japan Earthquake/Nuclear Disaster
2010: Aug 9 - 27	18	1129	1040	-7.9%	Global Growth Concerns
2010: Apr 26 - Jul 1	66	1220	1011	-17.1%	Europe's Debt Crisis, Flash Crash, Growth Concerns
2010: Jan 19 - Feb 5	17	1150	1045	-9.2%	China's Lending Curbs, Obama Bank Regulation Plan
2009: Oct 21 - Nov 2	12	1101	1029	-6.5%	Worries About The Recovery
2009: Sep 23 - Oct 2	9	1080	1020	-5.6%	Worries About The Recovery
2009: Jun 11 - Jul 7	26	956	869	-9.1%	World Bank Neg Growth Forecast; Fears Market Is Ahead Of Recovery
2009: May 8 - 15	7	930	879	-5.5%	Worries That Market Has Gotten Ahead Of Itself
Median	**26**			**-7.9%**	COMPOUND

All of this is to say that we don't expect a resolution any time soon. In fact, we don't really want a quick resolution because it will indicate that we haven't completed all five stages. The market, like the rest of us, will need time to heal. As we said before, though, healing brings with it opportunity. Valuations were a bit stretched beyond recent averages due to last year's run-up… they've quickly returned to more reasonable long-term averages. The yield on 10-year Treasury bills is now the lowest it has ever been in history, meaning yield-seeking investors have no choice but to turn to the stock market for income (data from FRED and Factset, 2/28/20). In sum, the risk-reward proposition for stocks has improved. Although we believe this will take some time to resolve, our conviction in the market's potential to combat inflation and deliver positive long-term results has not wavered, and we will be using this environment to buy stocks and funds on sale (where appropriate, of course… have to keep the compliance department happy).

As with the panics of the past, we recommend all long-term investors with properly-diversified portfolios stay the course. You'll notice we use the phrase "long-term" frequently because markets are prone to bouts of extreme irrationality over short periods of time. Review your risk tolerance. Feeling a little uncomfortable is normal and expected. Feeling scared, concerned, worried, or worse is a good indication that we should revisit your portfolio. Of course, whether you're feeling concerned or just want to give us a hard time, please don't hesitate to reach out.

Peter, Ben & Keri

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