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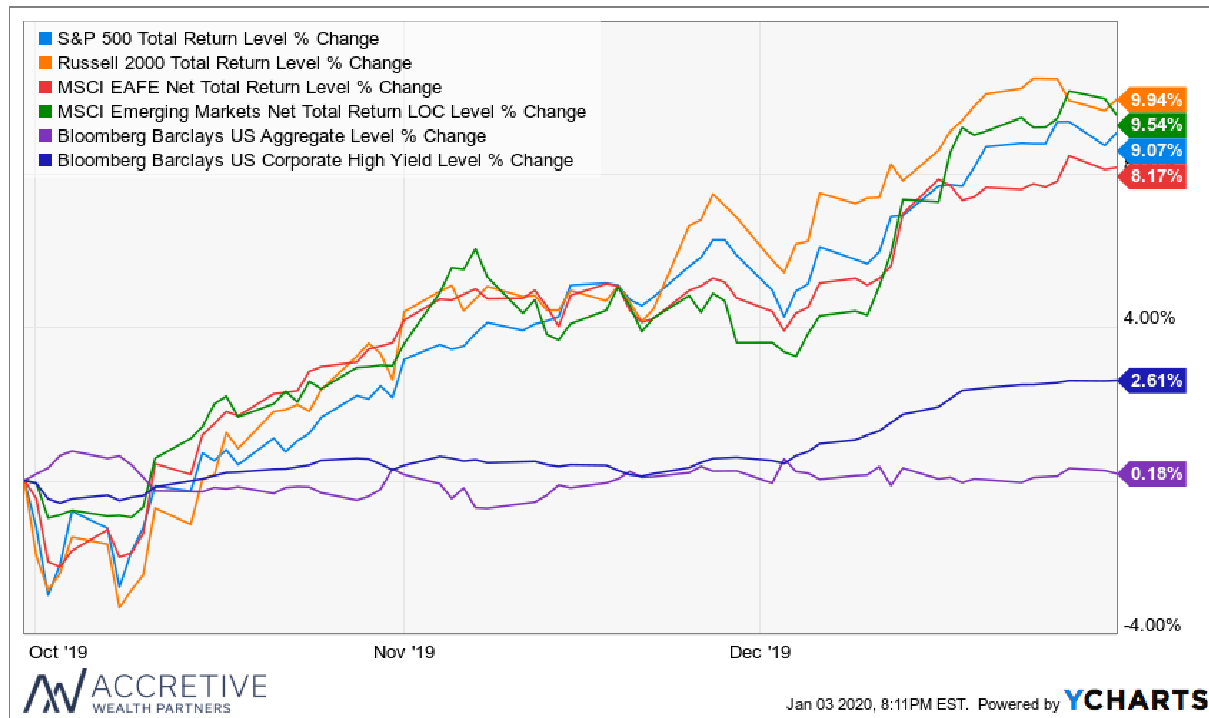
Fourth Quarter 2019 & Year-End Client Letter

Dear Clients and Friends of Accretive,

2019 ended pretty much the way it started, with a robust market across a variety of asset classes. Equities were higher, the corporate credit environment remained healthy, and while rates were modestly higher it was not enough to cause bond investment losses on a total return basis.



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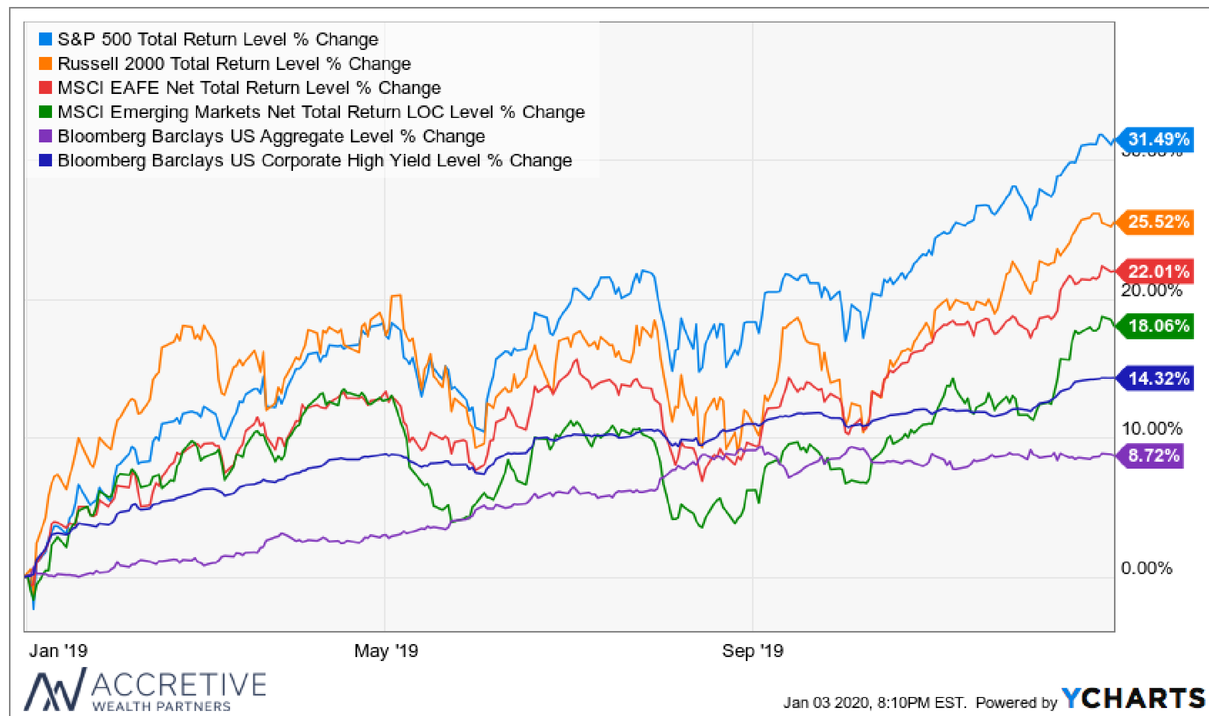
What Worked in 2019?

Since the year is out, it is worth reviewing 2019 in its entirety. Some types of equity investments outperformed others, but the full year story is very similar: everything worked. This includes conservative bond investments, as falling rates confounded forecasters and led to price appreciation.



As you can see, the leader was clearly the S&P 500, which posted its best annual return since 2013. Dispersion of returns was very wide, and the more investors diversified away from large cap US stocks, the less robust the results were and materially so.

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It is worth pointing out that dispersion also occurred within large cap US stocks, as the performance gap between growth and value stocks was nearly 10%.

Investors might be forgiven for wondering why one would do anything else but invest in large US growth stocks. While the narratives surrounding the outcomes seem obvious in retrospect, we should remember that the outcome shaped the narrative. Investors pay high prices for rosy forecasts, and companies cannot always meet or exceed already high expectations.

From our perspective, the reason is that the past is not always prologue and we do not know what the future holds. We try not to confuse what we know with what we think. The reality of investing is that the future is always uncertain, so we avoid all or nothing bets as we try to hedge our ignorance. As a result, some part of our portfolio will always be outperforming another part. In our view, this is not a tragedy.

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2019 Recap & The Stark Contrast to 2018

As we entered the year, the outlook was quite bleak. Most economists had forecasted rates to rise and the Fed to keep tightening. Many commentators were quite bearish on the global economy and corporate profits. The yield curve flattened, then inverted, and later normalized. The Fed went from forecasting a couple of hikes this year, to forecasting no hikes at all, before eventually cutting rates three times before year-end. This is to say nothing of the dysfunction in Washington and the geopolitical tensions.

Against this backdrop the market climbed a wall of worry. Apart from two difficult months, May and August, the market looked healthy and relatively strong all year.

With the benefit of perfect hindsight, we can say that by the end of 2018, taking risk seemed to be imprudent. By the end of 2019, it was avoiding risk that seemed to be imprudent. We try not to let recent results color what we think is prudent now. This discussion on risk is a good segue into our quarterly topic.

Accretive On: Risk Taking, Behavioral Economics, and the Impact on Portfolio Management Process

The topic of risk in investing is an important one for investors and it is worth noting there are different definitions. Academics define risk as volatility, fundamental investors define it as the possibility of permanent capital loss, and financial planners define it as the possibility of not meeting one's financial goals.

From our perspective, the academics, fundamental investors, and financial planners all have a point. What matters most to clients in the long run is the financial planner's definition. However, the long run is comprised of all the various short runs. As such, volatility and the risk of permanent capital loss need to be addressed. We think about volatility within a portfolio context. We ask: how does a collection of investments behave collectively and work together over a market cycle? We also think about the possibility of permanent capital loss on a discrete basis in our individual equity portfolios where we are making a deliberate decision to buy, sell, or hold a company.

It may surprise you, but we also spend a great deal of time thinking about permanent capital loss on the *client* level. We ask ourselves: do clients have a portfolio they can stick with through good and bad market environments? Are we giving clients a good experience over the cycle?

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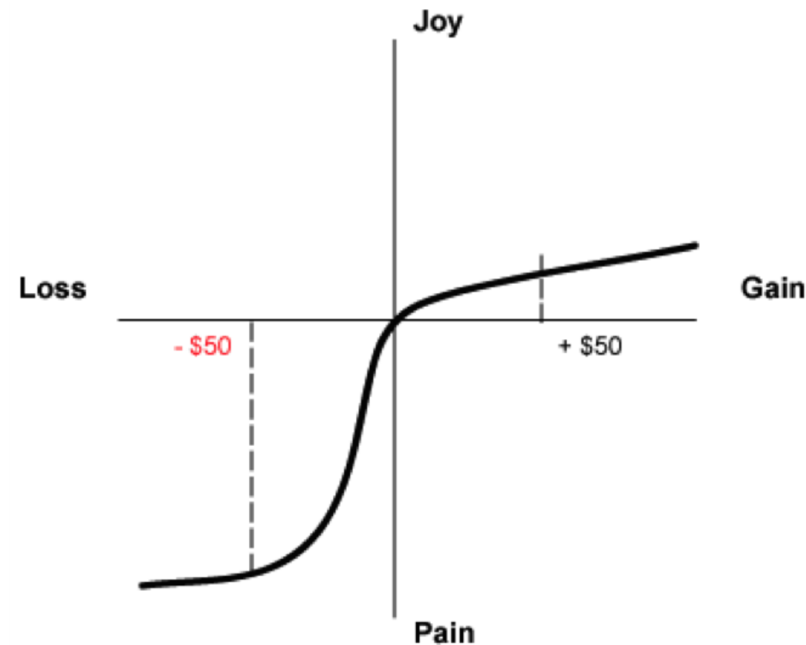
The reason for this is that empirical research has shown that the emotional experience of gains and losses is not proportionate or symmetrical. Investors feel the emotional pain of loss roughly *twice* as much as a they feel the joy of an equivalent gain.[1] This is called *Loss Aversion* and the following chart may help you conceptualize it.



Reacting poorly in the short-run can put the long-run at risk. We think about it this way; if the performance of a client's portfolio led them to sell in the fourth quarter of 2018, with the market down nearly 20% peak to trough, then they would not have experienced the subsequent gains in 2019. 2019 was only a success if clients were able to stick with things through the rough fourth quarter in 2018. A big part of our job, *as wealth managers* is to identify a strategy that meets a client's long-term financial goals but is also one that they can stick with over all kinds of short-term environments. A key part of my job, *as the portfolio manager*, is to understand the average client's psychological stance. This informs how I structure and manage portfolios; the end goal is to help clients stay on the path.

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2020 Outlook

Any comments on the upcoming year should be caveated by pointing out how badly so many forecasters missed on 2019 predictions. With that said, let's take a prospective look at 2020.

When we look ahead, we believe it is helpful to distinguish between what we know and what we think.

We know the rally in 2019 was not supported by earnings growth, as corporate earnings were essentially flat. Most of the gain was simply the result of investors putting a higher price on the earnings stream. We think that was because investors were feeling better about the environment, the Fed's accommodation, and the prospect for earnings growth in 2020.

We know right now Wall Street consensus is for earnings to grow mid to high single digit in 2020. We also know that the consensus tends to be most optimistic around the New Year and those estimates tend to come down throughout the year. We think given the elevated valuation, companies will need to deliver on those expectations for the market to move higher, and we don't think this year's performance is repeatable in 2020.

We know that rates are historically low. We think there are good reasons for that and the risk to rates remains to the downside. We also think the amount of debt out there in the developed world is an overhang that creates an environment of lower highs and lower lows in rates.

We know that 2020 is a Presidential election year in the US. We think the economy should favor the incumbent, but we also note that this is an unusual incumbent. Regardless of the outcome, we know that roughly half the country will be upset. The outcome for markets depends on a number of variables and just knowing who sits in the White House may not be enough information to make an accurate prediction about the market. We are reminded of this Bloomberg article from the last election, which profiled an investor who called the election outcome but ultimately whiffed on the market outcome.

We know 2019 was a year with below average volatility and above average returns. We think base expectations should be for higher volatility and lower returns in 2020.

Our Portfolios

We build portfolios with the idea that we will encounter a variety of different markets environments. Generally, we build them with a difficult market in mind and there will be times when they have difficult time keeping up with a very robust one. For those of you that had prior experience with me as your CIO, you probably have a better understanding of this, having experienced both 2018 and 2019.

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This year, in the months that were challenging, our portfolios behaved as expected or maybe a bit better. In the months that were robust, there were times we kept up and there were times we did not keep up as much we would like. We were a little weak relative to the market in the strongest months, but for the full year, we would say the overall outcome was satisfactory, given what happened.

In our individual equity portfolios, which we also use in some of our broader asset allocation portfolios, we believe our Equity Income portfolio had a good year, particularly on a risk-adjusted basis. The Equity Growth portfolio had a good year on an absolute basis, but relative to the benchmark was a bit behind. Both portfolios were affected by two things: a modest cash position and no exposure to one of the largest companies in the world (you are likely reading this on one of their devices), which happened rise almost 100% in 2019. This company is now an 8% position in the Russell Growth benchmarks, so it had an unusual out-sized effect. In investing, sometimes you miss one, but it usually doesn't impact the relative performance quite so much.

Closing Remarks

2019 was a good year for the markets and for Accretive. As we look back and take in everything that happened over the last twelve months, we feel two things: a sense of accomplishment and gratitude. The gratitude is toward those clients that saw what we were doing and knew they wanted to be a part of it. Accretive is something that would not be possible without many of you. Eric, Steve, and I thank you.

As we enter 2020, we are doing so with a lot of momentum in the business and optimism about what we are building. We hope to have a few more updates to share with you throughout the year. As always, we appreciate the trust and confidence you have placed in us; we do not take it lightly. If you have any questions, please do not hesitate to reach out.

Happy New Year,

Gary

Gary C Ribe, CFA, CFP®

Chief Investment Officer

[1]Kahneman, D. & Tversky, A. (1992). "Advances in prospect theory: Cumulative representation of uncertainty". Journal of Risk and Uncertainty. 5 (4): 297–323.

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