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TOUCHSTONE Strategy

Richmond | Goodman Wealth Management

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TouchStone Update – 1st Quarter 2019

Our last report to you at the close of 2018 was titled '**In like a Lamb, Out like a Lion**'. Perhaps the first quarter of 2019 should be described as '**Off to the Races**'. Markets have surged this year (so far) but, quite frankly, the last 9 months have been atypical (decline…steeper decline…rapid rally) – except for one trait we have seen happen a few times since the last recession. To be clear the 'trait' we refer to is not a characteristic we like, and forms the basis for remaining cautious of late.

Our condensed overview is as follows:

- Our strategies carried high cash positions in Q4 2018, and as a result we outperformed the indices in 2018.
- As 2019 began, we maintained that stance with evidence of a slowing economy and US/China trade rhetoric, etc.
- The US Fed announced a halt to further rate increases, further enhancing the argument for economic weakness.
- In what can only be considered as "odd", the market ignored the "slowing" aspect of the economy and roared higher (doesn't slower mean less spending, less corporate profits?).

What drove the market to its impressive rally in Q1?

- Certainly, many stocks rose but what we found interesting, and which we have seen happen before, is the following:

- What often happens after a very steep decline (December 2018) is that the stocks that performed the worst, go on to rise the most in any subsequent rally (at least in the short term). This may occur because of *short-covering* (i.e. buying back the shares that were shorted in order to lock in gains), and *value-trap hunting* (picking stocks off the scrap heap with the optimism that they won't go down forever). Neither behaviour is in our repertoire, for we don't subscribe to an investment strategy based on speculation (for the former) or hope (for the latter).

- We mentioned that we have seen similar periods before. Evidence of the short-covering rally is demonstrated by fact that the US Dangerous Portfolio was **up** +29% (and the Canadian Dangerous Portfolio **up** +21%) for Q1. They are the two best performing models in the Morningstar Equity Universe…for all the wrong reasons.

- The “Dangerous Portfolio” is a special collection of stocks, and has its name for a reason. These are lousy companies, plain and simple. It is a basket of stocks that would be the best ‘shorts’ (i.e. they should go down in value). So, when instead, they have a huge positive return, it should be cause for concern. In other words, one should be skeptical when the best performing “area” of the market is the one which contains the weakest companies. We do not get tempted with ‘fear of missing out’ (FOMO) in such circumstances.

- In a nutshell, our client portfolios experienced good returns in Q1 but lagged the indices – simply because we are not willing to own companies that are inferior. History tells us that the relationship of rising prices for the worst companies cannot last.

- What matters most is delivering good risk adjusted results – on this basis we have performed well above the index.

In broader financial markets, another curious development has occurred thus far in 2019.

Stocks have been moving in tandem with bonds prices. This positive correlation of equities and fixed-income prices presents investors with contradictory indicators on where the economy is headed. A strong stock market *should* indicate a robust economy…and a strong bond market *should* portend a weaker economy. One of them is wrong. We make no predictions on the victor. However, we do observe that the bond market’s pessimistic view has some credibility, history shows. It generally has the better record.

Bottom line: We continue to hold shares of companies that deserve to be held, sticking to our time-tested investment process. Whether we make additional investments or raise cash further, it will be done in a systematic and rational way. It is only with years of experience (25 in our case) that one knows that while history doesn’t repeat itself, it often rhymes. (kudos to Mark Twain).

Thank you for your continued confidence and, as always, we are happy to discuss any topic of interest to you.