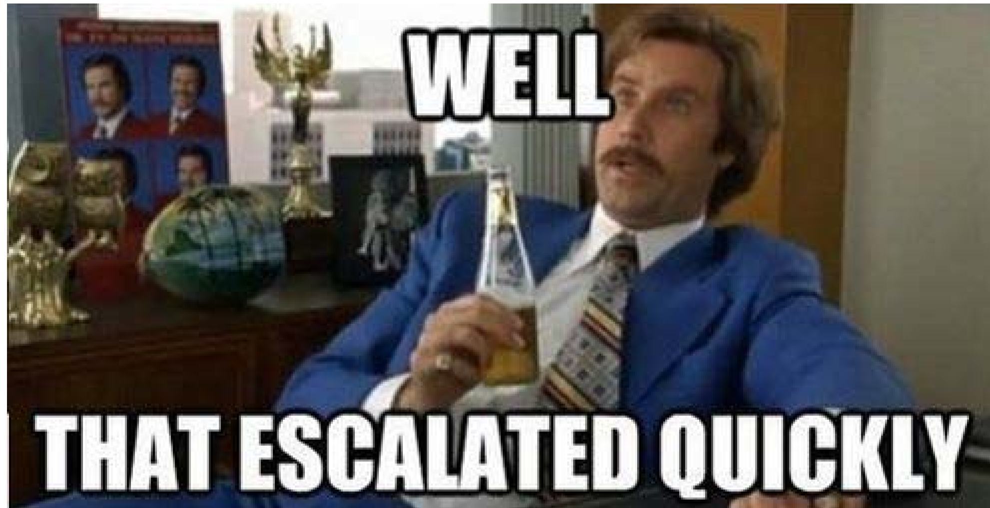
OBSERVATIONS 9.4.2015

TANDEM Investment Advisors



Source: http://s23.photobucket.com/user/realityhelix/media/reaction%20images/anchorman-well-that-escalated-quickly.jpg.html

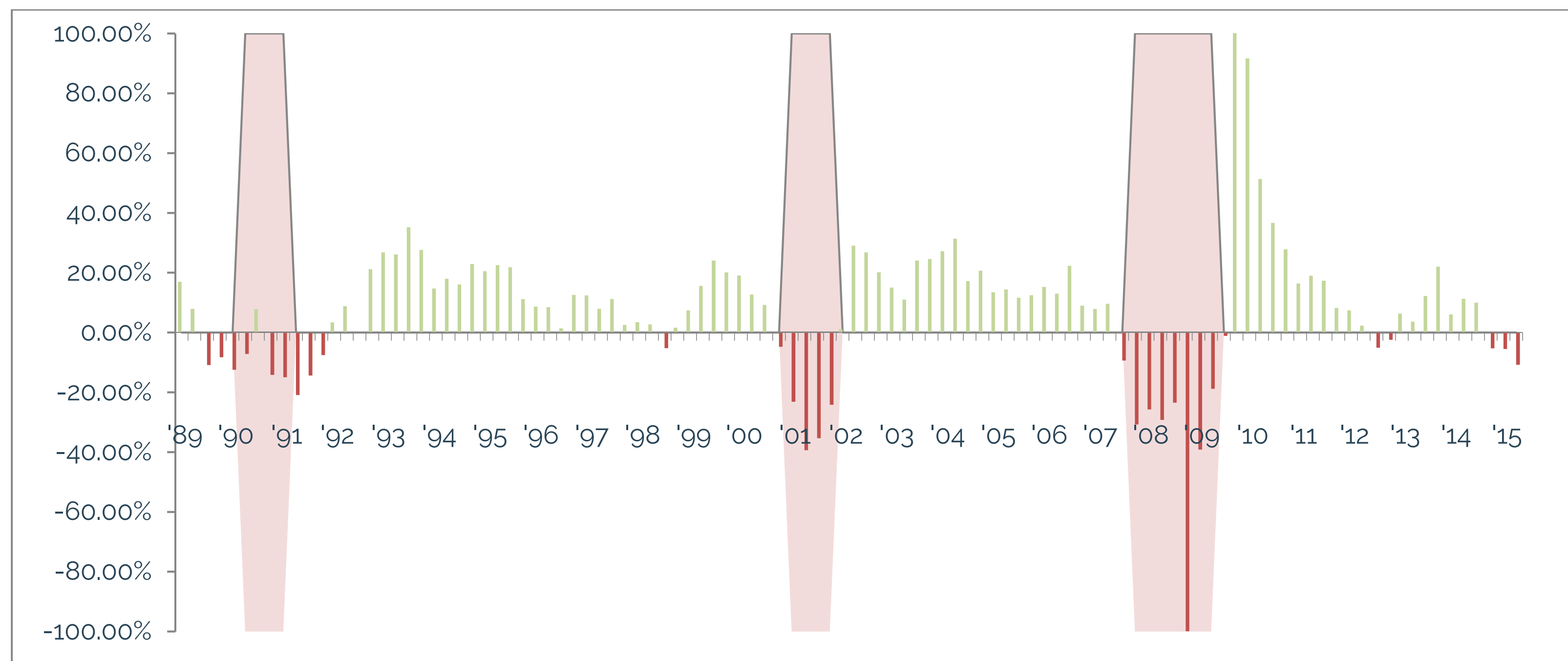
The U.S. equity market went from *Groundhog Day* to *Friday the 13th* in quite a hurry. It wasn't more than four weeks ago I was writing about the U.S. stock market being stuck in a trading range. No matter what was being thrown at the market, we went nowhere. Anyone who tried to challenge the underpinnings of the market was immediately dismissed as being a permabear. Over the past several months, I constantly heard how resilient the market was in the face of bad news. There is no doubt the market was resilient, but that is no reason to blindly invest one's hard earned cash. As I stated several times over the past nine months, you need to be proactive in your investment approach and not reactive. So, now that the S&P 500 has declined 12.54% from the year-to-date high to low, the biggest question I hear is, "what do I do now?"

Well, for starters, there is no reason to panic. If you are a regular reader of this column, you definitely shouldn't be shocked by the recent market moves. As I mentioned in the closing of my column posted on July 7th of this year...

"I'm not saying we are headed for a year like we had in 2008. What I am saying is that caution is probably warranted... But, now is not the time to be going "all-in". That time has passed for now. The prudent thing would be to assess the risk of your portfolio and make sure you are comfortable with what you own. It's not time to be complacent or fear what you may miss. Each investor has their own tolerance for risk and it would be wise to make sure your portfolio is structured to allow you to sleep at night. Buy low and sell high. It's a lot easier said than done. But, if you don't start now, you never will."

I trust you didn't go "all-in" and buy the market top in July. And, if that's the case, you should be in a good position to benefit from other investors' fear. Unfortunately, a lot of people were not positioned correctly and reacted in an irrational manner to the sea of red on their computer screens. On August 21st and 24th, the VIX, a measure of fear, posted the 5th and 6th largest single day spikes going back to January 1990 (earliest time the CBOE compiled data on the VIX). These spikes were proof that most people became way too complacent and were willing to sell at any cost. Now that is no way to manage your portfolio. Another way to not manage your portfolio is to assume that the market is now cheap since it just declined a little over 10%. An expensive market that falls 10% is only a little less expensive. By no means is it cheap. It is true that prices for the majority of stocks are less today than they were a month ago. However, that doesn't necessarily mean they are "cheaper". In the short run, stocks tend to trade off of emotion. And, in the long run, stocks tend to trade off of earnings. If prices decline in line with earnings, valuation stays the same. What may appear to be cheaper in price is not necessarily a better value.

As I have mentioned for several months now, the underlying fundamentals and growth prospects have not matched up with prices. Until now, the market didn't seem to care and for some reason mid-August was the turning point. Many pundits point to weakness in China and a potential interest rate hike by the Fed as the main catalysts to the recent market correction. It is utterly amazing that no one will bring up the significant slowdown in corporate revenues and earnings. Weakness in corporate fundamentals did not happen overnight. Instead, this has been in the making for the past several quarters and reflected in just about every other asset class except for U.S. equities. The graph below depicts year over year growth in quarterly S&P 500 operating earnings along with recessionary periods shaded in red.



Source: http://www.standardandpoors.com

There are a few things that stand out in this chart. First, year over year negative earnings growth occurs far less than positive earnings growth. Second, since 1989, clusters of periods where negative earnings growth are observed have occurred during a recession or preceded a recession. In fact, over the past 25 years, we have yet to see three consecutive periods of negative earnings growth and not experienced a recession. So, are we in a recession? Technically, no. However, we typically don't know we are in a recession until well after the fact when all the data gets revised multiple times. There are certainly no shortage of economic indicators pointing to recessionary times - factory orders, wholesale inventory build, inventory to sales ratio and business investment spending. On the flip side, there are plenty of signs that say we are not in a recession - GDP, jobs and weekly jobless claims. No doubt, these are very confusing times. At the very least, it is quite clear we are in the midst of a late cycle slowdown. And, it is my belief we are much closer to a recession than the beginning of a recovery.

Knowing where you are within an economic and market cycle shouldn't drastically change the way your portfolio is managed, but rather adherence to your discipline can't be stressed enough. A shift in market cycles coincides with a dramatic increase in volatility. Don't let the volatility manage you. Instead, use the volatility to effectively manage your portfolio. There will be time periods when forced selling through margin calls, or when ETF selling creates irrational pricing among individual stocks. These are golden opportunities to put a little cash to work. However, please understand that it is not a buying opportunity every day the market sells off. You need to be picky with your entry points. As I mentioned earlier, in an environment of declining earnings, falling stock prices don't inherently make stock prices attractive. It is only when the stock price falls more than the expected earnings deterioration that value is created. This is what you are waiting for, so be patient. It's not necessary to react to every violent swing in the stock market. The days of *Groundhog Day* have come and gone. It's time to embrace the uncertainty and volatility and take control of this modern day horror movie.

--Billy Little, CFA

"It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it." ~ Ralph Waldo Emerson

DISCLAIMER: This writing is for informational purposes only. The information contained in this writing should not be construed as financial or investment advice on any subject matter. Tandem Investment Advisors, Inc. does not represent that the securities, products, or services discussed on, or accessible through, this site are suitable for any particular investor. You acknowledge that your requests for information are unsolicited, and the provision of any information through this site shall not constitute or be considered investment advice, or an offer to sell, or a solicitation of an offer to buy any product, service, or security. Past performance is no guarantee of future results. Indices are unmanaged and not available for direct investment. They are shown or referred to for illustrative purposes only and do not represent the performance of any specific investment. No data in this writing should be construed in any way as performance of any Tandem investment product. For complete performance information and disclosures, please contact John Carew at jcarew@tandemadvisors.com

From time to time Tandem may discuss select purchases and/or sales within this report. All past portfolio purchases and sales are available upon request. Any portfolio transaction discussed here does not constitute advice or a recommendation. Please consult your financial advisor before making any investment decisions. For information regarding past purchases and sales, please contact John Carew at jcarew@tandemadvisors.com.