Market Commentary

Winning at the Horse Races

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For most people the end of summer means one last dash to the beach, back-to-school shopping, and some final wagering at the horse track. At least this has been the case for me. The last bet on the last race at the Del Mar Racetrack in Southern California comes at Labor Day. Betting on a horse means putting money on a hopeful winner before the announcer shouts “go” and either picking up a gain or losing it all several minutes later.

Investing shouldn’t be like that, though. In our view, actually, no manager should pick a horse in the race, but that is usually how we see it work. At several conferences recently, we conducted some informal polls: will the S&P 500 be lower or higher at the end of the year than it is today? Will the 10-year Treasury fall from current levels or go back higher?

Like a horse race, no one really knows, but that doesn’t stop many from wagering on the unknown future. We’ll take a look at the bull case for stocks and bonds. Then we’ll propose our approach to making money without actually wagering on a horse in the race.

Stock bulls make some quite convincing arguments in support of that view. First, there is the Federal Reserve (“the Fed”) which is doing its very best to engineer a soft landing for the U.S. economy. Efforts by the Fed, executed successfully, could extend the upward trend in stocks by months or years. It could well be true that the U.S. economy does not need the Fed to do much at all: unemployment is low and people with jobs often feel confident to buy homes, cars, and more. A fiscally confident U.S. consumer can go a long way to keeping the economy in check while pushing the stock market to higher and higher levels.

The stock bulls state these strong arguments for keeping a higher risk exposure to win the race. But with trade wars, contracting global economies, falling corporate profits, and other factors, this bet could derail this outlook, and the resulting portfolio pain could really hurt.

Bond bulls believe bond prices will rise and that means that interest rates will fall. Considering that the 10-year Treasury rate has fallen to a low that it hasn’t visited in over 3 years, the camp betting on falling interest rates is sold on a lethargic view of forward economic growth in the U.S. The lower interest rate bet says, yes, absolute economic levels may be okay: that unemployment is low and confidence fairly high, that manufacturing is still going strong and real estate continues to be healthy, but what matters is that these good things are getting worse, not better. For instance, confidence may be at a good level, but it’s getting worse. This camp supports

that view that better or worse is more important than good or bad.

The bond bulls may be right. Or the stock bulls may be. Maybe they both are; maybe they both are wrong. We have not picked a horse for the race, and we don't intend to pick one. Instead, we are constantly adjusting, something you can't do in an actual horse race where the betting closes once the race begins.

We identify the asset classes and securities trending positively when we make a decision to buy. We can and will consider investing in any security in a rising trend. However, when that uptrend switches to a falling trend, we seek to eliminate the impact on the portfolio by selling. Essentially, we place our wager on the horse with the best odds of winning, but adjust our bet throughout. The most unique advantage this brings are periods of time when we have no wager at all and rest in cash until the trends become clearer. In fact, there are times in recent history when our various strategies have had up to 100% in cash because every single horse has scratched out of the race.

Our strategy is always agnostic to the loudest (or "smartest") point of view. For instance, we touched on the stock bulls who are pointing to an accommodative Fed and strong employment here in the U.S. We also looked at the bond advocates who argue that things may be good, but they are getting worse, not better. We won't pick a horse in the race, making money instead by owning asset classes in an uptrend, but selling and holding significant cash positions when the trends are all down.

We hope it has been a terrific summer for you.

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Terri Spath is Chief Investment Officer at Sierra Investment Management. She jointly oversees the investment activities of the organization and appears frequently in the financial press.

Definitions

The Standard & Poor's 500 Index (S&P 500) is a market-capitalization-weighted-index of the 500 largest U.S. publicly traded companies. It is widely regarded as the best gauge of large-cap U.S. equities.

Investors cannot directly invest in an index and unmanaged index returns do not reflect any fees, expenses or sales charges.

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