The Conservative Strategist

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WHOA: 4 reasons retiree portfolios should trot, not gallop

If you're a client of *Seasonal Strategy,* you know by now most of the market-based reasons for caution. Near-record valuations, slowing business profits, ballooning debt and deficits, an aging expansion, less-than-confidence-inspiring political and economic leadership, and growing geopolitical risk — all argue for lowering portfolio risk.

But there are at least four reasons *not directly related to market con-ditions* that support *Seasonal Strategy* in seeking to keep portfolio volatility moderate and liquidity high *as a policy.*

1 Withdrawals

Many, if not most, of our client portfolios are under the stress of systematic withdrawals to support our clients' lifestyles. These withdrawals rise over time to keep up with inflation. In the inevitable portfolio declines, the withdrawal amount by definition increases as a percentage of the portfolio.

If the portfolio decline is steep enough and lasts long enough, portfolio withdrawals can seriously erode the portfolio's capacity to bounce back. Hence, the importance of keeping declines as shallow as possible, even if it's at the expense of some upside potential.

Want to be less aggravated? Check the market less often.

1971-2018

Percent of time S&P 500 total return was down each…

DAY	MONTH	YEAR
47%	34%	20%
Check the market every day, and you'll be disappointed nearly half the time.	Check it every month, and your disappointment rate is down to one-third.	Check in yearly, and you'll wear a sad face only one instance in five.

Of course, Seasonal Strategy's portfolios are less volatile than the S&P 500, but the same principle applies.

2 Health

Health is wealth, it is said. And in at least one respect, wealth is health: A sudden decline in net worth can damage physical well-being. A 2018 University of Zurich study found that a 10% or greater loss of wealth leads to a measurable drop in physical and mental health, and significantly increases hospital admissions. Another study out of Italy found that larger-than-usual daily drops in the stock market trigger a rise in the rate of fatal car accidents.

Both studies seem to confirm a link between investment loss and psychological stress, and to support prior studies that found a similar correlation.

(Continued on page 4)

The Markets June 28, 2019	Price/Yield	Gain, Qtr	Gain, YTD
US Stocks (S&P 500/Vanguard Index)	2941.76	4.27%	18.47%
International Stocks (Vanguard Index)	16.93	2.72%	13.21%
Emerging Markets Stocks (Vanguard Index)	26.89	0.68%	12.05%
Real Estate Stocks (Vanguard REIT Index)	29.08	1.69%	19.23%
Bonds (30 year US Treasury/Vanguard Index)	2.52%	5.47%	10.32%
Dollar (US Dollar Index)	96.13	-1.18%	-0.04%
Gold (London Afternoon Fix)	$1402.50	8.27%	9.66%
Money Market Funds (Vanguard Prime – SEC yield)	2.38%	-0.08%	-0.04%*

*change in yield

Is anything still cheap? Yes. Emerging markets value stocks.

With interest rates once again headed toward historic lows, cheap credit is spurring rampant speculation and sending risk assets close to prior highs. The world is picked fairly clean; hardly any assets are fairly valued, let alone undervalued.

But one sub-asset class remains a genuine bargain: value stocks in emerging markets (EM Value). Granted, they are also risky. But their cheapness today more than compensates for their risk.

A perfect storm

For the past several years, a strong US dollar has hit emerging markets, foreign markets currencies, while a slowdown in China has pressured Emerging Markets stocks. Meanwhile, the romance of large tech has drawn money from value investing to growth investing. Finally, rising trade tensions in the past two years have kept a lid on both emerging markets and value investing.

It should be little surprise, then, that EM Value has been the world's most beleaguered asset class for some time. This despite the fact that the companies (as opposed to the stocks) which compose EM Value have actually fared reasonably. Burgeoning middle classes and trade among EM nations have been supportive.

Solid value

Result: Impressive value now exists for EM Value. Today it sells for an average 9 times earnings (versus17 times for US Large-Caps, and even 17 times for EM Growth). That's back to 2011 valuations, before a big surge.

At 9 times earnings, every dollar you invest purchases 11 cents of earnings — a so-called 11% earnings yield. On top of that, the average EM Value stock offers a dividend yield of roughly 3.5%.

You can see why global asset allocation firm GMO projects 12% annual returns (9.5% above its 2.5% inflation projection) for EM Value for the next seven years.

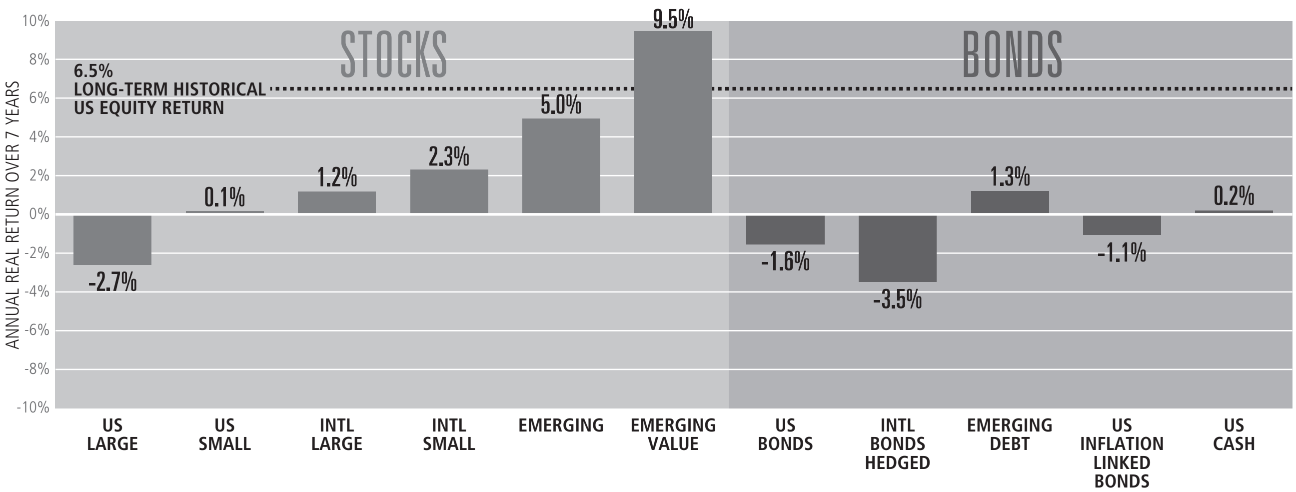
Risks and rewards

Sure there are risks: a worsening of trade wars, a general global recession, continuing US Dollar strength and weak commodities.

But against those risks, you enjoy four return levers: earnings, dividends, possible currency appreciation, and a general re-rating from today's 9 times earnings to something closer to a historically normal 13-16 times earnings. ■

EM Value a standout

7-year asset class real returns forecasts, as of May 31, 2019

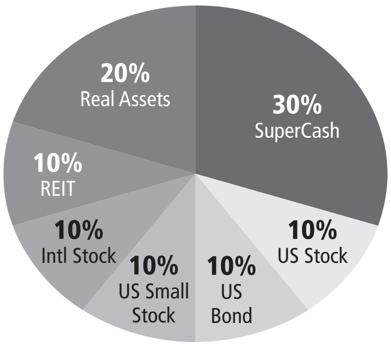


Global asset allocation firm GMO has published these projections monthly for more than 20 years. They have proven quite accurate according to The Economist *magazine. Today, GMO sees a lack of profit potential across the investment universe — except for emerging markets (EM), and particularly EM Value.* *Source: GMO*

SuperDiversified Portfolios (SDPs)

Up-down-up pattern in Q2

SDP1 ***Conservative***

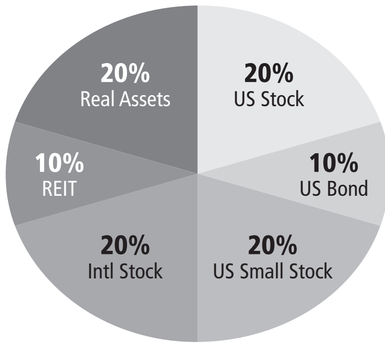


2nd Quarter **1.91%**

Year-to-Date **10.66%**

Q2 saw a continuation of Q1 strength, though with more volatility and rising risks. Risk assets rose in April, plunged in May, then rallied strongly in June.

SDP2 ***Moderate***



2nd Quarter **2.59%**

Year-to-Date **14.88%**

Recession fears sent rates lower and bond prices higher. Geopolitical tensions (trade war with China, drone shot down by Iran) triggered gold to break out of a multi-year range. Yet stock investors remain oddly complacent.

The above model portfolios are not intended to indicate the performance of any real account, but reflect the composite performance, before fees, of the percentage allocations in the asset classes and funds listed in the table below. Seasonal Strategy's actual allocations vary from these models, and among portfolios.

How the Sectors Performed

Alfred E. Neuman market persists

Asset Class	Mutual Fund	Performance 2nd Quarter '19	Performance Year-to-Date	
SuperCash	PIMCO Instl Low Duration	1.27%	2.77%	Best
	Merger	0.36%	2.44%	Worst
	Calamos Market Neutral	1.40%	4.24%	
US Stock	Vanguard Index Trust 500	4.27%	18.47%	
US Bond	Vanguard Long-Treasury	5.47%	10.32%	
US Small Stock	Vanguard Small-Cap Index	2.85%	19.46%	
Intl Stock	Vanguard Intl Index	2.72%	13.21%	
REIT	Vanguard REIT Index	1.69%	19.23%	
Real Assets	PIMCO Commodity Real Return	-0.49%	8.61%	

"The warning signs have been growing in number and frequency. Yet for all the fretting about the trade wars, Cold War II, Brexit, Euro-fragility, populism, sky-rocketing debts, grossly underfunded pensions, social instability, and the slowing economy, the vast majority of investors remain confident that all these problems can and will be solved painlessly. If they thought otherwise, the S&P 500 would not be trading within 2.5% of its all-time high and the yield on the corporate junk bond index would not be hovering within 1% of its all-time low."

— Simon Mihailovich,
Tocqueville Bullion Reserve

Causeway

Causeway Emerging Markets (CEMIX) is not a pure emerging markets value fund, but it's got enough going for it to merit attention.

First, it is overinvested in smaller companies versus the benchmark. That's good timing, because after a 22% underperformance vs. larger companies since 2016, EM small-caps are poised to reward patient investors.

Second, it combines momentum investing with value investing, a proven synergy.

Third, despite its tilt to value and small-cap, and despite the underperformance of these two factors in the past two years, *Causeway* has beaten the emerging markets stock index by one percent per year over the period. It has also beaten the EM Value index in 80% of all rolling three-year periods since inception. That's solid stock-picking.

A seasoned team

Years at *Causeway*

MANAGER	CO-MANAGER	CO-MANAGER
Arjun Jayaraman	MacDuff Kolmert	Joe Gubler
13	18	14

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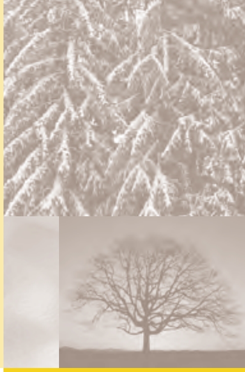


WHOA: 4 reasons retiree portfolios should trot, not gallop *(Continued from page 1)*

3 Opportunity

Bear markets are opportunities. Near major bottoms for risk assets, widespread panic by over-leveraged speculators can produce once-per-decade-type bargains.

Studies show that if your portfolio is down more than 20% to 25% in such a crisis, you will not be in a bargain-hunting mood. On the contrary, you may be thinking: "What if my portfolio falls another 25%?" You are more likely to panic, or at least freeze, than to calmly accumulate.

But if your portfolio is down only 10% to 15% in such an event, and you have plenty of cash and cash-like assets in reserve, you are more likely to be prepared — financially and psychologically — to buy from the panic sellers.

4 Asymmetry

The above three reasons don't persuade you to keep volatility low? Then just look at the math:

- If you suffer a 10% loss, you will need an 11% gain to get back to where you were before the decline.
- If your loss is 25%, you will need a 33% gain to emerge whole.
- And if you are unfortunate enough to be down 50% (the fate of many an aggressive investor in the past two great bear markets), you will require a 100% gain for complete recovery.

This is called the *asymmetry of returns effect,* and it's a powerful argument for keeping portfolio volatility moderate. It's especially pertinent to older investors who may not have more than a couple of market cycles ahead of them, and thus limited opportunity for recovery.

There's a further asymmetry that should concern all investors. It's an *asymmetry of perception.*

Research into investor behavior by Nobel-Prize winning Israeli psychologists Daniel Kahneman and Amos Tversky found that investors react roughly twice as strongly to losses as gains. That is: The pain of a loss of X% is twice the intensity of the pleasure of an equivalent gain.

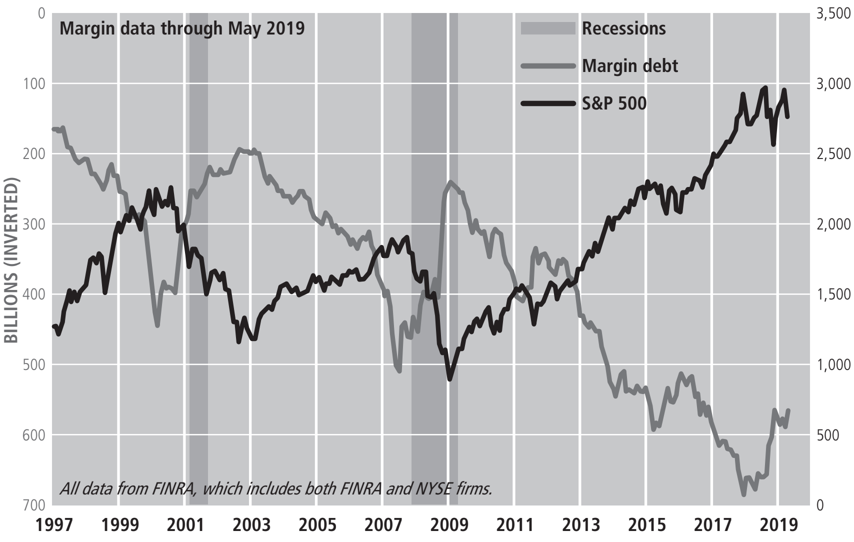
It follows then that volatility produces net misery. The more volatility, the more misery. (And we have already seen the effect of all this on physical health.)

Yet there is no gain without risk. Clearly, our clients need to endure enough volatility to achieve the portfolio returns that will support their lifestyle, longevity, and legacy.

But more portfolio risk than necessary can detract from the emotional (and physical) bottom-line. That's why at *Seasonal Strategy* the goal is to structure and maintain portfolios that take enough risk to meet clients' long-term goals — but no more risk than that. ■

Here's how an overleveraged market looks (version 3.0)

FINRA margin debt and the S&P 500
Real values (adjusted to present-day dollars, June 2019



◀ *Once again, an awful lot of investors are playing the market with money they don't have. This third speculative rush of the new century is likely to end much like the other two — with forced selling by those with margin calls, and opportunistic buying by investors with conservatively positioned portfolios and ample cash reserves.* Source: dshort.com