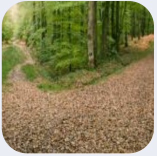
▶ The Road Less Traveled.................... 1-2

▶ Message From The Investment Team 3-5

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Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

The Road Less Traveled

Sometimes doing the right thing means consciously choosing a tougher road. When it comes to helping people manage their money, there's no question that the path of least resistance would be to go with the flow and do what most other advisors do, which is to stay invested at all times and ride the market ups and downs in pursuit of a decent long-term return. A standard diversified portfolio based on the last few decades of asset class returns that fits the risk tolerance and time frame factors would probably do just fine. When the market's up, all is good. When it's down, well, it's down for everybody else too, so you're not alone. Just wait it out and you'll be fine, goes the advice. It's just the way markets work and since there's no predicting when the ups and downs will be, there's really no alternative.

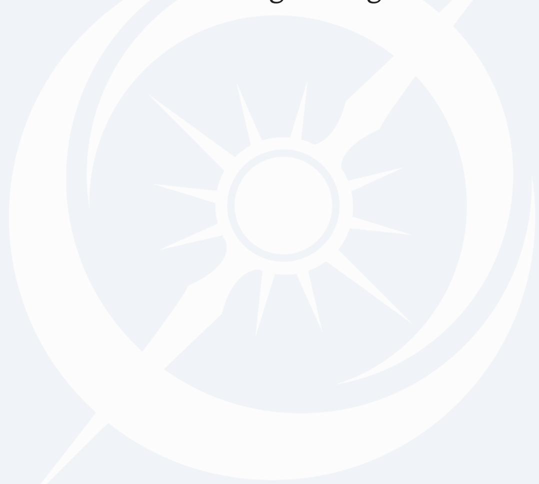
Well, that philosophy never sat quite right with us. You see, there are a number of reasons why Wall Street financial houses would have you believe that this stay-invested-at-all-times and stay-the-course approach is the only way to invest, not the least of which is the fact that management fees can typically only be assessed when assets are invested. The money management industry also knows that it's psychologically easier for investors to be making and losing money at the same times as everyone else. So keeping the boat in the water with a forecasted hurricane track running right over your harbor remains a convenient piece of advice. The right thing to do however? We don't believe so. Most of the rules of thumb the investment industry operates by were developed over the last 25 years or so during the rise and rapid expansion of Wall Street investment banks and mutual fund companies and were developed using fairly recent market history that conveniently suited their needs pretty well. One that still passes through the lips of investment experts is that if you have more than 10 years to wait, stocks are actually a rather conservative investment. This advice seems to disregard entirely the experience of a stock investor in 1929 and 1968. In both cases, that investor would have had to wait closer to 20 years net of inflation to get her investment back. And who's to say that couldn't happen again? Just ask a Japanese investor if that sort of experience is possible in

modern times. Their Nikkei stock market index is at about half of what it was in 1990. That's a span of 26 years and they're still not even close to getting back to even.

So the just-wait-it-out meme may be the easy course, but it's not always the responsible one. Let us draw a distinction between when it would be good advice versus reckless advice. If the market is trading somewhere in the middle to lower end of its historical valuation range, then it would be sound advice. Markets move up and down and selling out of a reasonably priced investment just because it dropped is rarely a good decision. On the other hand, if markets are expensive by historical standards, and we know based on past experience that at some point the complete market cycle will bring them back down in price, then keeping the same allocation to stocks and riding them down when the cycle turns is counterproductive. The exact turning point is irrelevant as long as market prices ultimately get cheaper than they are now. The correct advice in this case, as we see it, is lighten up on "risky investments" much more so than you ordinarily would since there's a much better chance of the market being lower in 1,3, or 5 years than there is of it being higher. So the "stay invested" meme goes out the window as the portfolio is tweaked substantially, and the "stay the course" part becomes relatively moot.

Our view is that this philosophy can only truly be implemented so long as advisor and client interests are aligned. If the advisor's compensation is tied directly to the success of the clients portfolio (in some cases, this means preservation) rather than the use of a particular type of investment, that's a great start. A comprehensive knowledge of market history and the application of investment valuation methods to the portfolio management process is also necessary. And finally, there must be a service mechanism in place that helps to keep the bigger picture front and center. Dangerously expensive markets have a tendency to get even more expensive before coming back down to Earth. Watching other investors reap the benefits of these late gains while you're largely sitting comfortably and somewhat regrettably in a zero interest cash account can be hard to bear. Sometimes not making money when others are can be a stronger negative emotion than not losing as much as others is a positive one. In the end, the math is our guide. As we covered in the article, "Winning By Not Losing" in our July 2012 edition of Cadence Clips, avoiding the big losses in a down market is more beneficial to long-term investment performance than getting those short-lived additional gains. We must fight the urge.

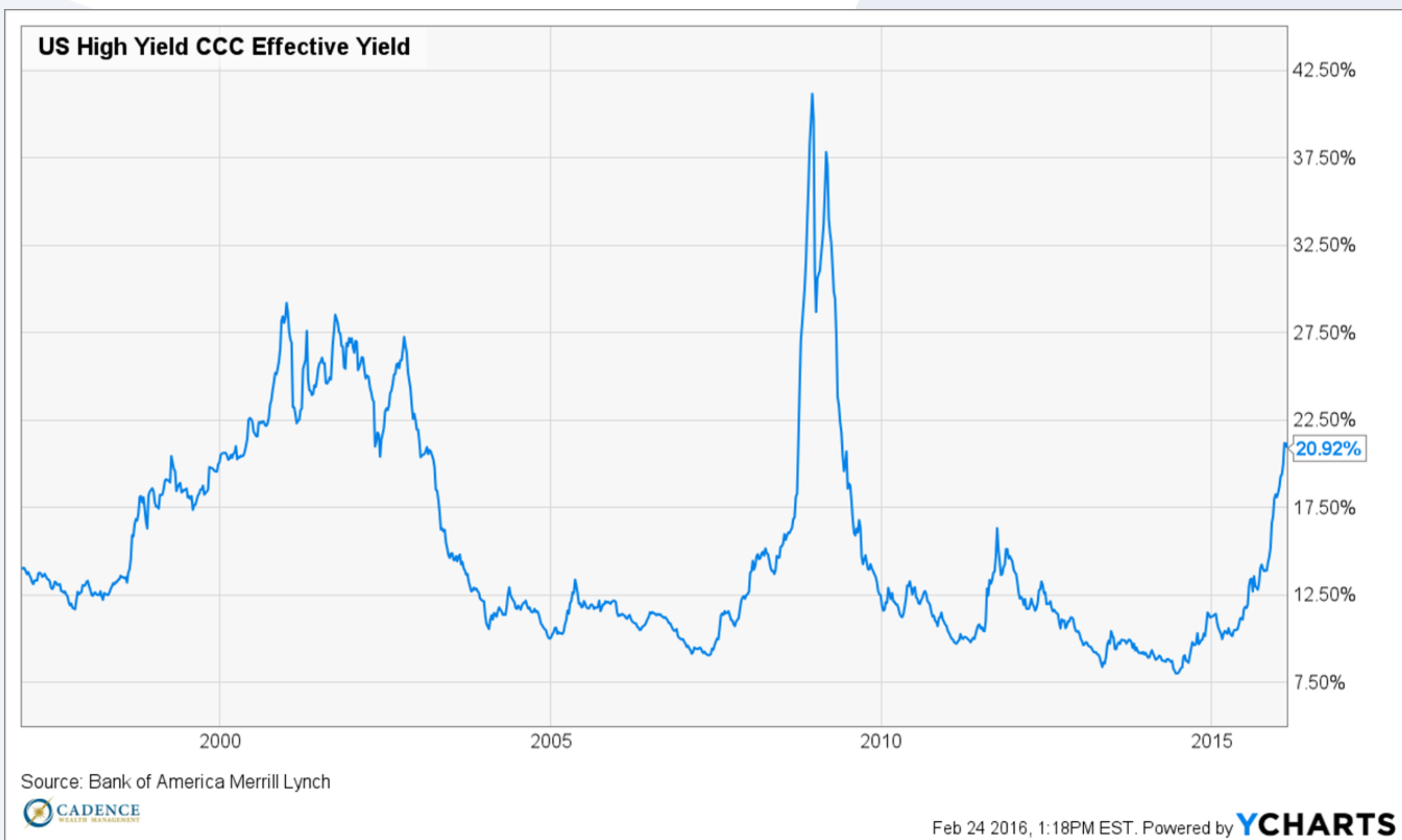
At the moment, markets are really expensive. History and math suggest a strong likelihood of more losses than gains coming up for equity markets as we experience the natural and inevitable "other" side of the market and business cycles. If your portfolio strategy hasn't changed much over the years to reflect these conditions, reconsider it. Worse, if you haven't prepared your portfolio for current conditions, you're nursing some losses over the last couple months, and you're thinking that riding it out is the best advice, reconsider it. This may not be one of those times where staying the course makes sense. For us, going against the grain isn't always easy, but it doesn't matter. Sometimes the right thing isn't.



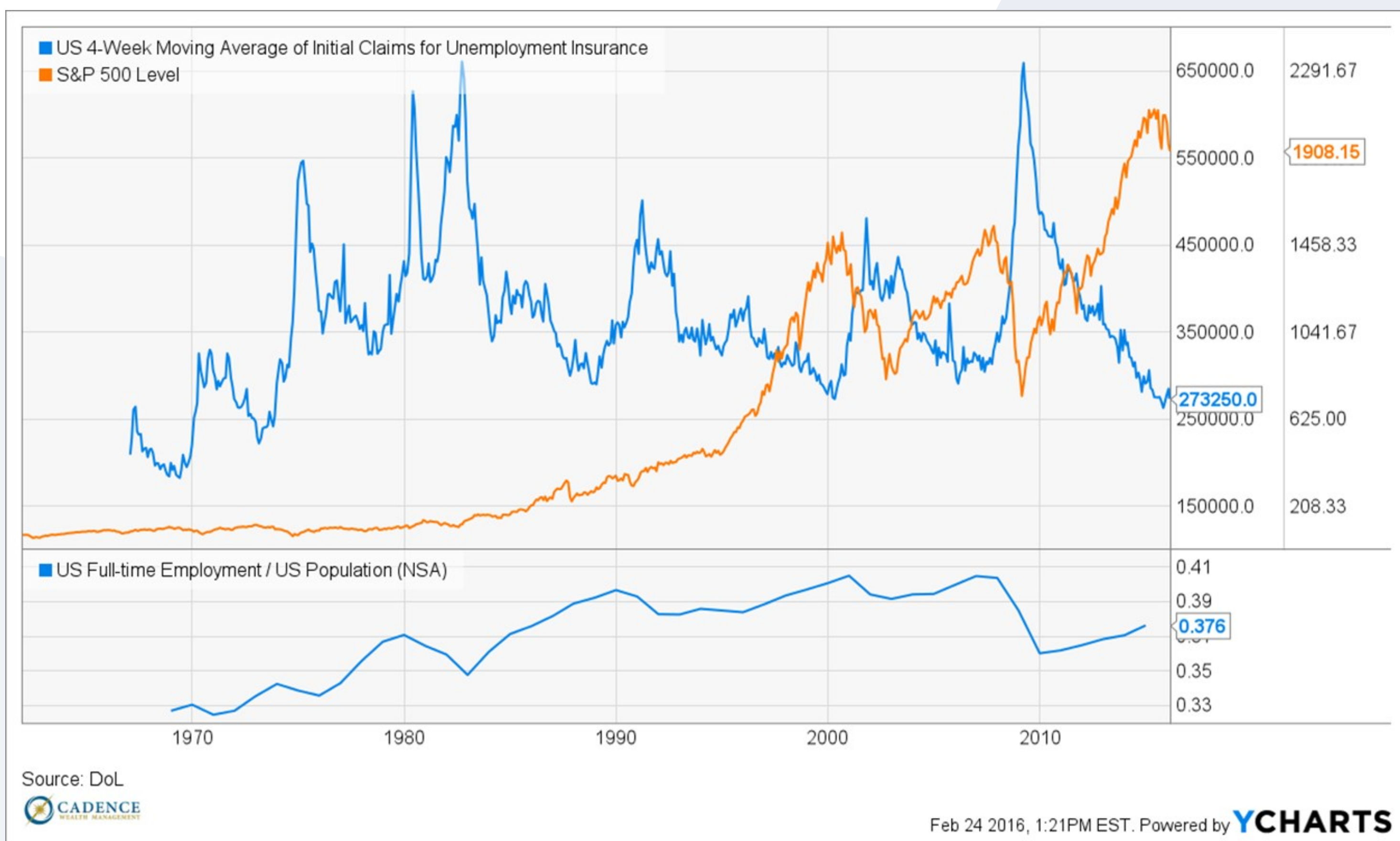
Message from the Investment Team

This hasn't been a very good start to the year. Since topping out in May 2015, the markets have chopped around with heavy declines in August and September of last year, then again in January and February. After each steep decline, the markets rallied back sharply, but haven't been able to set new highs. For the most part, the highs have been lower than previous ones and the lows lower. This is a classic sign of a trend change and indicates that the direction of the markets now is down. Regardless of how sharp the rallies off the lows are, we know that the biggest most breathtaking market spurts take place within downward trending bear markets. This is normal. As of the time of this writing, the markets are bumping up against resistance at approximately 1950 on the S&P 500. If they break through, then there could be some additional room to run beyond that. We doubt however that they'll test the May market highs as the overall market is still very weak, in a downtrend, and facing very strong headwinds from bubble-like valuations against the backdrop of a weak and fractured credit market and economy.

Credit markets have tightened considerably over the months. As we've mentioned before, this is already affecting less credit-worthy companies as they're both finding it tougher to find funding to finance their operations and getting downgraded by the credit rating agencies. The potential for this to spread to larger swaths of the market cannot be ignored. When credit gets tight, activities that helped to prop asset prices up begin to ebb. Whether the borrowing went toward profitable operations or buying back company stock, without it, market valuations have to be reconsidered. Below is a look at the CCC bond yields via Merrill Lynch.



The current level of economic activity just isn't supportive of current market prices. Manufacturing is in recession as indicated by the year over year change in manufacturing new orders and one of the best lagging economic indicators we know, the unemployment claims numbers, are revealing a classic late-stage trough. Notice in the Unemployment Claim graph below how the last two market peaks occurred at similar low unemployment claim levels. Remember, this is data often cited by Wall Street as reason to stay invested due to the strong economic conditions it implies. Quite the contrary. What's more interesting to us is that when you look at the number of full-time employed relative to the total population at this late stage in the economic cycle (with low unemployment and low unemployment claims), it's not only much lower than at the end of the last two expansions in 2000 and 2007, but it's at levels not seen since the mid 1980's. This is a clue as to the true employment story. Although the unemployment rate is at 4.9%, the participation rate in our labor force is at 40 year lows, there are more part time jobs than ever before, and not a commensurate level of full time jobs given the population relative to previous economic recoveries. With this type of weakness after 8 years of monetary tinkering where just about everything that could have been tried has been tried, there are issues. In our opinion, this tells us that the natural path for the global economy and markets is lower.



Under this scenario, we see markets working their way lower over time with plenty of bounces along the way. Some may be worthy of participating in via our actively managed strategies, while others may be shorter lived. We'll take each as it comes and make decisions based on what we're seeing at the time. It's important to keep in mind that in a bear market, if you're prepared, you don't have to look at it as lost time. With the S&P 500 down a bit under 6% and a standard 50/50 diversified portfolio around -2.5% so far this year, our actively managed Market

Trend and Contrarian strategies are up over 7% and 1.5% respectively. This certainly helps offset any losses in the more passively managed portion of the portfolio. With a strong focus on principal preservation and some active management to help take advantage of some of the ups and downs along the way, a bear isn't all bad. Stay cautious, don't let the bear market rallies fool you, and keep a positive outlook. If we can't change it, we need to embrace it.

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Examples provided are for illustrative purposes only and not intended to be reflective of results you can expect to achieve.