VAN LIEW TRUST COMPANY

as we see it

Spring 2019

THOUGHTS FROM OUR CHAIRMAN

During this period of trade negotiations, the market is understandably more volatile. So far, the significant price swings appear to have been instigated by the selling activity of large, computer-driven investment pools rather than the actions of long-term investors leaving the marketplace. We take comfort that, in this period of trade negotiations, the United States is economically in a position of strength and the impact of such trade disputes may equate to only ½ percent of US GDP. Likewise, we are pleased to see first quarter corporate earnings came in at a much higher level than expected. Investment advisors and trust managers use the many analytical resources that are available today to help us structure an investment portfolio. With this information we develop our strategy for fixed income and equity commitments. The eleven sectors of the S&P 500 are over or under-weighted based on an analysis of where we are in the economic cycle. Stock picking also plays a significant part in the process. Most assuredly, investment risk remains and in this Spring issue of AWSI our newest associate, James M. Powell, takes a look at how we and our customers can manage market risk.

Alfred B. Van Liew

Risk Management 101 (or It's All Greek To Me!)

James M. Powell, CFA, CAIA

The end of the quarter always brings an opportunity for my associates and me to talk with our customers about the changes in their lives and how that might impact their financial goals. It is also a good time to review their accounts to make sure their portfolios are aligned with those goals. Some of our customers track their accounts continuously by logging into them online; others are content to wait until their quarterly statement arrives.* Regardless of how often they check, the question is usually the same: *"How did I do?"*

There are a couple of easy answers that can be found right in the statement – no thinking involved. The first is to look at the balances: *"if my ending balance is higher than my beginning balance, that is good."* The second is to look at the performance return: *"if my account outperformed the index, I did well."*

The great scholar, H. L. Mencken, said, "For every complex problem there is an answer that is clear, simple, and wrong." Unfortunately, the measurement of performance return just doesn't break down that easily. In this article, I am going to share another way to think about your portfolio that I hope will lead to a deeper understanding of how the professional investment managers at the Van Liew Trust Company help you achieve your financial goals.

Many introductory finance articles express the sentiment that risk and return are two sides of the same coin. The two answers I discussed above focus on only one side of that coin – the return – without considering how it was achieved. In the world of portfolio management, it matters very much how that return was obtained. In fact, as investors we can really only control the risk side of the coin – *return is only an outcome.*

To illustrate, let's begin with a benchmark: over the past ninety years, stocks have returned approximately 10% per year on average, as measured by the S&P 500

Index. The 500 component stocks that have made up that 10% number, however, have had return profiles very different from 10% per year. In fact, they are almost always higher or lower than 10%. How those stocks move relative to the S&P 500 Index is very important in the construction of your custom portfolio. For example, when the market goes up 1%, there are some stocks that will go up 1.2% and others that will go up 0.8%, on average. Knowing how individual stocks behave relative to the broader market is very important to controlling risk. The risk metric that describes this behavior is called *beta*, signified by the Greek letter: β.

This is not a technical article, so I am not going to get into the complexities of measuring *beta*. Besides, you don't have to; you can find it for each of your stocks easily online. However, I am going to describe how to begin to understand it and how it can help answer that critical question I stated in the first paragraph.

Beta simply measures how a stock has performed relative to the broader market, as measured by the S&P 500 Index. If a stock has a beta of 1.15, for example, it has historically been 15% more *volatile* than the market. You could expect that in a rising market that this particular stock might rise 15% more than the broader market. However, the opposite is true, too: in a declining market, this stock might fall 15% more than the broader market.

Let's examine a stock with a *beta* of 0.85. In this case, during a market decline of 1% you might expect the price of the stock to only decrease 0.85%. Of course, the converse is true here as well: it might only increase 0.85% if the market increases 1%.

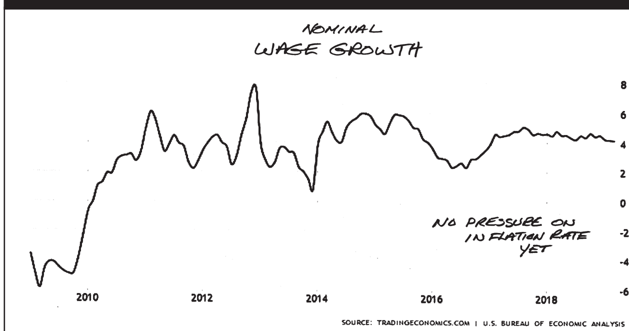
Armed with this information, let's apply this concept to your portfolio in an attempt to answer that key question laid out in the first paragraph. If the market increased 10% over the past quarter and your portfolio increased 12%, is that a good thing? Or if your portfolio only increased 8%, is that a bad thing? The answer to that question really depends on what is happening under the surface – the *risk* in the portfolio.

When we talk with our customers, one of our chief objectives is to develop an accurate understanding of their risk profile. It is how we balance what is happening in their lives with how their portfolio is constructed. Has something changed that we need to think about and adjust, such as a change in health or the recent birth of twins? We know that if we get that risk profile right, the outcome over the long term will be an appropriate, corresponding return.

As you might imagine, this becomes even more important when we consider capital gains taxes on stocks with a low cost basis. In a case like this, we are trying to find stocks that will behave well with the low basis stock position; *beta* is a good place to start. As professional investment managers, our job is to construct *custom* portfolios that take into account your unique financial situation in order to help you achieve your goals.

*For an interesting analysis of the impact of these two behaviors, simply type "myopic loss aversion" into your favorite search engine.

T R E N D L I N E S



Despite strong job growth and a low unemployment rate, wage growth has been surprisingly steady. Historically, falling unemployment rates and rising wage growth have been highly correlated. It seems different this time . . . or maybe not. Time will tell.

We would be delighted to meet with you to share comments about this article, or to review your portfolio in detail.

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Ask for James Powell