The Intelligent Investor—October 2016

Quick Thoughts:

While recently attending a client's wedding, I was reminded of the reason I am in this business—to make a meaningful impact in the lives of people put in my path and be a steward of their money and financial legacies. I understand the magnitude of this responsibility, and it is this very responsibility that drives me to continue to be the best I can be. I continue to appreciate the immense trust you place in me and my ability to help you plan for your future.

Moving on to the commentary, and with September having come and gone, we have finished the month with a period of unusual complacency.

Complacency is Wall Street speak for days upon days when the major market indices trade within an unusually narrow range.

Recall that last month I quoted a piece from LPL Research pointing out that the S&P 500 range for August was the seventh narrowest since 1928.

One thing that is absolutely certain – periods of sheer boredom for the short-term trading crowd will eventually come to an end. We don’t know when, but it will happen. In this case, a modest bout of volatility returned to the market by mid-September.

Much of it was related to interest rate worries and chatter from various Federal Reserve officials.

	MTD %	YTD %	3-year* %
Dow Jones Industrial Average	-0.5	+5.1	+6.6
NASDAQ Composite	+1.9	+6.1	+12.1
S&P 500 Index	-0.1	+6.1	+8.8
Russell 2000 Index	+1.5	+10.2	+5.2
MSCI World ex-USA**	+1.0	+0.6	-2.3
MSCI Emerging Markets**	+1.1	+13.8	-2.9

Source: Wall Street Journal, MSCI.com

MTD returns: Aug 31, 2016—Sep 30, 2016
YTD returns: Dec 31, 2015—Sep 30, 2016
*Annualized
**USD

I'll steer clear of the Fed in this month's letter, but I did want to go into a bit of detail on a couple of items—the first being—the election.

No doubt, politics can fuel all types of emotions. We sometimes feel strongly about certain issues or certain candidates and it's not uncommon to think, "How can anyone see things differently than I do?!" And that's when the fireworks begin.

Recognizing that we all have our own political views and filters, including myself, I want to cautiously tiptoe into the minefield and help you see the election through the lens of the market. Admittedly, it's a very narrow lens, but in fairness, I am not a political analyst.

Your Vote

The election is on everyone's mind; in fact, I have a tendency to watch the Dow Futures on the financial channels simultaneously with the debate itself.

During the first debate, I noticed that futures, which, among other things, is a gauge that gives us an idea how stocks will open the next day, rose by about 100 points (MarketWatch). The positive reaction extended into the next day, telling me that the professional investment community was pleased with Clinton's performance in the first debate.

As a dispassionate observer who is interested in viewing the election only through the objective prism of the market (admittedly a very narrow prism), the professional investment community sees continuity in a Clinton win, even if some in the community are more likely to subscribe to the economic and tax ideas of a Republican.

It's that continuity that appeals to the desire for certainty. As I've mentioned many times in the past, short-term traders fear heightened uncertainty. It's the vagueness of some of Trump's ideas, coupled with his rhetoric, that fuels uncertainty.

Of course, this is not an endorsement of either candidate. Let me also emphasize, short-term market volatility shouldn't determine how you and I vote in November. The nation faces much more pressing issues. Instead, it is more akin to the idiom, "Better the devil you know than the devil you don't," at least in the eyes of Wall Street.

I do, however, want to monitor important events that may create some ripples in the financial waters, even if those ripples are brief in nature.

Trying to time the highs and lows in stocks is much like trying to guess the string of plays your team will call as it hopes to charge down the field and score a touchdown. Or, it's analogous to trying to guess what the score might be midway through the fourth quarter, when your team sports a 21-9 lead heading into the locker room at halftime.

I enjoy listening to the keen insights of sport professionals during the halftime show. But none of them offer up a prediction of the final score. As baseball great Yogi Berra was fond of saying and I'm fond of quoting, "It's tough to make predictions, especially about the future."

Germany "Too Big to Fail"

Investors are living in the shadow of 2008. While the wounds have healed for those who maintained a disciplined approach, the scars may still run deep. That means some investors have a tendency to look over their shoulder, always wary that another crisis is lurking, ready to ambush them.

The latest such instance hails from Europe – Germany to be specific.

Deutsche Bank (DB $13) is Germany's largest bank. With assets that tower nearly $2 trillion, it is Europe's fourth largest bank by assets (Statista.com).

Safe to say, it's too big to fail.

Unlike their U.S. counterparts, which diligently raised capital in the post-2008 era, Europe's banking system is in a much more fragile state. And right now Deutsche Bank is the poster child for ailing European banks.

At the end of the second quarter, the International Monetary Fund said Deutsche Bank posed the greatest risk to the global financial system (*Wall Street Journal*). In part, problems spring from profitability issues and the lack of a solid capital buffer.

Fast forward to mid-September, when Deutsche Bank was asked by the U.S. Justice Department to pay a $14 billion fine for selling to toxic mortgage securities (*Wall Street Journal*). It was a punch to the gut for a bank that was already wobbly.

Then, two ill-timed stories hit the wire near the end of September. German Chancellor Angela Merkel reportedly ruled out any state assistance for the bank (denied by both parties), and about ten hedge funds that do business with the bank moved to reduce their exposure (Bloomberg). Today, it is an issue of confidence.

Not Lehman

Bad things can happen; I won't deny that and I certainly understand that some of you have concerns. If you would like to talk, you know I am always available to address any issues.

What ails Deutsche Bank also dogs many of Europe's large banks, all of which are grappling with a number of headwinds.

However, I believe the 2008 crisis was a once in a lifetime event, one I managed money in and one we all survived. Investors must be careful not to believe the sky is falling every time rain makes its way into the forecast. Such a posture will lengthen the path toward your financial goals.

What's different today? Unlike 2008, central banks and governments are painfully aware of the carnage that was sparked by Lehman's disorderly demise.

Additionally, U.S. banks are much better positioned today. The economic fundamentals aren't deteriorating, and banks aren't floundering under the weight of toxic assets.

While EU banking rules have been designed to limit taxpayer support of large institutions (*Financial Times*), it's hard to see a situation where Germany would allow a disorderly dissolution of its largest bank. Such an event would wreak havoc on its economy.

Moreover, firewalls are now in place that weren't available in 2008.

It's not that we can't see some volatility if problems persist, but U.S. fundamentals, which have helped support shares during periods of recent volatility, remain intact.

I hope you've found this review to be educational and helpful. As I always emphasize, it is my job to assist you. If you have any questions or would like to discuss any matters, please feel free to give me or any of my team members a call.

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