PALLADIUM
REGISTERED INVESTMENT ADVISORS
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PERSPECTIVES

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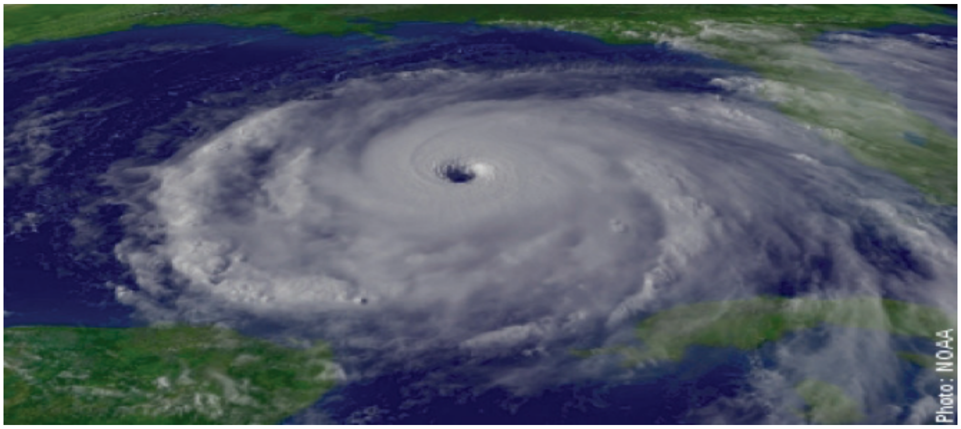
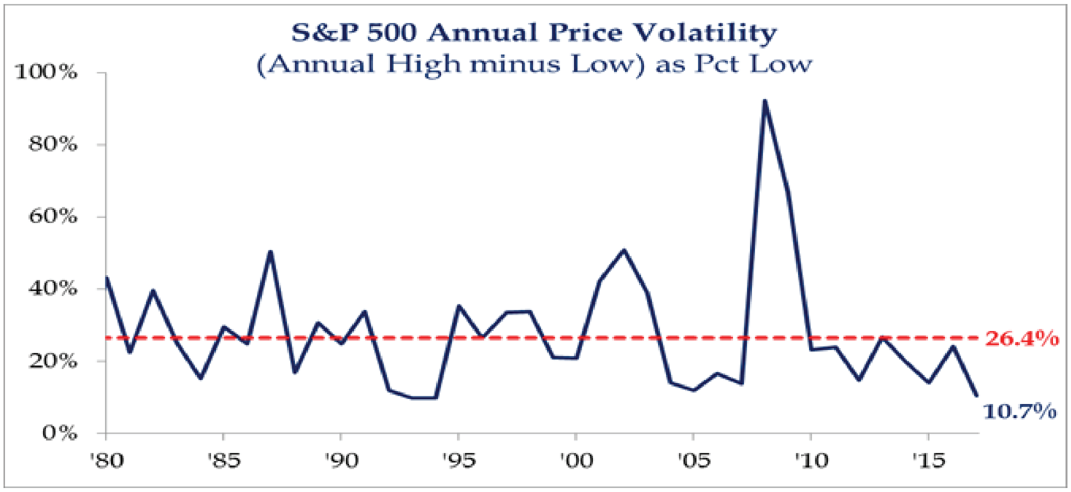
"Successful investing is about managing risk, not avoiding it."
Benjamin Graham, 1894-1976, investor, economist, professor

- **In our prayers…** are all those in Houston, Florida, Mexico and the Caribbean.
- **Fear, anger and stress…** seem to abound. If the horrific storms and earthquakes weren't enough, there's the zany behavior in Washington, nuclear threats from North Korea, terrorism seemingly everywhere and widespread theft of our personal information.
- **And yet, in the "eye" of it all…** there is an eerie calm in the financial markets.
- **So stark is the contrast…** we can't help but draw an analogy from the picture below:



- **The eye of the storm…** *Market volatility is at an all-time low!*

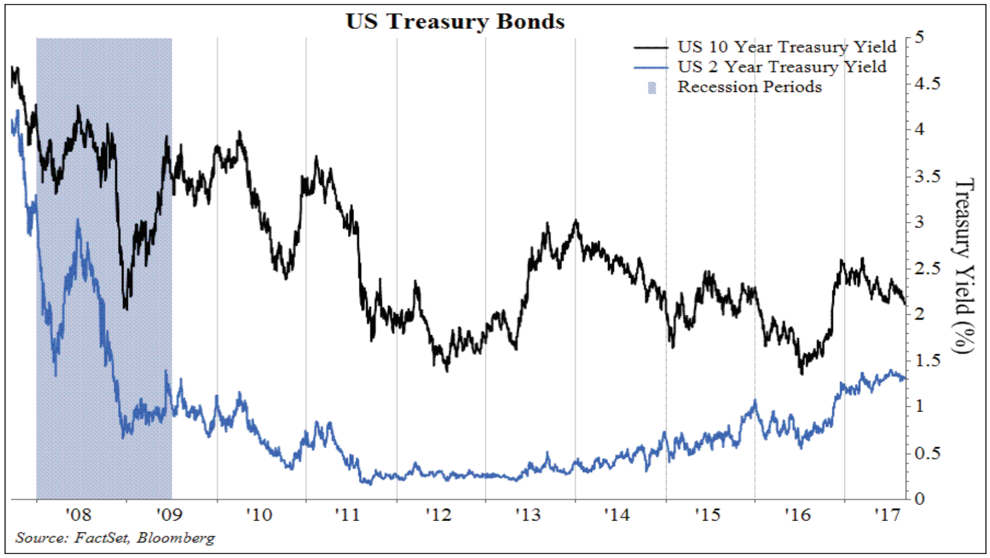


Source: Strategas Research Partners

- **Experience and history have taught us…** Volatility can ignite in a moment. Today's calm can be tomorrow's panic.

- **Low interest rates continue to punish savers…**

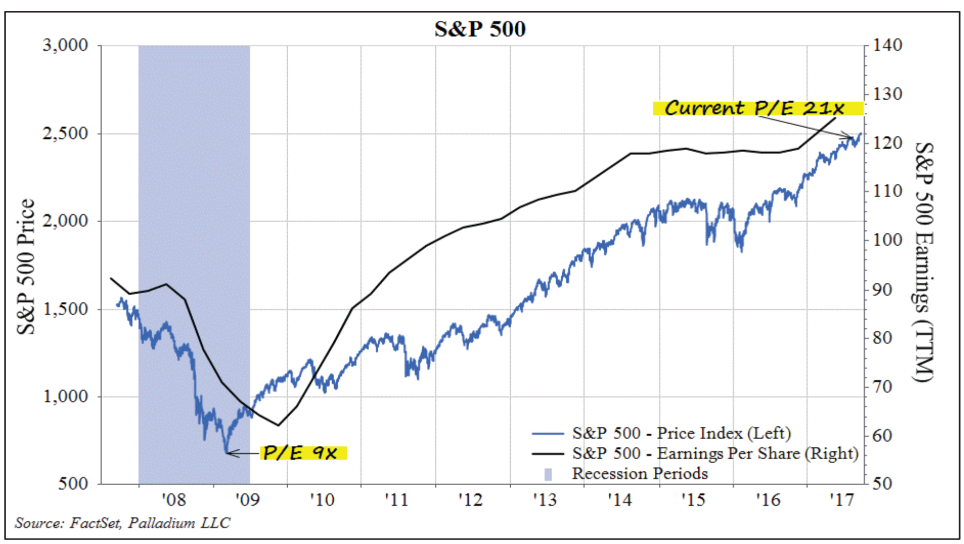
While 2-year Treasury yields have risen from less than one-half of 1% to 1.40%, it and the 10-year yield of 2.20% remain near all-time lows. Investors continue to pay a very high price for safety.



- **Is TINA still at work?** Fully eight years since the impending collapse of the banking system produced the Troubled Asset Relief Program (TARP) and, subsequently, Quantitative Easing (QE), interest rates have remained at or near their lowest level in history. One of the by-products has been a slow, reluctant gravitation by most investors back into the stock market. So-called TINA, *There Is No Alternative*, has seemingly become the "new" normal. The resulting eight years of positive returns from the U.S. stock market is the longest in modern history and, to our eye, has created a degree of complacency.

- **Price versus Cost…** Of course, we're delighted that share prices have risen for eight years running. What gives us concern is not the price, but rather the *cost*:

At the market's bottom in March of 2009, stocks could be purchased for $9.00 per $1.00 of earnings per share. Today, the purchase of the same $1.00 of earnings costs $21.00.



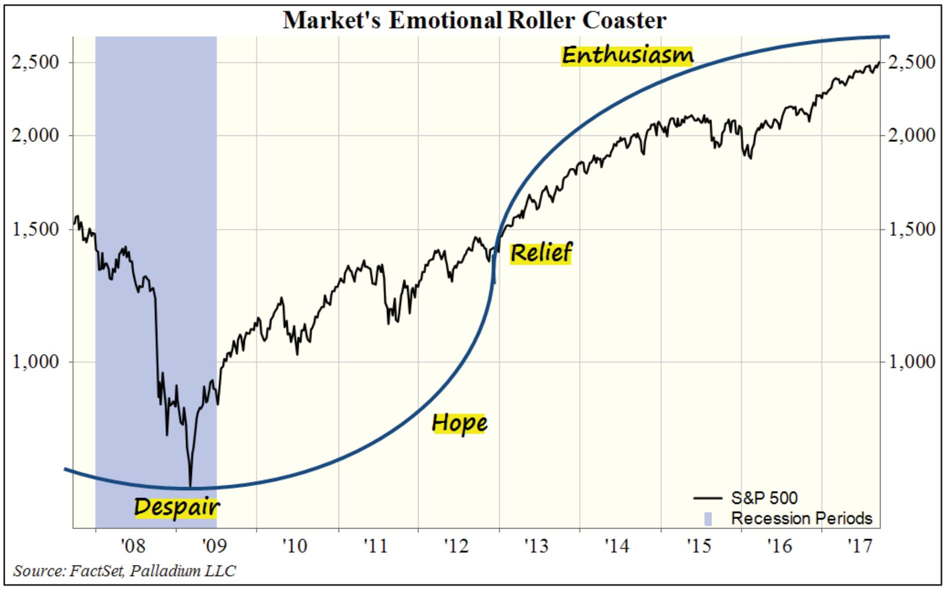
- **Future returns?** Over the past ninety years the average Price-to-Earnings ratio has been $16 per $1.00 of earnings per share. The average annual return, including dividends, has been about 10%. If today's investor is paying 30% more than the average cost ($21 P/E versus $16 P/E), it's reasonable to conclude future returns could be lower than the long-term average.

- **Don't be fooled by the calm of the "eye"…** Low interest rates and TINA have elevated the cost of shares and reduced their prospective return. Low volatility has masked the risk.

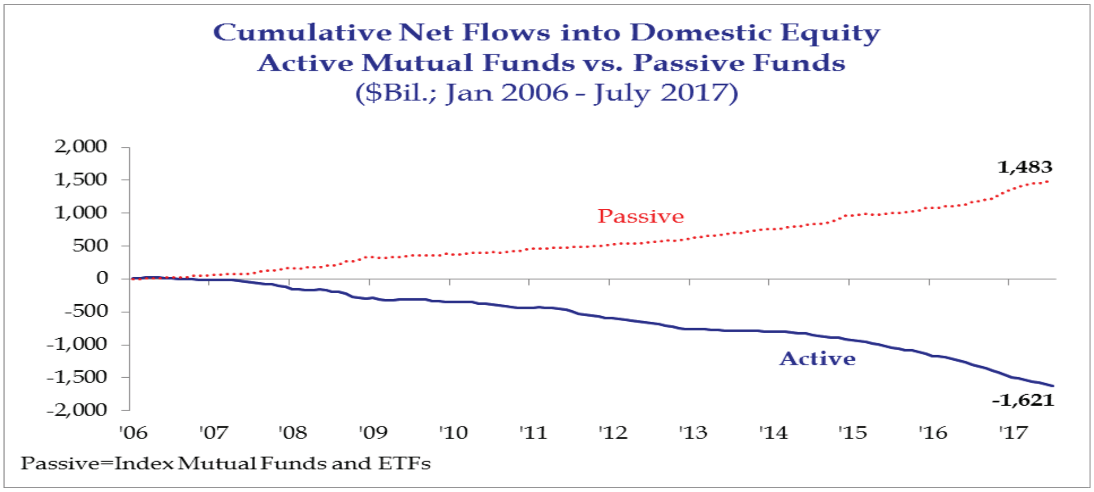
- **Change in the *wind*?** The Federal Reserve has announced that it will soon begin "normalization" of its now $4.5 Trillion balance sheet…effectively unwinding Quantitative Easing. Perhaps then the days of TINA are numbered. If so, complacency will be tested.

- **Behavior matters:**

Seen historically, the 2009 moment of despair was also the moment of opportunity. Eight years of advances have erased the memory of that fear. Lower future returns and greater risk are now under-appreciated.



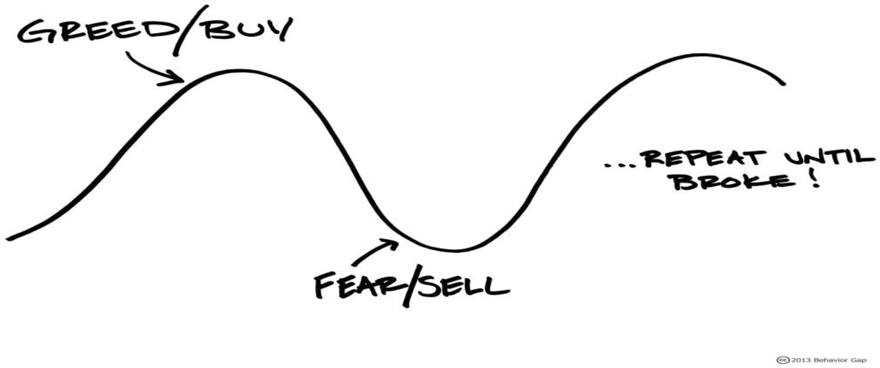
- **Evidence…** We believe the recent trend toward so-called "passive" investing is evidence of this under-appreciated risk.



Courtesy Strategas Research Partners

- **Passive investing…** Index funds represent a low-cost way to diversify investment in the market. However, they should not be treated as "one decision" investments (i.e. buy it and forget it). Frequently, index funds are "market capitalization-weighted." Accordingly, the fund apportions each new dollar according to the weight each share comprises within the index… and such weights vary significantly. The result is that "passive" investments give no consideration to the soundness of the companies comprising the index or for the fairness of the valuations of those companies. In this, we see both danger and opportunity.

- **Our biggest task…** is to understand and calibrate the constant ebb and flow of these risks and rewards and the emotions affecting them.



- **Speaking of managing risk…** the breach of Equifax's database should be a motivational event for everyone regardless of whether your information was specifically affected. We'd encourage you to assume that your personal data is in the hands of those who will attempt to use it to your detriment. The websites below offer detailed information on ways to protect yourself:

From the Federal Trade Commission:
https://www.consumer.ftc.gov/blog/2017/09/equifax-data-breach-what-do?utm_source=govdelivery

From Consumers Union:
http://consumersunion.org/research/security-freeze/

- **Testimony to the human spirit…** In the face of the chaos, fear and danger posed by the collection of recent natural disasters, the response of those affected and by those offering assistance has been extraordinary. The power of the human spirit is greater than any storm nature can produce.

- **Want to help?** The Center for Disaster Philanthropy offers tips on how to make your giving most effective.
  http://disasterphilanthropy.org/resources-2/basic-tips-for-disaster-giving/

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