"It's remarkable how much long-term advantage I've found by trying to consistently be not stupid"

-Mr. Xavier from Jacob Taylor's Rebel Allocator

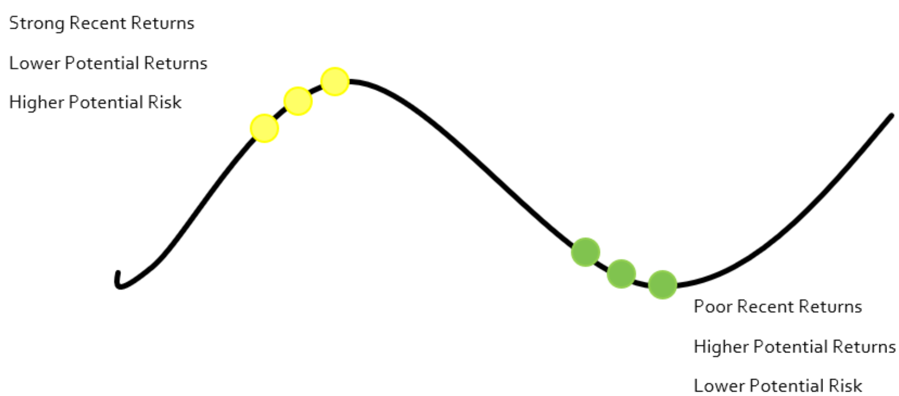
January Recap:

- It was an eventful start to the year, given this, bond proxies outperformed. The S&P 500 gave up its early lead to finish the month flat. Continuing the theme from last year, domestic large caps outpaced domestic small and international markets by over 2% during January.
- The 10-year yield fell sharply again and hit multi-month lows as fears of a global economic slow-down hit markets. Bottom line, the bond market continues to send outright worrisome signals about future economic growth, not just in the U.S. but also globally.
- The coronavirus has become the story of 2020. The virus is expected to reduce Chinese GDP growth in the first quarter of 2020 by 1.6%, sparking fear around the world that the virus threatens to choke off the expected rebound in global growth.

The Market Backdrop:

Let's apply the opening quote to the largest decisions we can make at the portfolio level – asset allocation.

Before we cloud this note with numbers and data, let's use deductive reasoning. That's a fancy way of saying common sense.
High valuations lead to lower returns associated with higher risks (a bad combo) and low valuation leads to higher returns associated with lower risks (a good combo). We'll let your imagination run wild as to where the current US stock valuations fall, green dots or yellow dots?



The biggest allocation decision we can make is the percentage of stocks and bonds we own. While the case can be made that stocks are expensive, we'd ask, relative to what? Definitely not bonds…

Let us try to explain the current and unexplainable bond market. The current 10-year treasury bond yields 1.52%. That's a dollar and a half for every $100 people are loaning the government. Not to mention, that $1.52 WILL NOT GROW. If you think about that $1.52 as earnings – people are paying over 65x earnings that are guaranteed not to grow!

Our Choices:

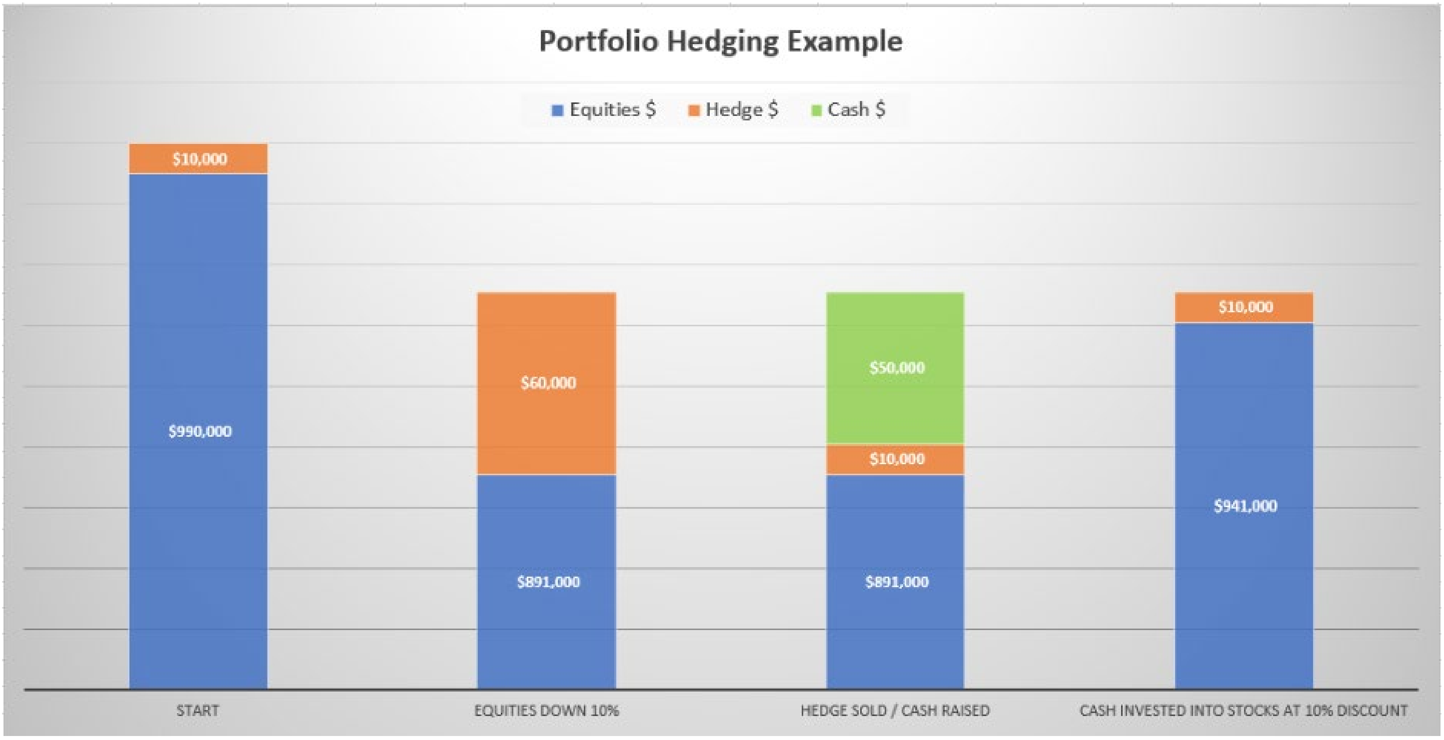
Allocation decisions are driven by the relative options we are given. When thought about in that way, stocks at a trailing Price to Earnings of 20x (ish) doesn't seem all that bad. We continue to underweight bonds and international stocks, continue to focus on consistent yield, and continue to own more explicit exposure to hedging techniques (forms of insurance against market drops).

We wrote more about the risks we've been seeing back in the 3rd quarter of 2019. Most of that sentiment remains as we are placing greater emphasis on the ability to reduce our exposure to potential drawdown. Volatility started to pick up as January ended.

Our overall aim is to tilt allocation away from areas that we think can be a drag on future returns(bonds!) and do so without injecting additional risk. Our ability to hedge away a portion of the risk associated with stocks is crucial to this point.

Hedging in Action:

Remember the colored dots? We'd love to say we "buy green, sell yellow" but come on. That said, the structure of our hedges *is* designed to create dry powder in a selloff. It *feels* closer to the yellow dots than the green ones, either way we take comfort in a proactive hedging approach that keeps us both protective **and** opportunity-seeking. See the illustration (as in, "picture to help explain" not "promised outcome") below:



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As with any kind of "insurance", hedging **does** have a cost, in this case a drag on returns. That said, we feel good about the ability of this protection to deliver overall exposure with solid participation in rising markets while reducing the impact of gut-wrenching drawdowns. That combination tends to create happy clients!

Thanks to our portfolio framework, we know where return can come from (1. Yield, 2. Growth, 3. Valuations Changing – see here for a breakdown), and it's up to us to make sound decisions when allocating capital. As Mr. X stated better than we can, we just want to be consistently not stupid.

Click here for latest performance and fact sheets. As always, don't hesitate to reach out with any questions at all.

The Aptus Team

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