CLIFFORD SWAN

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WISDOM *for* GENERATIONS

STAY CALM AND CARRY ON

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The current financial market panic is unprecedented—just as all preceding panics were unprecedented. Yet, during times of panic, malfunctioning markets, solvency concerns, and high levels of uncertainty, successful investors have learned from financial market history and from an irrefutable logic that reacting or panicking along with the herd is the exact wrong stance to take when attempting to preserve and protect previously accumulated wealth.

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Here are a few other things we have learned. Successful investors have long-term investment time horizons. Successful investors build resilient portfolios. Successful investors understand that it is impossible to time market swings consistently. Accordingly, when the pressure to sell out of solid businesses is highest, successful investors are instead focused on the opportunity for making long-term investments and developing a strategy for the prudent deployment of such investments, determining where and when to strike.

We know we cannot make a call on when the current period of selling will have run its full course or when the stock market will bottom out.

We also know that holding high levels of cash (for a long period) is not an effective means to protecting wealth. We have learned from previous bear markets and panics that it is delusional to believe that any one investor can successfully time the liquidation and reinvestment of long-term capital as markets plummet and then reignite higher. This is a fool's game peddled by the more unscrupulous side of the investment management community.

We have carefully studied financial market history, including how successful investors acted during times of stress. As a result, we have a time-tested investment discipline that provides us with the confidence to execute for our clients through all market conditions. This much we know: all previous market panics were unprecedented but did not call for unprecedented reactions. Investors are now quickly extrapolating to the worst possible outcomes. The ferocity of the current downturn is mostly due to this extreme psychological reaction by market participants. Market participants that were caught speculating before this decline are being forced to liquidate. Frankly, it seems imprudent to us to extrapolate to the worst possible outcomes.

Due to the severity of the reversal, markets are having an especially difficult time effectively digesting the flow of information (that is what markets "do" and what prices "mean"). In a sense, the markets are broken…temporarily. Liquidity, especially in the credit markets, has been below desired levels. Governments around the world, having learned from previous panics, are injecting massive amounts of liquidity into markets. In the short- to intermediate-term this liquidity will allow markets to reopen, reducing concerns about general solvency.

The global pandemic and the reaction of governments to shut down commerce and other economic activity will result in a recession, likely global in nature. A recession is a painful process, especially for those caught unprepared. The U.S. economy was quite strong prior to the government's shutdown of the economy in an effort to slow the spread of COVID-19. Our banking system is well-capitalized and in a good position to

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offer capital to investors and businesses in need. Interest rates are low and likely to remain so for the foreseeable future. Governments will play a major role in seeing us through to the other end of the economic challenges we are facing. Intelligent investors are trying to determine what the post-pandemic investment terrain might look like. There will likely be some lasting effects from the high level of government involvement in the financial markets, maybe even causing profound changes.

As long-term investors in high quality businesses and credits, we know that recessions eliminate weaker companies. The surviving companies, as a result, are likely to emerge from the recession in even stronger positions. Conditions are being set to drive the next bull market.

It is too early to predict either the depth or duration of the current economic downturn. It appears that the Asian economies in China, South Korea, Taiwan, and Singapore are already in recovery after having to deal with the pandemic. Moreover, over the course of economic and financial market history, the best way to preserve and grow wealth has been through the long-term ownership of high-quality businesses. Whether the risks were recession, depression, inflation, or even hyperinflation, the ownership of profitable businesses with conservative balance sheets best preserved wealth. One may be sorely tempted to trade in and out of those businesses to provide either short-term gain or avoid short-term losses, but this has proved to be a siren's song.

Our approach to equity investment incorporates a careful price discipline. We believe this reduces the risk of loss and improves returns over time. In troubled times, such as the present, we advise a cautious approach to new investment in common stocks. Our analysis has unearthed a myriad of bargains. We are also considering what the post-pandemic investment terrain will look like and will advise our clients how to invest accordingly. During periods of market tumult, successful investors take the opportunity to upgrade investment portfolios, take tax losses where appropriate, and add to investments in the very best companies that are rarely inexpensive enough to buy with a margin of safety.

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For now, we are maintaining a very conservative posture as it relates to bond investment. Fixed income markets are currently dysfunctional. In most markets, the supply of bonds far outstrips the demand. In reaction to the coronavirus pandemic and market turmoil, many investors are selling out of bond funds, resulting in many of these funds and exchanged traded funds (ETFs) liquidating bonds across the board. Unfortunately, many of the financial broker-dealers do not have the capital capacity to handle the substantial bond inventories, especially as compared to 2008 and the financial crisis then (an unintended consequence of the 2010 Dodd-Frank law). As a result, bonds are being sold as quickly as they appear, at whatever price it takes to get a new owner.

Investment managers, as a result, must sell portfolio assets that are the most liquid, in order to raise cash and liquidity. Illiquidity in other parts of the market is creating supply issues in many of the liquid bond markets. In anticipation of these kinds of potential liquidity problems, Clifford Swan began to focus intently on liquidity and quality over the last few years, making sure that the risk/return relationship was strong. We are comfortable that the bonds and bond funds where we have focused investment are of good quality and that there are sufficient levels of liquidity for them to operate normally.

We look forward to working with our clients in maintaining resilient investment portfolios designed to weather even the most difficult market conditions. We encourage you to speak with your investment counselor about how best to react to the markets and take advantage of unique opportunities as they present themselves. ◆

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