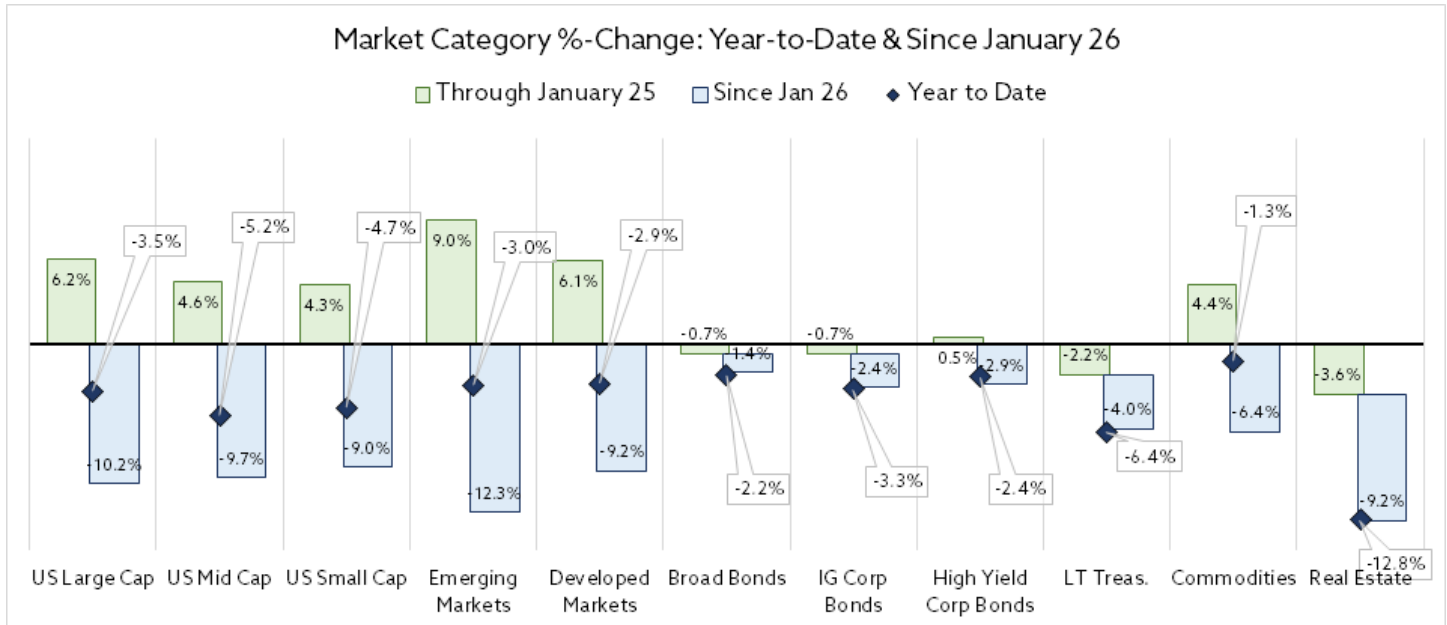


Pendleton Street Advisors
1st Quarter Interim Investment Commentary
February 9, 2018

On Recent Market Volatility

Over the last two weeks, all major US and international equity indexes have declined by more than 5% from their most-recent highs. As of market-close, the US market entered a market-correction (i.e. a decline of more than 10% from the most recent high). From the moment this market downturn began, nearly all of the media's focus has been on **why** it is happening, with very little attention on understanding **what** is happening. So, that is where we will begin.



The Situation: As of February 8th, all major market categories we regularly measure are down for the year. Large cap US stocks, which have been unstoppable for the better part of two years, have declined by 10.2% since January 26th, and are down by close to 3.5% year-to-date. Along with similar behavior across stocks more broadly, both commodities and real estate have also fallen sharply since January 26th. Even bonds, which historically have low or negative correlation to equities, are down year to date. The VIX (CBOE Volatility) Index is about the only index that is up year to date, having risen sharply from a level of 11.04 on December 29th, to a current level of 33.46 – a 203% increase (see the sidebar on the following page for more on volatility indexes).

In our [most-recent quarterly commentary](#) from January, we discussed the lack of market volatility and our concern that investors were underestimating the possibility of change. As we wrote at that time:

“The S&P 500 just completed its 14th consecutive month of positive total returns (the longest streak in the history of the index), and volatility measured by the VIX index is still near all-time lows (the last time it was nearly this low was in January 2007). There are no signs that those trends are at an end, but we firmly believe they cannot go on forever.”

We did not expect the trends to end less than a month after writing that commentary, but we are not exactly surprised either. Volatility is often talked about as a measure of uncertainty, but times like this highlight an important distinction: uncertainty exists whether market volatility is heightened or not. A sharp rise in volatility is more-often a result of the wider-spread **acknowledgement** of factors already known to be risks. To illustrate, we received the following Breaking News headline from Wall Street Journal on Friday, February 2nd:

“Breaking News: Dow industrials plunged 2.5% [...] fueled by inflation concerns and political tensions.”

To its credit, the Journal named the two reasons most everyone would be *talking* about over the following week. But, neither of those points were new to investors. We do not think the majority of investors awakened on February the 2nd and suddenly discovered the potential for rising inflation and political tensions; risks that had already been identified and talked-about for some time.

Either we are wrong, and investors as a whole just discovered inflation and political tension, or the suddenness and magnitude of the downturn experienced over the last two weeks is largely driven by emotion and herding mentality. Either way, we believe fundamentals and drivers of long-term value will cut through the noise over time.

The behaviors that have caused a significant downward swing are mirror images of the behaviors that contributed to markets rising so significantly and persistently for much of the prior few months. In our third-quarter 2017 commentary, published in October, we discussed the growing popularity of momentum as an indicator of investor over-optimism:

The popularity of Momentum as a stand-alone investment strategy exemplifies the current state of investor sentiment: "Just keep doing what has worked and expect it to continue."

Up to that point in 2017, MTUM - an ETF (exchange-traded fund) tracking momentum - had increased in price by 29%. Since then, it has increased in price by another 4.01%. Yet, the size of the fund (i.e. its total Assets Under Management) has grown by 150%. This means that the vast majority of the ETF's overall growth has come from purchases by investors expecting more of the same but ending up with relatively little.

Strategies like momentum are most attractive to investors after they have produced significant gains, and at a point when almost everyone is nearly-certain that the good times are here to stay. By January, most major indicators of investor sentiment were at or near record levels, meaning that the vast majority of investors believed with a good degree of certainty the bull market would continue.

In this case, investors' certainty about market strength resulted from continual reward for a simple, repetitive action: buy → price increases → buy → price increases → buy... etc. Markets have been in a positive feedback loop for so long that many investors had become conditioned to expect nothing else. Now, we are experiencing *something else*.

The Broader Context: The current downturn may feel like a moment of historical significance, but historically the S&P 500 has been 10% or more below its most-recent high almost 1/3rd of the time (see chart below). Yet, over rolling 5-year periods since 1950, the total price change in the index has only remained below -10% (or about -2% annualized), 9% of the time.

One of the most dangerous things about a time like this for investors is the impulse to do something, anything to stop portfolios from declining in value any further. Unfortunately, in reacting to market declines by selling, investors may ultimately just be doing something in hindsight that they wish they would already have done. This is not to say that selling is never the right decision, but it is not the right decision if the objective is to avoid losses that have already occurred. That is about as useful as putting on a seatbelt 10 minutes *after* an accident. Risk must be managed

What is VIX, XIV, and volatility?

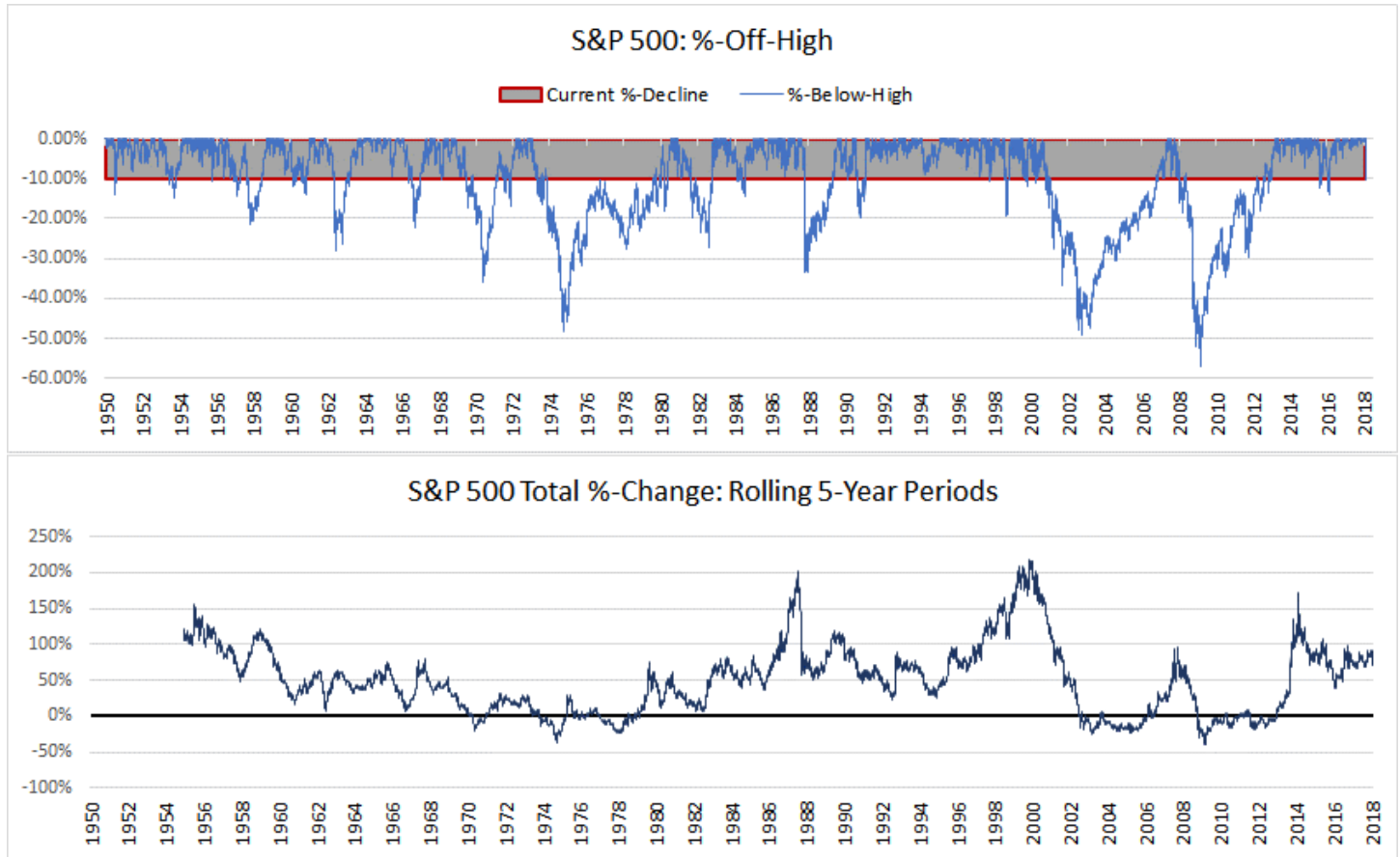
If you have been tracking the financial news this week, then you are hearing a lot about volatility. As you have seen, market volatility has been almost non-existent for almost 2 years. Yes, we have had some ups and downs, but the ride has mostly been smooth and steady for awhile.

Today we are hearing about VIX, XIV and things that seem to have nothing to do with investing, and everything to do with making a fast buck. Here is a quick primer in non-finance speak to get you up to speed:

- VIX; this is the ticker symbol for the Volatility Index—it's a real thing. Simply put, this is an index that measures the uncertainty of uncertainty. Let that sink in for a second. A higher VIX means there is more uncertainty about uncertainty and vice versa.
- XIV; if the above was a bit absurd, get ready for this one. XIV is a way to "short" VIX. Shorting something is like saying you think it'll get lower in price versus where it is currently. So, amid historically low VIX, the financial wizards on Wall Street developed a way to make a directional bet to say VIX at current levels--can go lower.

The markets will adjust to these disruptions caused by XIV. It will take some time, but thankfully this is when our deep and liquid markets come in very handy.

proactively. Nothing can be prevented *after* it happens. In the case of investment management, this means constructing, maintaining, and adjusting portfolios based on actual risks, not just risk-levels implied by a volatility index.



What We Are Doing: Proactively managing risk while actively seeking returns is at the core of our firm’s investment process. For example, we increased allocation to emerging markets stocks in portfolios in early 2017 when we determined that they had been priced for a persistently deteriorating business environment with little evidence that was the case. Broad emerging market stock indexes increased over 30% during the year, and diversified client portfolios benefited from increased allocation to that asset class.

Meanwhile, beginning in the second quarter of 2017 we began systematically taking gains across equity holdings, including emerging markets, as they grew in proportion relative to other asset class allocations throughout the year. The proceeds were primarily reinvested in bonds. Just going by portfolio theory, those proceeds would have been reinvested in a market-portfolio of bonds, which is more heavily weighted towards bonds with longer-dated maturities and higher interest rate sensitivity. But, we have instead been reinvesting proceeds into shorter-dated bonds, which are less sensitive to changes in interest rates. As a result, diversified client portfolios benefited from increased exposure to equity markets in 2017, but have been less exposed to the current downturn in both equities and bonds as a result of systematic maintenance and research-based adjustment leading up to late January.

We see it as an important part of our work to not only manage your portfolios from day-to-day, but also proactively communicate how we are doing so, especially during times like these. If you would like to discuss this with us further prior to our next quarterly meeting, please reach out to us directly or call our office and someone on our team will schedule a time that works for you. We always appreciate hearing from you and hope to speak with you soon.

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