STILLWATER
INVESTMENT MANAGEMENT, LLC
Counselor • Advocate

"Opinion is like a pendulum and obeys the same law. If it goes past the centre of gravity on one side, it must go a like distance on the other; and it is only after a certain time that it finds the true point at which it can remain at rest."
Arthur Schopenhauer
German Philosopher
1788-1860

THE MARKET PENDULUM

By James K. Tonrey, Jr., Chief Executive Officer

Last year was a very unusual year for the equity markets. It was the first time in history that the market had positive returns every month in the calendar year   Notably it was also one of the least volatile years on record with 1-2% daily swings. This low volatility combined with a very healthy annual return was certainly the best of both worlds. The first quarter of 2018 has proven that nothing stays static in life, especially the financial markets. It is with this sentiment that we need to look under the hood to see what is behind the recent upswing in volatility and how long-term investors should view it.

Let's begin our discussion with the pendulum. We have all seen these instruments work up close. Once set in motion the object swings from side to side as gravity takes hold. It can be mesmerizing watching it swing so consistently and smoothly. Sometimes the pendulum swings to a resting place and other times it can remain in motion for very long periods of time. Many variables play a part in how long it will move back and forth but that scientific discussion is beyond my expertise and this commentary.

Financial markets, like a pendulum, tend to swing back and forth and are influenced by multiple variables as well. The key difference is that the markets are affected by *human behavior* where the pendulum is in a vacuum. How a person feels about the world as they watch the pendulum swing isn't going to change its course of action or momentum; gravity and science handle that. However, how an investor feels about current geo-politics, tariffs, the economy and their associated risks can modify their short-term investment behavior. The one critical variable that causes the *market pendulum* to swing more wildly is that intersection of people, their money, and worry.

Real life examples can provide some color. A little more than ten years ago the price of a barrel of oil rose to one hundred dollars. Everyone started to panic and talk about peak oil, which is the point at which oil production reaches its maximum rate, after which it declines.   This led to the fear of running out of oil this century. As prices continued to rise, and the pendulum swung in an extreme manner, things began to change. Car companies started to promote smaller cars that could get thirty-five miles a gallon or more, and also sped up their plans to manufacture electric cars. Consequently, investors piled money into oil and gas companies thinking we were on the verge of two hundred dollar per barrel oil. Not too long after this self-inflicted panic, the price of a barrel of oil crashed to twenty something dollars a barrel. We have settled at around sixty dollars today.

Back in the dark days of 2008/09 the Dow Jones Industrial Average rapidly reached lows of around 6,500, a 40% drop from its peak. Investors headed for the exits to find only one door to get out. The stock pendulum overshot gravitational pull due to the powerful human emotion of fear. Those that didn't open their monthly statements and stayed the course have experienced about a 400% increase in their portfolios from the lows. The pendulum eventually swung the other way.

After the recent financial calamity, the government undertook, rightfully so, a complete review of our banking risks. The result was the enactment of the Dodd-Frank Bill into law. This law put banks and other financial institutions under intense scrutiny and imposed some very obstructive rules relating to reserves, leverage and terms. The pendulum then swung abruptly to the other side. Our politicians, with good intention, tried to put an end to excessive and reckless behavior, in order to avoid another meltdown. Unfortunately, this went beyond problem solving and added many unnecessary restrictions, which has constrained smaller and mid-size banks, who were never part of the problem. People from both sides of the aisle are now trying to correct this overreach that has had many unintended consequences.

A final example of human overreaction today is best seen in our current financial system. The equity markets in the US were established exactly two centuries ago, in 1817, for the primary purpose to help companies raise capital. This capital was needed to hire workers and grow the companies, so they could in turn provide solutions to societal challenges, infrastructure, medical, and food source obstacles. Investors were very long-term players. Fast forward to today and we now have the ability to day trade from our cell phones. There are more get rich schemes and resultant short-term thinking than at any time in history. Many studies have shown trading/speculating on emotion or short-term price movements, for the average investor, leads to significant underperformance over a long period of time. Now that investors over the past few decades have experienced the wasted time, energy, and continued underperformance of their portfolios, the pendulum is once again swinging to the other side. This is certainly apparent in the meteoric rise of passive index investing.

Earl Nightengale, an American author and radio show host, frequently spoke about human motivation. He famously said, *"we become what we think about all day long."* Another way to look at this is the concept of a *self-fulfilling prophecy*: If we strongly believe something to be true, whether or not it is, and we think about it often and make it a part of our daily lives, then our future expectations will accept it as truth. Circling back to our *market pendulum*, this powerful emotion to believe something to be true, regardless of any other facts to the contrary, will create such momentum that the pendulum will overcorrect. For example, in 2008, the public companies listed in the stock exchanges were oversold by any metric, yet most investors ignored the incredible buying opportunity, *the financial reality*. Instead, they focused on the self-fulfilling prophecy that we were indeed headed even lower. Fear begets more fear and eventually self-fulfills.

In all parts of our emotional lives, whether in simply disciplining our children or investing our money, our tendency can be to overreact. After a child makes a bad choice we take their cell phone away for a week and ground them for a month. A day later when we become a bit more rational (and less emotional), the parenting pendulum swings to adjust the consequences to fit the problem in a more reasonable manner.

The stock market, in the short run, is a beauty pageant. Money always seems to flow to the next best thing. Benjamin Graham, the noted father of value investing, said *"the market in the short run is like a voting machine – tallying up which firms are popular and unpopular. But in the long run, the market is like a weighing machine- assessing the substance of a company."* Markets do what they have always done, over-correct and under-correct, but rest assured, in the long run, value is *always* recognized and patience rewarded.

In accordance with SEC regulations, we ask that you contact us in the event there have been any material changes in your financial circumstances or investment objectives, or if you wish to impose any reasonable restriction on the management of your accounts or modify any existing restrictions.