MARKET INSIGHTS

BULL BEAR NEWS

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RISK? WHAT RISK?

Investor Euphoria Causes Markets' Melt-Up

We have moved beyond "Goldilocks," beyond "irrational exuberance." It's a new paradigm where investors chase returns with mad abandon. With hedging activity decreasing, many investors and advisors are dismissing risk protection due to costs. It would seem that investors' greed for high returns has finally won the tug of war over fear of losing capital. It's time to make a change.

Consistently low volatility has reduced the fear of bear market correction as the pain of the S&P 500's brutal decline of 57% in the Financial Crisis fades from memory.[1] With market advances of 20% becoming commonplace, investors have started to look for higher octane investing thrills in bitcoin and other speculative crypto currencies that were up 100-500% or more in 2017.[2] The fear of missing out on these exciting returns has investors shrugging at the 20% returns posted by equity index funds last year.[3]

It's clear that a major market correction is inevitable over the next couple of years. The problem is we don't know when the meltdown will begin. The low volatility environment has failed to reinforce the risk-return equation for the past nine years and has lulled investors into complacency. It is our job as advisors and fiduciaries to help clients make rational decisions in the midst of an investing world driven by emotion and an irrational "herd mentality." As it gets harder to meet these unrealistic expectations, advisors need to maintain "courage of their convictions" and not fall prey to investor

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greed. What is unfolding is the classic emotionally biased behavior that causes a buy high - sell low disaster.

While the fundamental trends are currently supporting the bull run with fiscal stimulus from recently enacted tax policy, faster GDP growth, and a strong corporate earnings cycle, these benefits may play themselves out relatively quickly. At the same time, the Fed is tightening by raising interest rates and by reducing their QE-bloated balance sheet. One of the most important adages on Wall Street is "don't fight the Fed."

The current market environment is giving me a dizzying sense of "déjà vu," looking very much like the final speculative run in 1999 during the Dot.com tech boom. Back then, the Fed aggressively raised interest rates as they became fearful of the runaway stock market bubble. And the investing herd chose to ignore the Fed's policy shift by blindly chasing returns. As investors poured more capital into stocks, the market continued to melt-up with the NASDAQ posting an 85% return for the year. Unfortunately, the spectacular melt-up was followed by an even more dramatic meltdown as the index fell almost 80% from its highs leaving many investors who came late to the bull's party in financial ruin.[4]

Hedging activity has been shrinking since the end of 2016 and has continued to contract. One of the telltale signs of investor euphoria is the elimination of hedging as individual and institutional investors capitulate to the cost of downside protection. As markets continue to melt-up, these hard costs become just too high. Even though the markets have continued to move persistently higher, risk managers have found the continuing cost of option put premiums that help maintain downside protection so costly that it has consumed a large portion of the equity returns on long positions during this market cycle. On the other hand, shorting stocks requires that you borrow stock. Borrowing can be expensive, but the cost to cover and close out losing positions can be even higher. Shorting is a very challenging strategy to make pay in "Fed controlled" rising market cycles characterized by low volatility. These are hard costs that become difficult for investors to swallow if indexes are posting strong returns.

Folks, now is not the time to blindly chase returns and abandon risk management. While the cost of traditional hedging with options or by borrowing and shorting stocks has been truly painful for hedge funds and other risk managers, there is another way. WBI's dynamic management program that raises cash as risk increases may offer a better and lower cost alternative. Over the past 25 years, our risk management system has aimed to mitigate risk, protecting investors from large declines in two of the worst bear market cycles in history.

The Achilles heel of WBI's process typically occurred during later stage bull market rallies as markets became overvalued and volatility increased. These conditions would tend to cause our proprietary stop and goal process to raise cash, and then market overvaluation would limit the number of acceptable stocks that pass our quantitative buy screens causing us to hold cash. If the market rallied higher our strategies would temporarily underperform relative to the markets, as we did in 2015.

In early 2016, we delved deeper into our quantitative tool kit to tweak and improve our process, because it became obvious that Fed policy was distorting the market cycle. Our goal was to allow strategies to stay invested longer, attempting to capture returns we would have otherwise missed. At the same time, we tightened up our risk controls to allow us to move more quickly to cash should stock prices or market conditions deteriorate into a bear trend. The improved return participation we experienced in the second half of 2016 and throughout 2017 gives us confidence in our ability to optimize the risk and return equation to *Tame the Bear and Run with the Bull*.

IMPORTANT INFORMATION

1 "CNNMoney.com Market Report - Mar. 9, 2009." Money.cnn.com. 9 Mar. 2009. Web. 23 Jan. 2018.

2 Hu, Bei. "Bitcoin Frenzy Helps Crypto Hedge Funds Reap 1,100% Gains." Bloomberg.com. 16 Jan. 2018. Web. 23 Jan. 2018.

3 "S&P 500 Index - CNNMoney.com." Money.cnn.com. Web. 23 Jan. 2018.

4 Kiplinger. "3 Lessons for Investors From the Tech Bubble." NASDAQ.com. 11 Feb. 2015. Web. 23 Jan. 2018.

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