FLOWER CITY CAPITAL

May 2019 Newletter

Dear Members of Flower City Capital,

We hope you are having a wonderful Spring. As always, we begin with an executive summary.

Executive Summary

- Before the recent trade headlines, the S&P 500 posted one of the best YTD returns at over 17%
- The market has since experienced increased volatility in response to the trade talks with China
- Given that sentiment and valuations have increased significantly this year, the recent pullback may be viewed as a healthy normalization
- Though there are still no clear signs of a coming recession, our portfolios remain disciplined in terms of diversification and asset allocation given the high levels of uncertainty
- Lastly, in our Spotlight section, two recent experiments from Warren Buffet and the Wall Street Journal demonstrate the merits of minimizing costs and focusing on what can be controlled

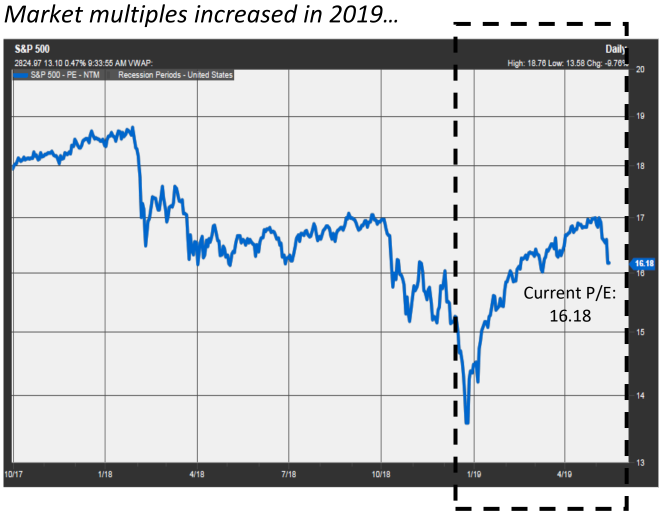
Market Overview

Before the recent trade tensions, equity markets were enjoying a strong 2019 due a variety of factors: improved investor sentiment, easing financial conditions, supportive monetary policy, continuous positive economic data, and signs that global growth would pickup as the year progressed.

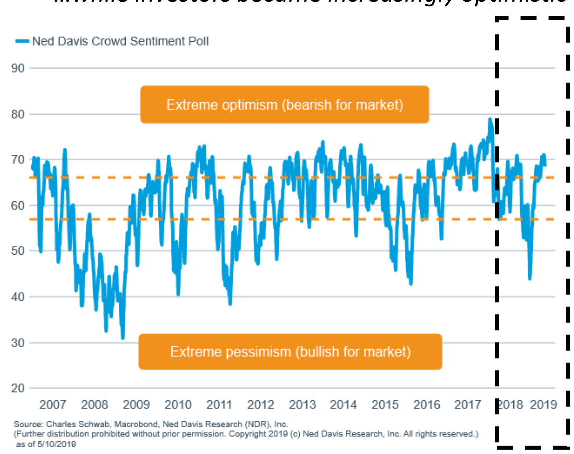
While there is still hope that some form of trade resolution will be reached, the newly applied tariffs and escalating rhetoric has certainly been viewed as a threat to the underlying thesis driving this year's rally.

Nobody likes market pullbacks, but the resulting declines and volatility could be considered a consequence of an overoptimistic market in the form of extended valuation multiples and investor sentiment. Overall, late-cycle economic fundamentals remain strong. GDP numbers have been better than expected, the labor market remains solid, and consumer/corporate data are positive. In short, near-term recessionary risk remains low.

Market multiples increased in 2019…



…while investors became increasingly optimistic



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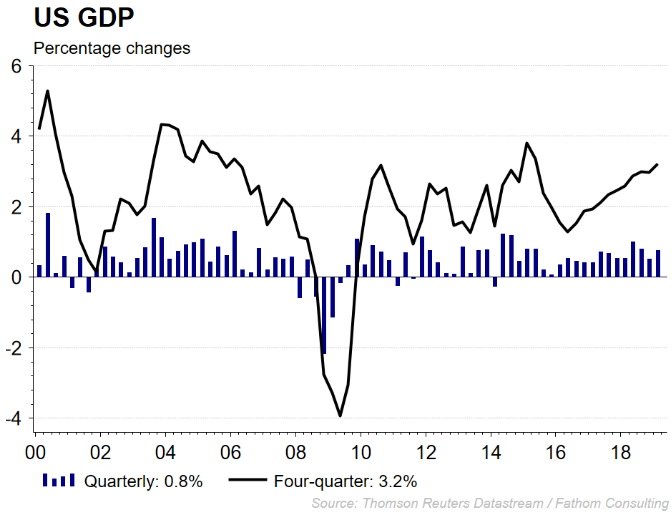
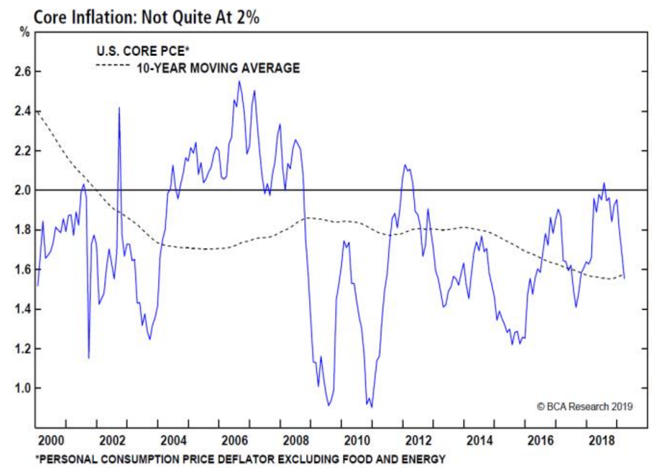
GDP numbers are strong…



…while inflation remains subdued



Trade tensions drove the recent correction, though markets are still up YTD

	Price Return (As of May 13, 2019)				
	1 Mo	3 Mo	YTD	Recent High 5/3/19	Yield
Equities					
US Large Cap	(3.2%)	2.3%	12.6%	17.8%	1.9%
US Mid Cap	(4.6%)	(0.4%)	14.0%	20.1%	1.3%
US Small Cap	(3.9%)	(1.0%)	14.4%	21.0%	1.3%
Intl. Developed USD	(4.3%)	1.2%	8.4%	13.8%	2.8%
Emerging Markets USD	(7.1%)	(1.5%)	5.7%	14.3%	2.5%
Fixed Income					
US Bond	0.7%	1.6%	2.4%	1.9%	2.9%
International Bond USD	0.5%	1.7%	3.0%	2.8%	0.8%
High Yield	(1.7%)	0.6%	6.0%	7.4%	6.5%
Emerging Market Bond USD)	(0.9%)	0.3%	4.4%	5.6%	5.1%

Our Portfolios

While the recent correction may be healthy and fundamentals reveal no clear signs of a coming recession, there are several uncertainties in the market. Should trade talks further devolve or inflation appear prompting the Fed to raise rates, the case for continued global growth could come into question.

It is worth revisiting the steps we have taken so far this year to adjust portfolio risk exposures. In March, when global equity markets were up double digits, we proactively took profits and de-risked portfolios. This shift brought portfolios back to "target neutral" weights, particularly reducing exposure to emerging markets. While monitoring the situation closely, our portfolios remain disciplined and focused on adding value through the elements we are able to control.

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Spotlight: Active Management and Costs

Markets are mostly efficient over the long-term and prices are usually right. While in the short-term, returns are largely driven by swings in sentiment. This leads us to one of the most important principles in our investment philosophy – **focus on what you can control.** There is an overwhelming supply of evidence supporting this conclusion, not the least of which demonstrates nearly all active managers fail to outperform their benchmark over long periods of time.[1] An investor could pay more fees and costs for an active manager to pick stocks and ultimately deliver below market returns. Or that investor could utilize passive index funds and focus on what can be controlled: asset allocation, diversification, and costs.

Two recent trials put this to the test, pitting active management against the basics of indexing and chance. In 2007, Warren Buffet wagered $1,000,000 that a S&P 500 index fund would beat a basket of hedge funds over a 10-year period. What were the results? Mr. Buffett's index fund returned 7.1% annually, compared to an average of 2.2% earned by the competing basket of hedge funds.[2] In another example, the Wall Street Journal validated a common axiom that an expertly crafted portfolio could be beaten by "a blindfolded monkey throwing darts at a newspaper's financial pages."[3] In this case, a team of columnists did just that with a handful of darts and came out ahead by 27% over the past year.[4]

There are a couple of things happening here. It is virtually impossible to predict what is going to happen to a company or be able to time the market with any degree of certainty. There is however something that can be predicted and is fully under an investor's control – cost. The added commissions, fees, taxes and implicit costs associated with active management directly translate to an investor keeping less returns, an effect that compounds dramatically over time. In both Buffet's and the WSJ's experiments, the wide difference in returns can largely be attributed to the significant costs of investing in hedge funds, which normally take 20.00% of profits in addition to a 2.00% management fee assessed every year. On the other hand, a typical S&P 500 index fund would charge somewhere between 0.03%-0.05%.

However, the decision to invest passively is not a passive decision. While markets are efficient most of the time, there are cases where excessive optimism can drive prices too high (bubble) or where excessive pessimism can drive prices too low (crash.) There may be an opportunity to add value above a benchmark when the pendulum swings too far in either direction. But bubbles and crashes are rare – requiring both discipline and execution to be "right" twice when the rest of the market thinks otherwise.

A portfolio should not be measured by how much it beats the market. Instead, by focusing on what is within your control, it is possible to construct a portfolio to meet your goals and objectives as part of a comprehensive financial plan, without being dependent on the ups and downs of the market.

Please do not hesitate to contact us with any questions, investment or otherwise.

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[1] https://us.spindices.com/spiva/#/reports
[2] https://blogs.wsj.com/moneybeat/2017/12/30/biggest-winner-of-famed-buffett-bet-girls-inc-of-omaha/?mod=article_inline
[3] Burton Malkiel, *A Random Walk Down Wall Street,* 1973
[4] https://www.wsj.com/articles/making-monkeys-out-of-the-sohn-investing-gurus-11557115260