Smooth Sailing (So Far)

Hanging out by the pool or in the backyard is a staple of summertime. Good times with family and friends are often accompanied by some music playing in the background. For many, that summertime hang music is "yacht rock" – the chart-topping smooth music from the late 1970's and early 1980's that is, if nothing else, easy to listen to. The Doobie Brothers, Steely Dan, Hall & Oates and Christopher Cross are all giants of the genre. Yet if there was one single artist who most epitomized the smoothness of yacht rock, it would have to be Michael McDonald.

McDonald's prowess was no more apparent than on The Doobie Brothers' 1978 classic "What a Fool Believes". His smooth delivery, combined with an effortless melody and an electric piano might just be the easiest "easy listening" ever produced. However, listening to the lyrics paints a more sullen picture – the story of a man foolishly believing he has a chance of rekindling an old flame.

Much like the smooth music of "What a Fool Believes" the stock market has had a very smooth ride thus far in 2021. The S&P 500 Index is up over 20% on the year, and has experienced very little turbulence along the way. To date, 2021's biggest decline has been a blink-and-you-missed-it 4.2% drop in February and March. In most years, the stock market experiences a decline of 10%-15% at some point along the way. This type of uninterrupted smooth sailing has only happened a handful of times since 1928 (see table at right).

SMOOTHEST OF THE SMOOTH

Smallest Intra-Year Declines Since 1928

	Biggest Market Decline
1995	-2.5%
2017	-2.8%
1964	-3.6%
2021*	-4.2%
1958	-4.4%
1954	-4.4%
1993	-5.0%
1972	-5.1%
1991	-5.7%
2013	-5.8%
1961	-6.2%

** Through August 27*

Source: SentimenTrader

Similar to the somber lyrics that accompany the smooth melody of "What a Fool Believes", this year's stock market is a little bleaker than it appears on the surface. While the S&P 500 Index has only experienced a 4.2% drop, more severe declines have

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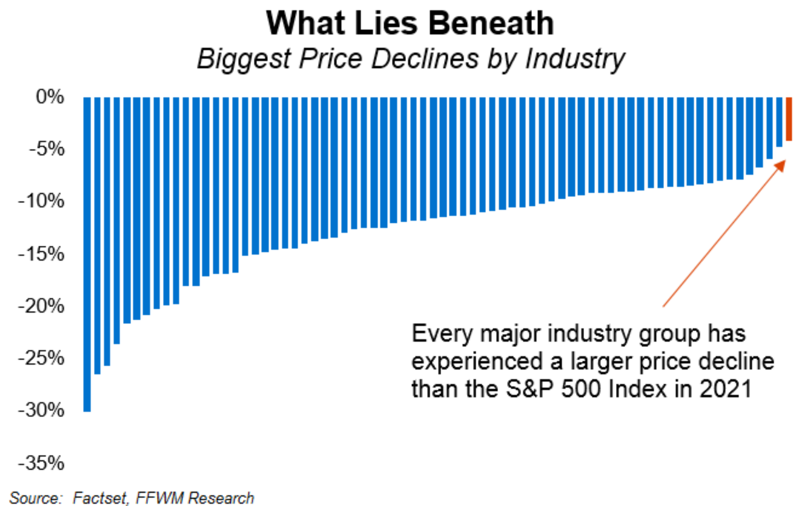
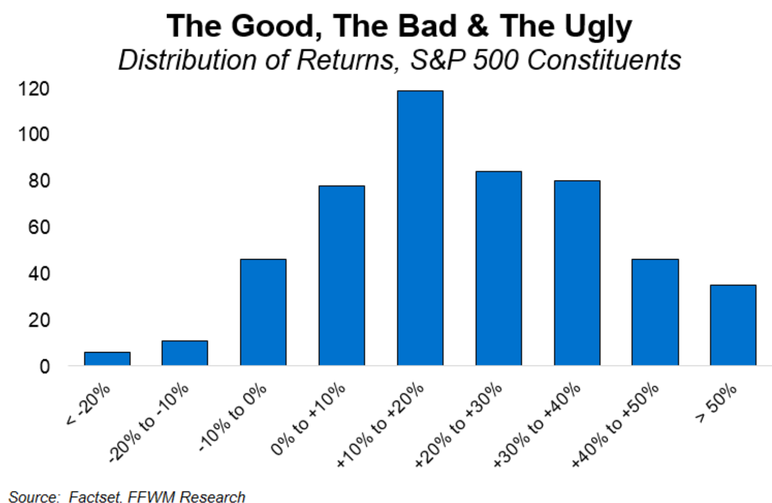
rotated through the index beneath the surface. The chart at right depicts the largest price declines for over seventy industry groups that make up the S&P 500 (through August 27). Somewhat surprisingly, *every single industry group* has suffered a bigger drawdown than the market at large. This is due to the fact that, at any given time, some areas of the market are going up while some are going down. Put them all together and you get a much smoother picture in the aggregate.



This dynamic illustrates a difference between "passive" and "active" management. For the "passive" money manager, simply matching an index's returns is the ultimate goal. This usually means more diversification for the end investor, but it also means that the investor *owns the entire market* – the good, the bad, and the ugly.

"Active" management, on the other hand, seeks to outperform an index. This can really be broken down into two approaches – either by picking the absolute best performing securities out there, or by avoiding the worst parts of the market. "Active" money managers subscribe to the notion that there isn't a "stock market" but rather a "market of stocks." As we mentioned above, owning the "stock market" exposes an investor to everything. A "market of stocks" allows an investor to be selective about what they own and, just as important, what they don't own. As you can see in the chart at right, there is a huge discrepancy of returns among the stocks that make up the S&P 500 Index (data through August 27).



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At First Financial Wealth Management, we actively manage client portfolios with the goal of owning high-quality securities that will deliver satisfactory risk-adjusted returns over the full market cycles. While we aim to always select good securities, avoiding the worst parts of the market is where we'll likely deliver outperformance relative to our benchmarks over the long haul. What this strategy may lack in sizzle, history has shown it can deliver on the steak.

As investment managers, we won't chase the hottest areas of the market just to keep pace with benchmark returns. We will remain focused on our commitment to "quality" and keep a keen eye on valuation. History has shown that those who chase returns on the way up are often caught offside when the trend changes. Or, as Warren Buffett said, "Only when the tide goes out do you discover who's been swimming naked."

Currently, what we own reflects our belief that the macroeconomic picture is one of rising growth, rising interest rates and rising inflation. This "reflationary" environment has historically benefitted cyclical "value" stocks which should lead the market higher from here, though with the potential for some volatility along the way. In preparation, we recently trimmed our overweight allocations to riskier areas of the market in order to manage total portfolio volatility. Overall though, our client portfolios maintain their cyclical orientation.

Within equities, we previously increased our clients' exposure to larger, more developed international markets. We've also made moves to increase exposure to smaller companies in the US and have added targeted exposure to more cyclical areas of the US large cap space. We believe that, as we enter the second year of the current Bull market, earnings growth will be more important in driving returns rather than expansion in valuation multiples. This just reinforces our position that cyclical "value" stocks should benefit more than expensive "growth" stocks.

In the fixed income area, we remain focused on more credit-sensitive securities (with less exposure to the more cyclical areas of the market) with shorter maturities as a hedge against potentially rising interest rates. Within the alternative market segments, we have increased our exposure to "real assets" (think commodities and real estate) as a hedge

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against the potential for higher inflation. We have maintained our exposure to the diversified alternative sector as a hedge against potential market volatility.

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