THE OPTIMIZED PORTFOLIO SYSTEM®

A Message from the TOPS® Portfolio Management Team

The Market Catches a Cold – November 21, 2018

With the falling of leaves in a large part of the country and arrival of Thanksgiving, we welcome the onset of cold and flu season. Each year, most Americans will be inflicted with a sickness ranging from a 72-hour sniffle to a wicked 3-week illness. Many of us can remember seasons where it seemed we just couldn't get away from sickness and were hit with multiple bugs.

We all must expect to get sick sometime, it's part of life. Living in a bubble would be the extreme measure necessary to avoid sickness. Even though sickness is expected, that doesn't make it enjoyable. Likewise, we recognize all sicknesses are not created equal. The market is not immune to sickness either. Similarly, all market sicknesses are not created equal.

The Current Market Ailment

The global equity markets have been battling illness for the last few weeks. From the closing high on September 21st through yesterday's market close, the S&P 500 was down 10.17%, and other global markets are down as well. While our Portfolio Management Team runs constant vitals on the markets, we thought this would be a good time to provide a short message, supplementing our regular market communications.

While we have experienced a generalized global equity market pullback, this week U.S. growth stocks have been particularly impacted, an event which tends to have an enhanced effect on market sentiment. Even though this symptom has caught the attention of many investors, market pullbacks like this have been as common as the common cold. According to JP Morgan, the average stock market (S&P 500) decline on an annual basis is 13.8% since 1980. Even so, the stock market return has been positive in 29 out of 38 years.

Market pull backs, like sickness, are not fun. Nobody wants to be sick and most rational humans are risk averse. However, illness and market pull backs are both expected parts of life. The best way to prepare is to work under the care of experienced professionals.

Our team has over 75 years of combined investment management experience and we are doing the prudent things necessary to take measured risk, in search of appropriate returns over time. However, we are not living in a bubble. Risk and return are yoked together, much like leaving the house and sometimes catching a cold.

We Should Recognize, We all Have Post Traumatic Stress Disorder (PTSD)

The two most recent bear markets were the "Tech Bubble" of 2000 and the "Financial Crisis" of 2008. Worthy of scary nicknames, these were historic market pull backs marked by extreme situations, neither of which are occurring right now. However, they have left their mark on the psyche of investors who experienced them. These two most recent bear markets are inevitably where our mind takes us when the market stumbles, even healthily.

We analyze US stock valuations on a monthly basis according to numerous different metrics. At the height of the technology bubble on December 31st, 1999, the historical price to earnings ratio (P/E) on the S&P 500 reached 29.32. As stocks declined during the resulting bear market, the P/E ratio also declined to 18.11 on September 30th,

2002. As of October 31st, 2018, the P/E ratio was 18.75. Further, P/E ratios on international stocks currently sit below historical averages. This information shows the market is not nearly as overvalued as it was twenty years ago and that company earnings are more supportive of current stock prices. While this doesn't guarantee anything going forward, it does give perspective on current market positioning.

Likewise, the Financial Crisis was a 3 standard deviation event, occurring less than 1% of the time. We have only experienced one global economic crisis like that in the last 100 years.   The symptoms of the financial crisis are not the same symptoms being experienced over the last few weeks.

While experience is incredibly important, and we learn each day from the markets, it is important to get a fresh diagnosis each time markets falter. Our investment process is designed to take out the impact of PTSD from these recent market pullbacks.

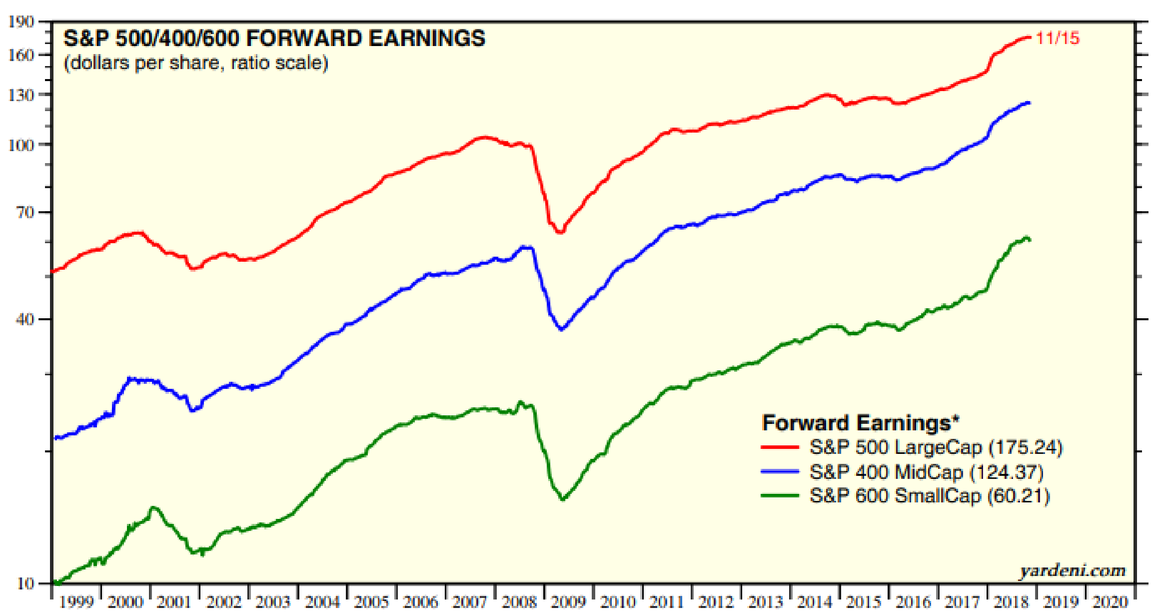
The Economy is Healthy Coming into this Sickness

How long will this market pullback last? Is it over? Obviously, nobody knows the answer to these questions. We do know the economy has been historically strong for the last few years. Likewise, the signs of recession in the near term are low. Recessions will come though, they always do.

The healthy economy has helped companies to produce healthy earnings. The S&P 500/400/600 indices (representing Large, Mid and Small U.S. companies) continued to register record high forward earnings through mid-November. Likewise, we have not seen many analysts revising their earnings estimates downward for the S&P 500 Index for 2019 and 2020.

As the primary fuel for stock growth, solid earnings growth continues to be a significant component of the underpinning of this bull market. While, markets continue to balance many impactful factors, record-high earnings are a bullish factor.

The following chart shows forward earnings in the S&P 500 (large companies), S&P 400 (mid-cap companies), and S&P 600 (small-cap companies) over time. As you can see, companies have grown earnings significantly over the last 15 years, and more recently, have continued strong growth year over year. While rising interest rates and wages may prove challenging for companies in the short run, history suggests profits will continue to grow over a longer-term horizon.



* Time-weighted average of consensus estimates for current year and next year.
Source: I/B/E/S data by Refinitiv.

Some Closing Thoughts

In the classic piece *As a Man Thinketh* by James Allen, he writes, "By the right choice and true application of thought, man ascends to the Divine Perfection; by the abuse and wrong application of thought, he descends below the level of the beast."

As portfolio managers, we are continually balancing a wide array of decisions. Our professional discipline, and the discipline built into our investment process, are pillars of the value we can provide to investors. While no investor will ever reach Divine Perfection, we will continue to use our experience and resources to guide the portfolios through choppy markets.

We are seasoned to expect events like we have experienced in the last few trading days. While it's not fun to see red numbers on our monitors, we understand periods like this are necessary and normal in the course of equity investing. Likewise, we understand these events can be stressful on our investors. We remember speaking to clients when the S&P 500 sat at 683 in 2009, only to close at 2930 on September 21, 2018.

The TOPS team spends considerable time monitoring and discussing markets, to ensure we are appropriately investing client assets. While we can't control equity markets, we can monitor risk and appropriately manage investments with a goal of optimizing the risk versus return trade off over time. We are optimistic about the long-term prospects of equity investing.

TOPS® Portfolio Management Team

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