State of the Market Q&A

May 25th, 2022

The following questions were submitted by Steve Haberstroh, Partner at CastleKeep Investment Advisors. They were answered by Charles W.K. Haberstroh who is Founder and CIO of CastleKeep Investment Advisors LLC. Charles has been an investor personally and professionally for more than 50 years.

1. Through the close on May 25th, the NASDAQ is down -26.67%, the S&P 500 Index is down -16.03% and most global equity markets are down similar amounts this year. While it's impossible to pinpoint exactly, what are some factors contributing to the drawdowns?

- *As you said, it is hard to pinpoint exactly, however, it is important to remember that moment to moment and sometimes months and years, Mr. Market is a function of supply and demand. From time to time Mr. Market misprices securities-he doesn't always get things right. As an example, in early 2020, pundits claimed oil stocks were "dead money" and innovative technology companies were all the rage. In reality, the opposite occurred. Exxon Mobil has tripled off its lows and Cathie Wood's Ark Innovation ETF-the poster child for disruptive technology stocks-is down -80% from its highs. Right now, Mr. Market seems to be pricing in the negative impact of rising interest rates, fears of a recession, the war in Ukraine and reversion to the mean (markets have been very strong for 10+ years). Has Mr. Market correctly priced in these risks (and others)? Time will tell but with markets off -15% or so, much is priced in already.*

2. Bonds have also suffered historical drawdowns. Is this contributing to the equity market volatility?

- *I believe so, yes. Bonds have suffered historical drawdowns this year due to the prospect of inflation and rising interest rates—both of which haven't materially happened since the late 1970s in any prolonged way. To put today's action in perspective, the Bloomberg Aggregate Bond Index has never suffered a calendar year loss of -3% since its inception in 1976. It's down roughly -8.5% so far this year. If bonds don't appear to be safe any longer, investor fears may be elevated in equities as a result.*

3. What are your current thoughts on cryptocurrencies?

- *It's early days for cryptocurrencies. I'm sure the underlying Blockchain technology may "change the world". However, to this point the cryptocurrencies have been subject to much hype and have to be considered speculative. Financial institutions have proven adept at creating many financial instruments that have not proven themselves in the long term. While the World Wide Web had similar characteristics in that it too would change the world (it did), many of the earliest and "most promising" internet companies are no longer with us. There are too many to mention all, but do*

you remember Netscape? Geocities? Everyone used to use AOL; does anyone use it anymore (sorry to current AOL users).

4. Does this remind you of any previous dramatic sell-offs?

- *Yes, two:*
  - *One of which was in the late 1970s and 1980s (mentioned above), as inflation took hold. Stocks were weak for a period of time but in hindsight were the best house in a bad neighborhood. Like today, bonds didn't offer much protection.*
  - *The second was the dotcom bubble in 2000-2001. Many companies during this period had no earnings but were bid up to extraordinary levels. Remember pets.com? Folks were all consumed with the prospects of making millions if they chose the right stock (concept). Even solid companies, like Cisco were bid up to levels which it has still not reached some 22 years later. [The price in March 2000 was $77 per share. By March 2001 it had dropped to $15 per share. Today (May 25, 2022), it is $44 per share.] It was difficult for even the most disciplined investors to ignore the fear of missing out. Reckless gamblers were being rewarded while diligent investors were told their methods no longer worked. Tried and true investment discipline won out at the end of the day after the NASDAQ eventually fell -80% over a multi-year period and so-called value stocks held their values.*

    Much of the behavior over the last year or so almost perfectly resembles that of the late 1990s. Are we in for the same pain in technology stocks moving forward? Time will tell but money losing "disruptors" like Peloton, Teledoc, Coinbase and Roku are all off more than -75% from their highs. Fundamentals may indeed win out once again.

5. What lessons can you draw from those experiences?

- *There are a few:*
  - A. *Recognize speculation. Purchasing a company which has little or no earnings, but great prospects is speculation. Use prudent gambling techniques in that case: stop loss orders are an example. Sell at pre-determined levels. Don't bet the house. If it sounds too good to be true, it usually is. In short—use discipline. If you were lucky enough to bet correctly, take your profits and run.*
  - B. *It's easy to follow the crowd, but it is dangerous. In the end sometimes the only thing good about going with the crowd is that misery loves company.*
  - C. *Trading is difficult. Emotions can lead to buying high and selling low. You have to make two correct decisions.*
  - D. *Remember the rule of 72. Take the number 72 and divide it by a particular rate of return to find out how long it would take to double your money. Even at a relatively high rate of return of 10% per annum, it would take you 7.2 years to double. If you were lucky enough to double your money in one year, recognize that as extraordinary luck. Take chips off the table after unrealistic returns.*
  - E. *Successful investing is often times…boring.*

6. Can those lessons apply today?

- *These lessons apply to yesterday, today and tomorrow. It's just that they become more acute in times of greed and fear. The past 12 months have seen both. Remaining disciplined, ignoring*

crowds and resisting the urge to speculate may sound simple but it's not easy. It's hard to invest alone if you don't have the time, the knowledge or the discipline.

7. So where do we go from here? What would you say to those tempted to take risk off the table and move some of their equity exposure to cash?

- *As noted above, the markets have already priced in negative sentiment—to the tune of -15% or more in most indexes. Bond markets are also down historical amounts. It's generally not prudent to sell out after precipitous declines—you'd be locking in your losses and not giving your portfolio a reasonable chance to recover. Recoveries can happen rapidly and when you least expect it. So as long as you have built the right portfolio for your objectives, staying the course is generally the right move.*

  Ask any experienced investor who has been through similar times. They'd all tell you to resist the urge to sell into weakness. In fact, they most likely wish they had purchased more—of quality companies of course.

  I referenced the 1970s earlier. The S&P 500 Index bottomed in 1974 at $62.28. Today, it trades above $3,900.

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