Tough Year So Far for Active Risk Management, Outperforming Requires Short-term Underperformance

OVERVIEW:

- Underperformance that occurs in environments where a strategy is expected to struggle is good evidence of JCN Financial (JCN) staying true to our process.
- If we want to achieve long-term outperformance, you must be able to stomach short-term underperformance.

As William Bernstein said,
"The most important investment ability is an emotional discipline"

- Investing is a team sport that requires this discipline, Communication and Education from both JCN and all our clients.
- We use *Active Risk Management* on all our equity positions:
    - This means using stop losses to limit the potential downside of every stock we own. There is tremendous evidence that using risk control is the best route to avoid catastrophic losses, but the tradeoff is it can (as we have seen this year) lead to Return Avoidance as well.
- Our Strategy Timeline (assessment period) is a **3 -5-year timeframe**. 1 Month, 1 Quarter or even 1 Year in any investment strategy is not a reasonable or realistic amount of time to assess any long-term investment strategy. We do not invest (nor can any manager in our view) for Monthly or even Quarterly gains. As hard as it may to do so, it is imperative in our view to **educate** our clients to this fact. As well as the dangers of short-term thinking, in the area of long-term investments and long-standing partnerships.

At JCN we don't just offer advice. We teach understanding.

- At its core it's important to take things back to the basics and simplify what the process of our investment approach is. We use technology and science developed strategies to invest in business that we believe to be undervalued. It may take time for whatever companies we have positions in to overcome the short-term factors that have suppressed there share prices below our fair value.
- We also use quantitative methods to manage risk (losses). As we will cover in the next speaker's bureau, we will show in great detail why ***risk management*** is by far more important than which stocks to own.

For clients who are new to our process and management style, this is critical importance to understand. We don't believe in blindly buy and holding the market, it's very clear that investors who take this approach expose themselves to extreme risk in their retirement savings.

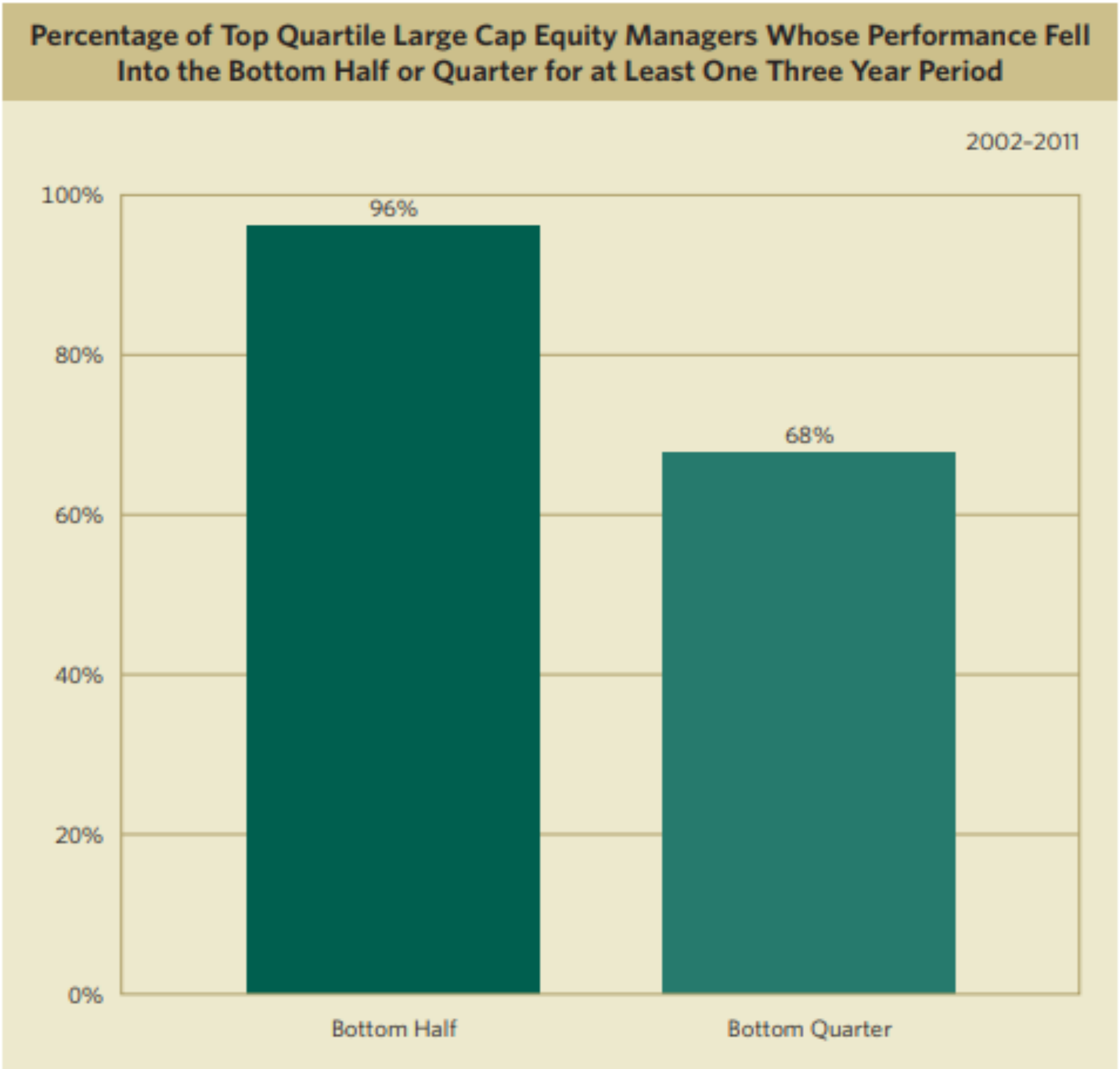
Even the Best Funds/Strategies Underperform: And Short-Term Underperformance is Inevitable

We all find periods of short-term underperformance frustrating. But we wanted to use this opportunity to share with you a few studies and data points on this topic, so we can all better understand the JCN process and why such periods are inevitable when building long-term wealth.

To prove this point, we want to share this study done by Davis, Inc. that examined what percentage of top-performing investment managers from 2002–2011 experienced a period of short-term underperformance on their way to building an attractive long-term track record. The results in our view are eye-opening:

- 96% of the top-performing managers from 2002–2011 fell into the bottom half of their peer groups for at least one three-year period
- Almost 70% fell into the bottom quarter of their peer groups for at least one three-year period though each of the managers in this study delivered excellent long-term returns over the entire 10-year period.

In the second part of this study, they compared the yearly investment returns of the managers that Warren Buffett named in his epic lecture, Super investors of Graham-and-Doddsville. Davis showed how, even though these managers handily beat the market, each and every manager had periods where they underperformed the market, sometimes by large amounts.



Source: Davis Advisors. 190 managers from eVestment Alliance's large cap universe whose 10 year average annualized performance ranked in the top quartile from January 1, 2002-December 31, 2011. **Past performance is not a guarantee of future results.**

Each one of these superstar managers underperformed the market one third of the time, on average and All but Buffett actually lost money at some point. Tweedy Browne itself lost money in one year of the 16 years listed in Buffett's famous piece, and the rest ended up losing money in two or more of the years recorded.

Year	S&P 500	Walter Schloss (overall)	Templeton Growth Fund (After Fees)	Warren Buffett (overall)	S&P 500	Sequoia Fund (After Fees)	Charles Munger (overall)	Windsor Fund (After Fees)	Pacific Partners (overall)	S&P 500 (Period Ended Sept.30)	Tweedy, Browne (overall) (Period Ended Sept.30)
(1stQ) 1984	(1stQ) -2.3	(1stQ) 1.1B				(1stQ) -1.6B					
(Full Yr.) 1984	6.3		2.2W					19.5B			
1985	32.2		27.8W					28.0W			
1986	18.5		21.2B					20.3B			
1987	5.2		3.1W					1.2W			
1988	16.8		23.6B					28.7B			
1989	31.5		22.6W					15.0W			
1990	-3.2		-9.1W					-15.5W			
1991	30.5		31.3B					28.6W			
1992	7.7		4.2W					16.5B			
1993	10.0		32.7B					19.4B			
Underperformance (vs. S&P 500) Years as % of All Years		28.3%	35.5%	7.7%		40%	35.7%	33.3%	42.1%		31.7%
Length of Period		28¼ years	31 years	13 years		13¾ years	14 years	30 years	19 years		15¾ years
Compounded Annual Return of Investment Manager		21.3	16.5	29.5		17.2	19.8	13.9	32.9		20.0
Compounded Annual Return for S&P 500		8.4	10.8	8.9		10.0	5.2	10.5	7.8		7.0
Compounded Gain for Investment Manager		23,104.7	11,340.0	2,794.9		775.3	1,156.7	4,843.7	22,200.0		1,661.2
Compounded Gain for S&P 500		887.2	2303.0	202.9		270.0	103.3	1,899.3	316.4		238.5

Sources: *The Superinvestors of Graham-and-Doddsville* by Warren E. Buffett;
Are Short-Term Performance and Value Investing Mutually Exclusive?
The Hare and the Tortoise Revisited by V. Eugene Shahan; Ibbotson Associates;
CDA/Wiesenberger; *Outstanding Investor Digest*

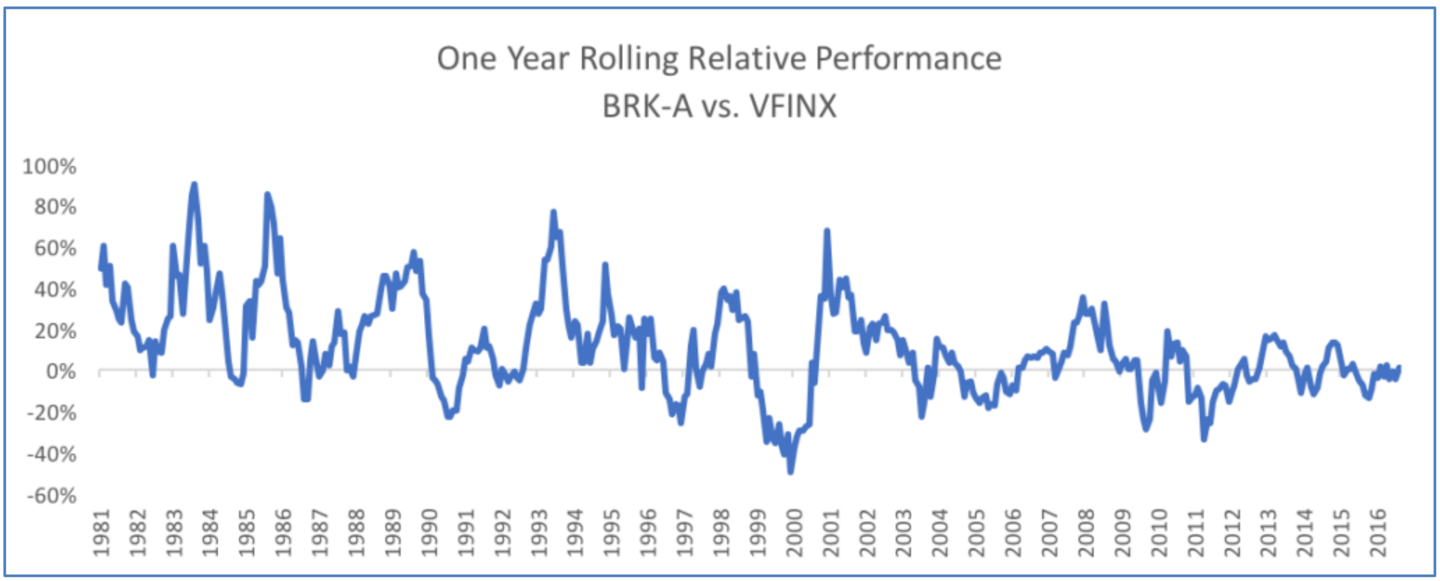
As good as these managers were, none of them could beat the market each and every year. Underperformance wasn't just a one-year blip, either. Actual underperformance ranged from just 1 year to a 6 year stretch! …yet all ended up beating the market by wide margins and all are considered among the best money managers who have ever lived.

For us, the clear takeaway from this study is that there is no holy grail to investing. The fact is if we want to outperform standard benchmarks over the long-run, we must hold positions that are **different** from the benchmark. Holding different securities creates tracking error…And tracking error inevitably means that short-term underperformance will occur.

Even Warren Buffett, by many measures "the best investor in U.S. history", is not immune from this truth.

From March 1980 to October 2016, Berkshire Hathaway A Shares delivered an annualized total return of 20.2%, 9.7% more per year than the Vanguard S&P 500 Index Fund (ticker: VFINX) over the same period. Berkshire's risk-adjusted returns are more than 60% better than the Vanguard benchmark (Sharpe ratio of 0.74 vs. 0.46) and the stock's alpha is an astonishing 1.0% per month.

The graph below plots Buffett's one-year rolling relative performance vs. VFINX. Positive (negative) numbers indicate that Berkshire beat (trailed) the index fund over the prior 12 months.



Data Source: Yahoo! Finance.

Even the great Warren Buffett has lagged the market **one out of every three years**. And in many cases this underperformance was very significant. There have been ten separate episodes where Berkshire underperformed the index fund by more than 10% over a one-year period and many periods of underperformance lasted significantly longer.

Peak	Trough	Recovery	Peak-to-Trough Underperformance	Time to Breakeven
October 1985	January 1986	September 1987	18.1%	1.9 Years
October 1989	September 1990	February 1993	25.6%	3.3 Years
February 1996	November 1996	March 1998	22.1%	2.1 Years
June 1998	February 2000	July 2002	54.4%	4.1 Years
September 2002	September 2005	February 2008	29.9%	5.4 Years
October 2008	April 2012	Ongoing	32.7%	8.1 Years

Data Source: Yahoo! Finance.

Through these difficult times, Buffett and Berkshire have remained committed to their investment process.

The JCN Team acknowledges tremendous value in this facet, *Discipline*.

Our investment process is really only one ingredient for our clients' success. This is precisely why we believe setting appropriate expectations through in-depth education is so *critical*. The Buffett case study points to a number of key lessons for expectations management.

1. Underperformance is not bad.
2. In isolation, underperformance, while it may be frustrating, is not necessarily evidence that a strategy is broken or should be abandoned.
3. For any strategy to beat the market, they must be different than the market.
4. Furthermore, risk-free outperformance is impossible over the long-run.
5. Understanding when a strategy may excel and when it may struggle is a ***core part*** of the JCN Client Education process.
6. We believe that by better understanding the potential magnitude and duration of underperformance, as well as the types of markets in which it is most likely to occur, investors can start to exhibit better emotional discipline and sound decision making during their retirement.

It's unrealistic to assume that a value investing strategy, no matter how promising it is, will provide uniform returns year after year. Even a great value investing strategy will underperform the market in a significant number of years and all strategies will have money-losing years…That's just part of the course.

Unfortunately, a lot of our new clients oftentimes bring habits of short-term focus and get quickly frustrated and discouraged when our strategy begins to underperform. Our first and main focus for all our clients is managing **RISK**. Our goal as YOUR financial planner is to evaluate, develop, and optimize strategies that not only aid in the implementation of a plan, but also ensure that through education, our clients understand "**why"** we're advising them in a certain direction.

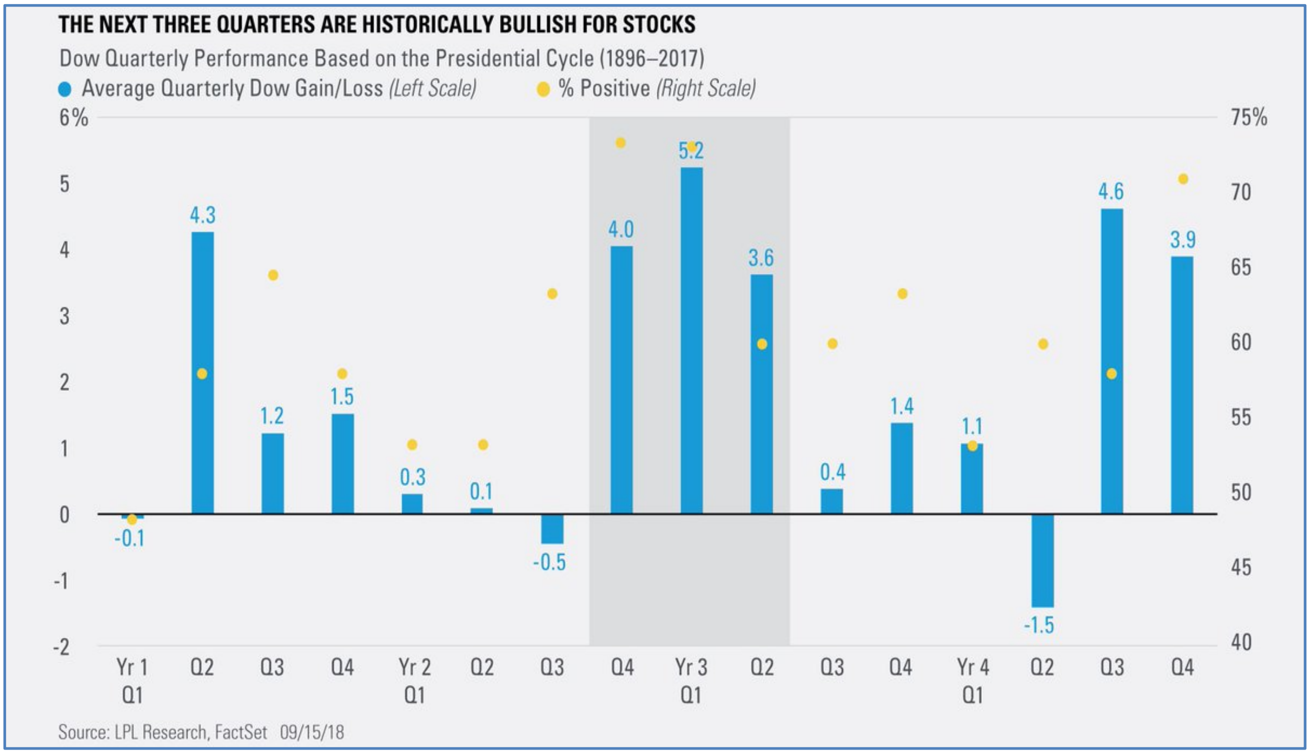
As a result, one of the challenges we have is building the experience, knowledge and trust with our clients to understand our process and hold steady through a full market cycle. The Benefits of giving up some upside participation in exchange for downside protection seemed like a no brainer in 2008 or 2000.

That being said, having the discipline to stick with a risk management plan also requires being realistic. While it would be great to build a strategy with 100% upside and 0% downside, such an outcome is unrealistic. Risk-managed strategies tend to behave a lot like uncertain insurance for the portfolio. A premium, in the form of upside capture ratios less than 100%, is paid in exchange for a (hopeful) reduction in downside capture. This upside underperformance is a feature, not a flaw.

Rest of the Year Outlook

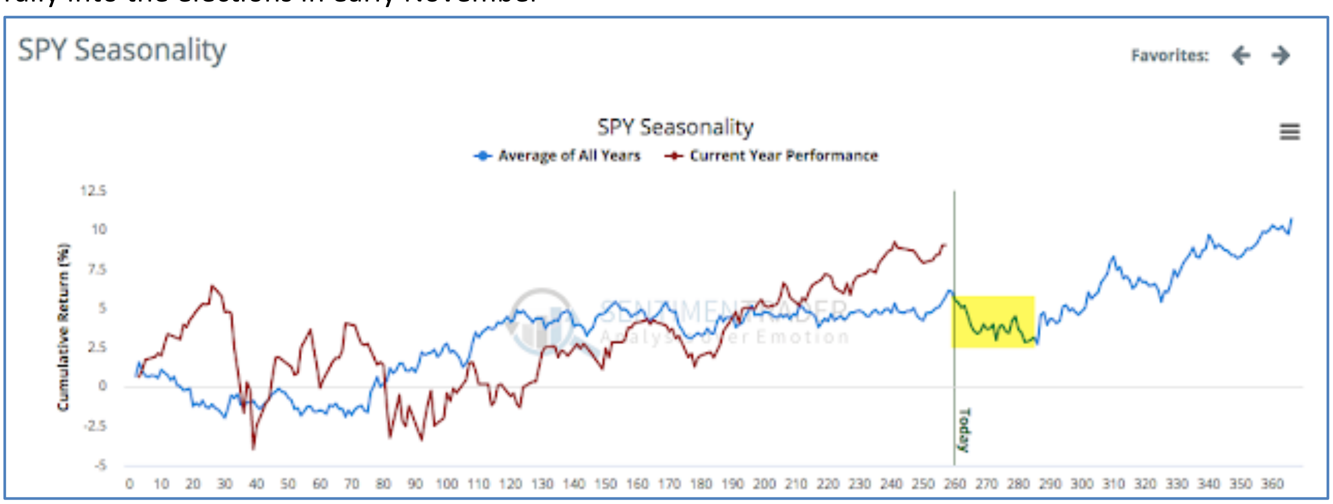
- US corporations start to put cash to work
- Entering the Seasonally strongest part of the year
- We expect value to start to close the gap

On a quarterly basis, the third quarter of the second year of the presidential cycle is the second worst quarter in the four-year presidential cycle, down .5% based on data going back to 1896.



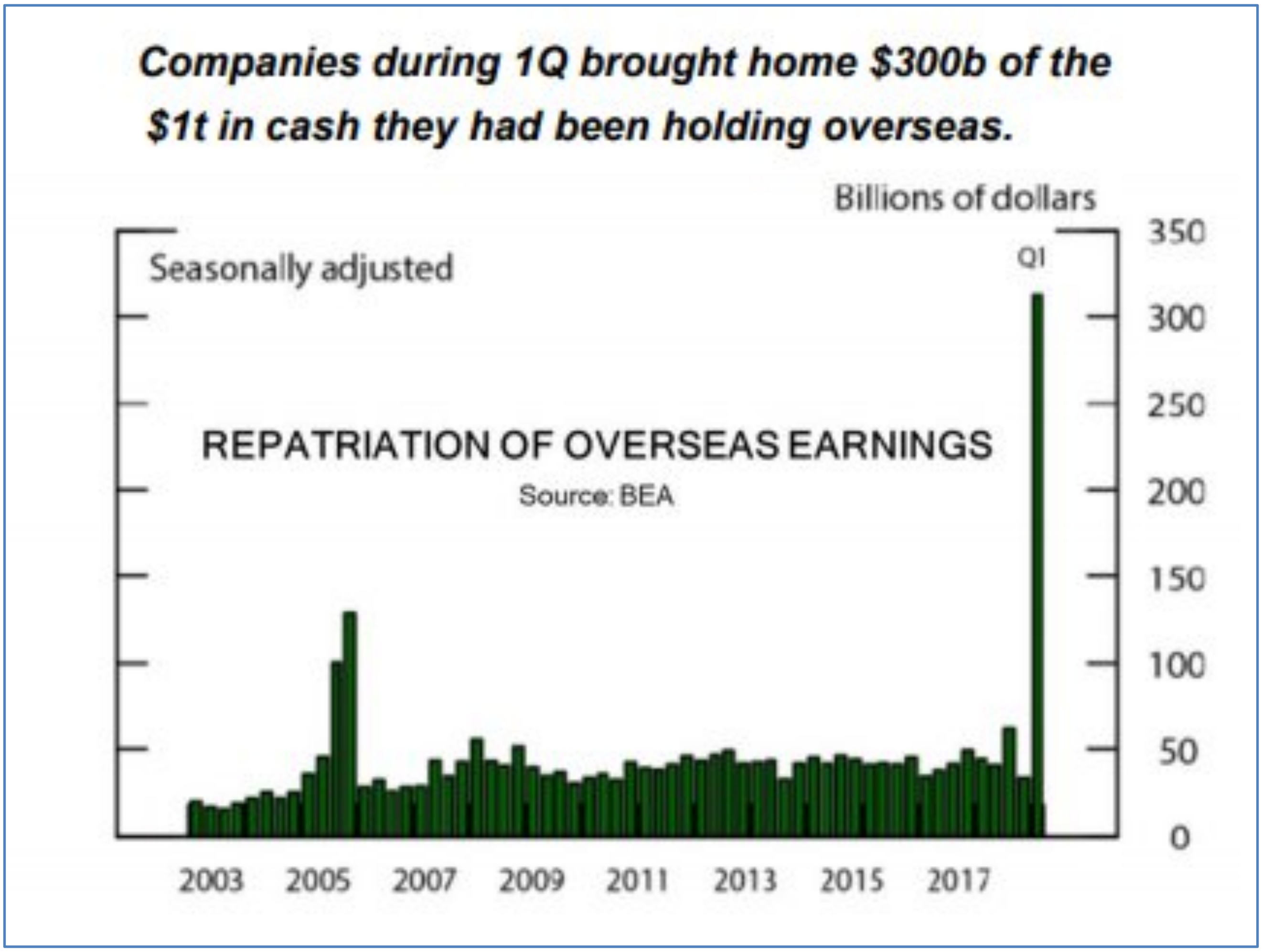
Source: LPL RESEARCH, FACTSET

Historically, the end of September and into October is a weak period for US equities. That typically sets up a rally into the elections in early November



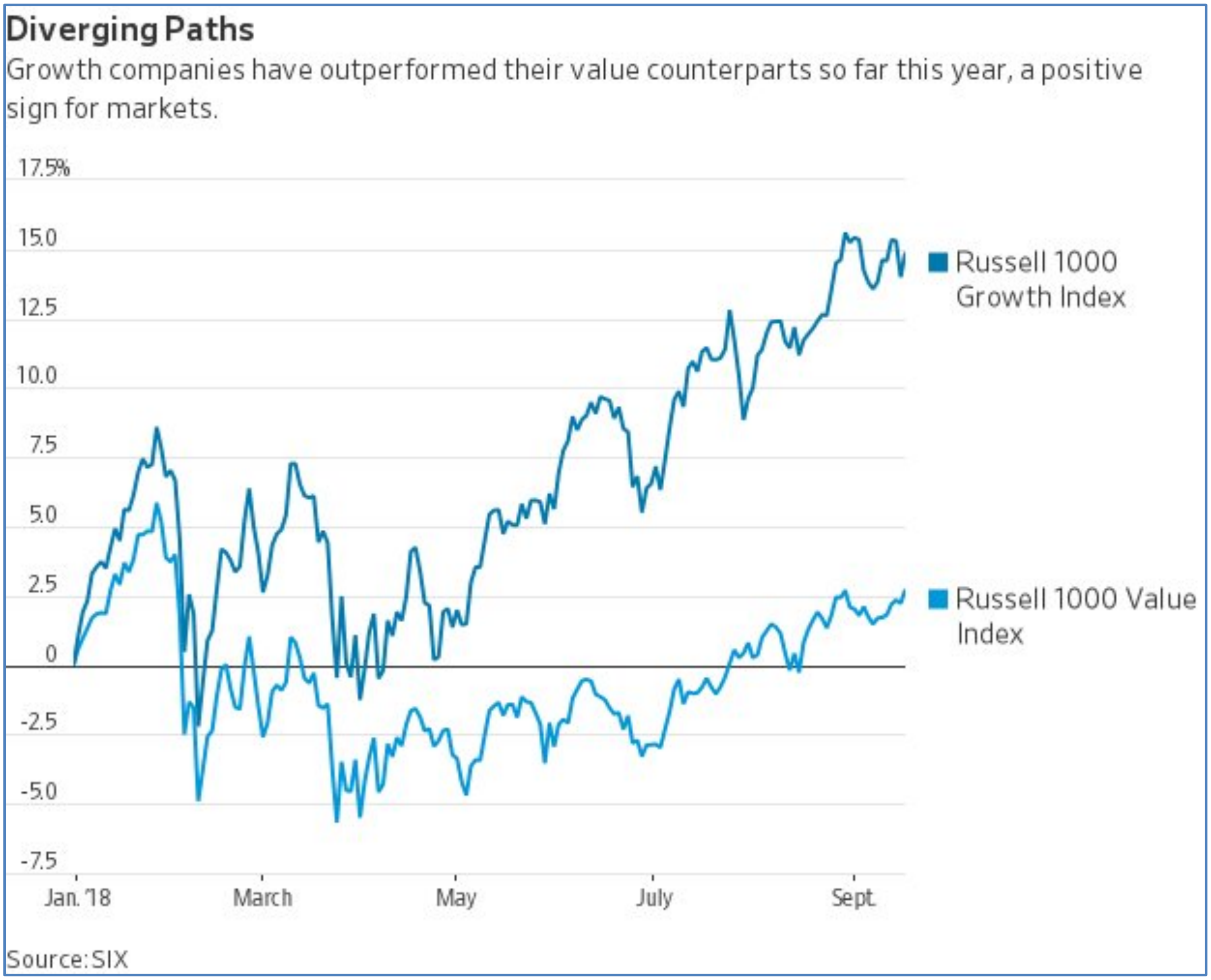
Source: http://fat-pitch.blogspot.com/

Companies repatriated $169.5 billion in the second quarter, according to data released Wednesday by the Commerce Department, up from $34.9 billion a year earlier. Still, that followed a downwardly revised $294.9 billion returned in the first quarter. The numbers for the first half of the year are just a fraction of the more than $3 trillion companies are estimated to have accumulated overseas to defer U.S. taxes on the money. President Donald Trump has said, without specifying his source, that he expects more than $4 trillion to return to the U.S., which will help to create jobs and more investment.



Source: **https://www.federalreserve.gov/econres/notes/feds-notes/us-corporations-repatriation-of-offshore-profits-20180904.htm**

As we detailed in previous speakers' bureaus, the market has been carried by only a handful of technology-based growth stocks this year. And with all the Trade war and Fiscal Policy causing divergences amongst different sector groups, we believe that the market will start to rotate from growth to value over the next market cycle.



Final Thoughts:

In closing, we want our clients to feel secure and confident in JCN Financial & Tax Advisory Group, LLC. Management of their accounts and understanding that investment is only one ingredient in the JCN strategy and our clients' success!

Thank you,

JCN Financial Team.

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