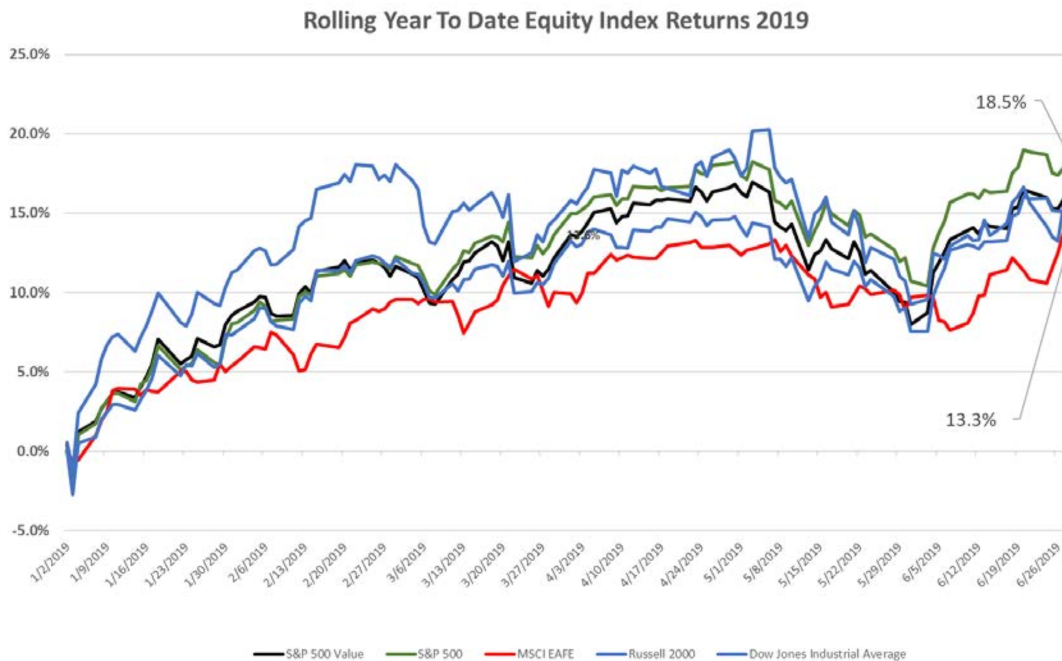
Third Quarter 2019 Commentary

Dear Turtle Creek Client,

Investment markets continued to wobble during the third quarter. Stock indices advanced just a percentage point and bond yields declined. The key issues impacting future economic growth - the ongoing trade war, international economic weakness, and the 2020 election - did not evolve in any meaningful fashion. Slowing economic data and heightened trade war rhetoric from the U.S. government resulted in a very volatile August. The possibility of a near-term recession remains a key focus not only for Turtle Creek clients, but also for most Americans as evidenced by investor positioning, media commentary, and trends in economic sentiment polls. During such uncertain times, analyzing the potential impact to your portfolio through a historical lens is very helpful as is considering your overall investment plan and how it will provide for your needs during a period of economic weakness.

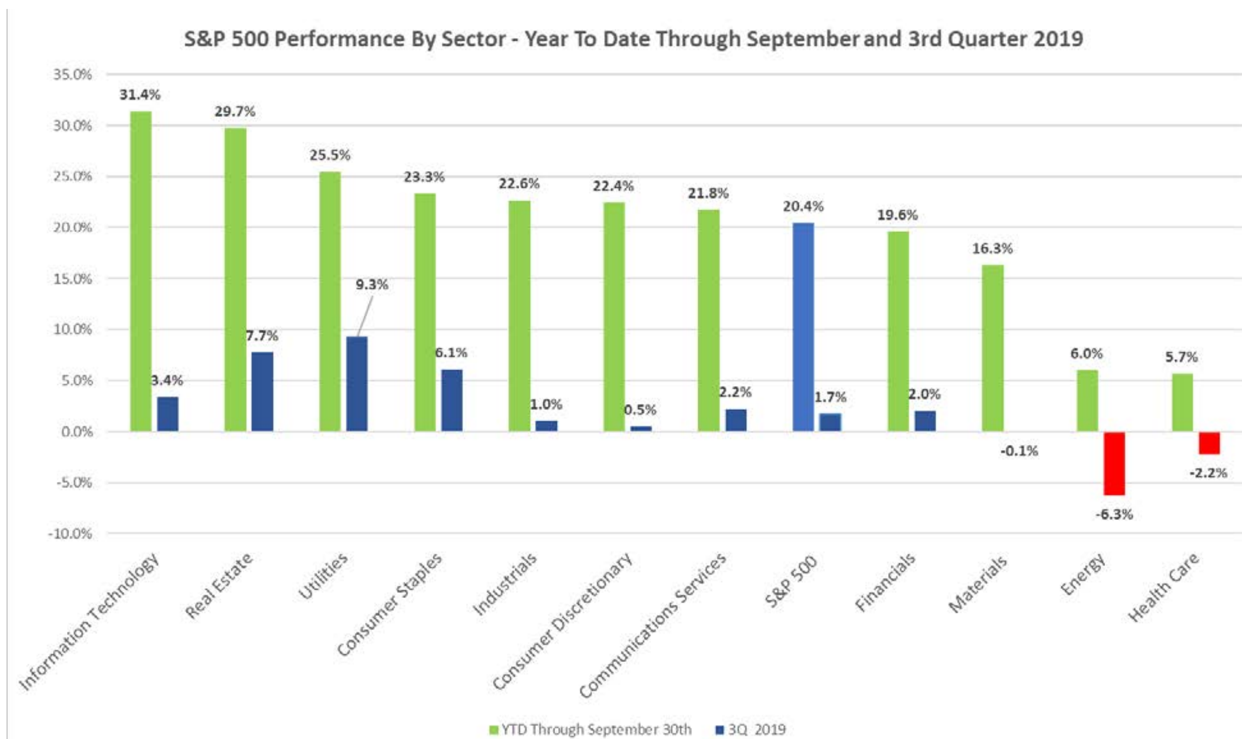


Source: Bloomberg

Stock Market Performance

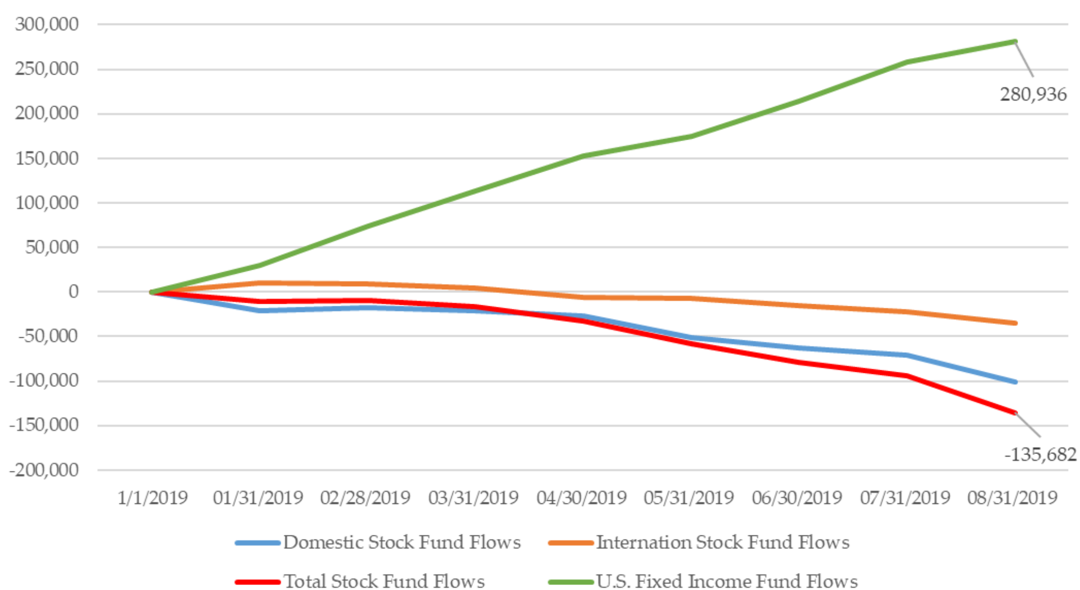
Stock performance through the third quarter reflects a clear defensive stance by investors. Recession resistant sectors such as Real Estate and Utilities lead the overall market by a large margin while economically sensitive groups like Basic Materials and Energy underperformed to a notable degree. The only exception to this trend was the traditionally defensive Health Care sector. The political tone in the run-up to the 2020 election has become more strident with discussions of Medicare-For-All displacing private health insurance, price-fixing for pharmaceutical companies, and heavier government oversight of hospitals and benefit managers. This profitable and growing group of companies has advanced only 5.7% this year, less than half the performance of the broader equity markets.

Turtle Creek Management, LLC | 3838 Oak Lawn Ave | Suite 1650 | Dallas, Texas 75204 | 214-468-0100 | 214-468-0106 fax |
turtlecreekdallas.com



Source: Bloomberg

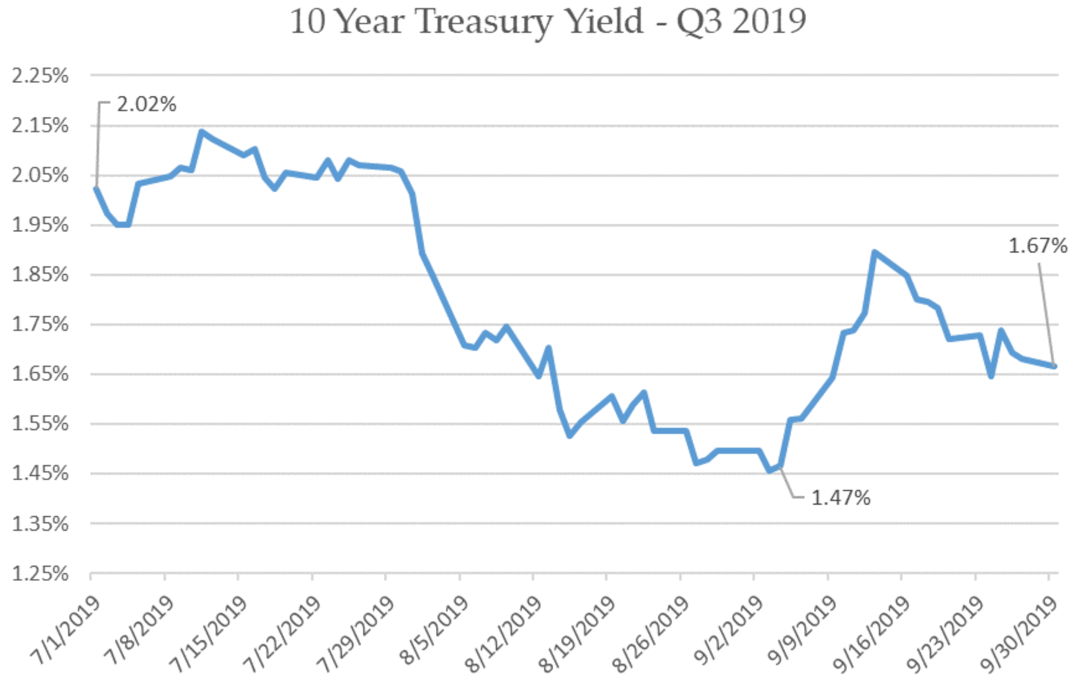
This investor flight to safety is further underscored by fund-flows, which measure investor additions or redemptions from various asset classes. Investors have steadily sold both domestic and international equity funds while plowing money into bond funds, a clear step away from risk and towards safe haven investments.



Source: Investment Company Institute

Fixed Income Markets

Heightened demand for fixed income further pressured bond yields during the quarter. The benchmark 10 Year Treasury Yield sagged a half percentage point through August as manufacturing indicators declined to near recessionary levels and the pace of job creation slowed. Macro-economic indicators improved throughout September, however, which triggered a rebound in rates.



Source: Bloomberg

Portfolio Strategy when Contemplating Recession

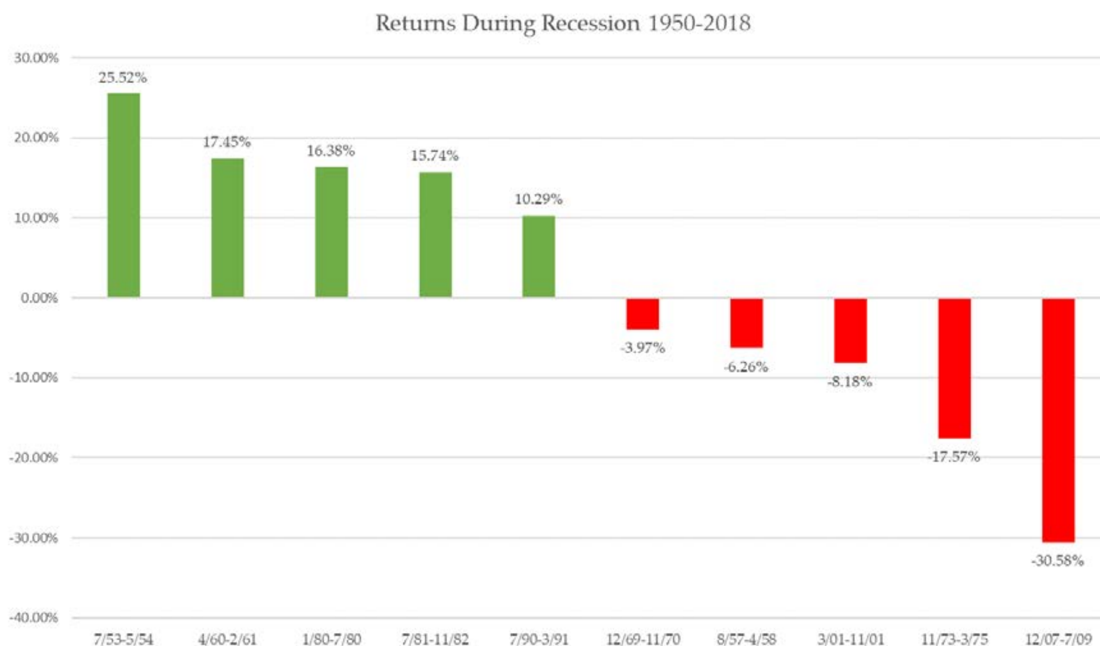
As the economy showed signs of slowing and trade war rhetoric between China and the United States climbed ever higher, investor's focus on a potential recession shifted into overdrive. Google Trends, which tracks the frequency of web searches for specific terms, notched a 15-fold increase during August in recession-related queries.

Investors almost always deal with recessionary uncertainty and potential for loss by contemplating market-timing or the selling of risky assets and sitting in cash or bonds until the smoke clears and (by their reckoning) improving portfolio returns in the process. The allure of this tactic rests on several assumptions including the ability for the investor to accurately anticipate recessions, a consistently negative relationship between risk-assets and the economy, and the ability for investors to time perfectly both their entry and exit points.

The ability of investors to accurately anticipate recession is historically suspect. While economists herald the predictive power of certain indicators like yield curve inversions, they often fail to mention historical false signals. 1998 featured a yield curve inversion that did not translate to a recession but instead preceded a 50% expansion in the stock market. As recently as 2011 and 2015, several leading economic indicators featured similar or greater swoons than we see today, only to see the economy chug along and markets deliver positive returns.

There is also a surprisingly large dispersion in historical stock market returns after the onset of recessionary indicators. While the most recent recession of 2007 produced a very painful market drawdown, other recessionary periods feature stock returns that were positive or delivered only small losses.

Nobel prize winning economist Eugene Fama recently tested this very concept. His research paper attempted to prove that switching from stocks to cash at the onset of a yield curve inversion would produce optimal investment outcomes. His conclusion was "We find no evidence that an inverted yield curve predicts stocks will underperform treasury bills for forecast periods of one, two, three, and five years."



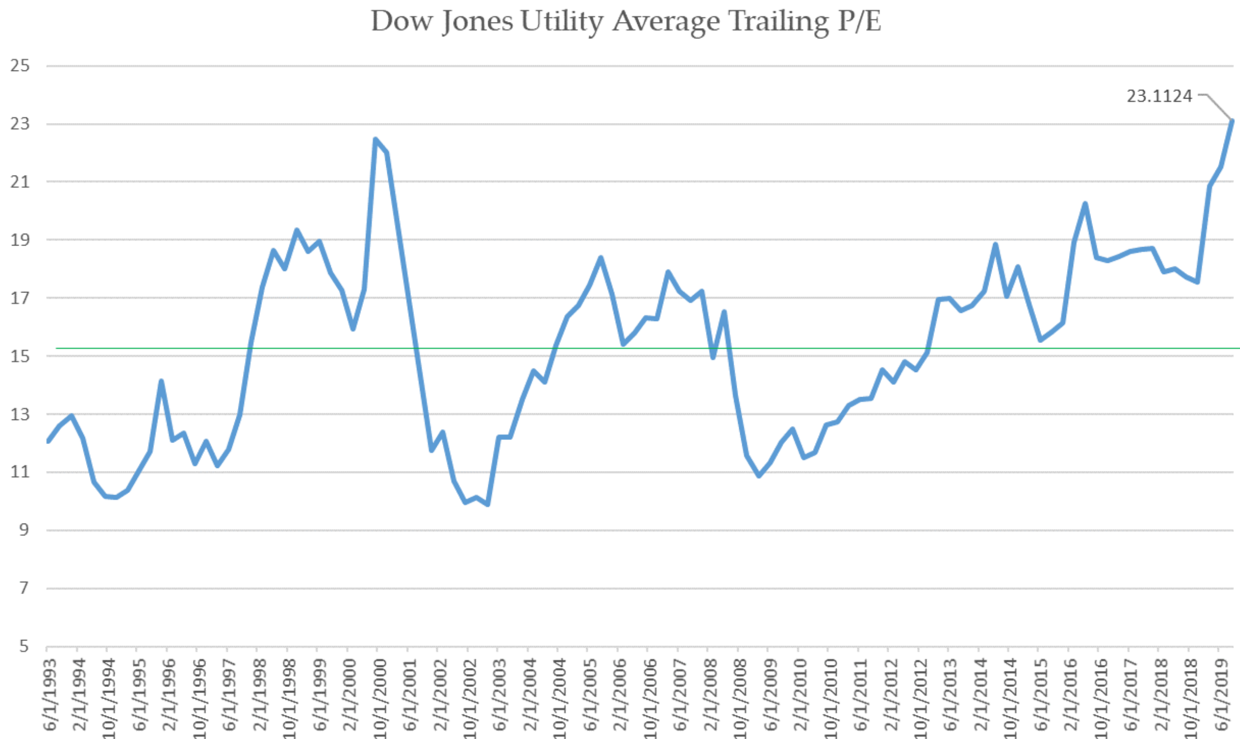
Finally, history shows that even if investors accurately predict market drawdowns, their portfolio timing usually eliminates potential benefit. Studies from a wide variety of research institutes ranging from DALBAR to Morningstar show that investors usually exit the market too early and re-invest well after market recoveries, impairing long-run returns in the process.

Heavyweight champ Mike Tyson once famously proclaimed that everyone has a plan until they are punched in the mouth. This wisdom is relevant to portfolio strategies that are developed on the basis of long-term returns rather than their potential behavior in the worst of market moments. If a portfolio currently underwrites your lifestyle or requires regular withdrawals, it is highly worthwhile to explore if cash and fixed income will serve as adequate stores of value during times of severe stock market stress. Rather than engage in historically futile attempts to game market returns, revisit your needs and goals.

The Safety Trade – Played out

Further complicating portfolio decisions are the currently un-appetizing valuations now on display in most safe haven sectors. The allure of low-volatility or defensive investments historically has been that they sit out stock market parties and therefore provided more stable returns through cycles. This time around, investors have bid up these sorts of investments to levels that make their future portfolio returns more questionable.

The Dow Jones Utility Average currently trades 23 times its aggregate trailing earnings compared to a historical average of approximately 15 times earnings. Similar trends are on display in other safe haven sectors. While these shares will likely hold their value in the event of a near term recession, over longer economic cycles reversion to the mean in valuation multiples will likely pressure performance.



<u>What this means for your assets</u>

In summary, don’t let recession fears turn you into your own worst enemy. While market downdrafts are emotionally challenging events, history shows that they do not represent a permanent impairment of a properly diversified portfolio of quality investments and frequently serve as speed bumps on the path to the longer-term growth of your assets. It is also worth noting that most traditional tactics used to position for market downdrafts have been pushed to their historic limits as evidenced by record valuations in defensive sectors and fixed income yields near multi-century lows. Fully embracing these strategies at this stage could result in missed opportunities over the medium and long-term.

A review and careful consideration of your longer-term strategic plan is prudent at this stage of the economic cycle and we stand ready to have that conversation. We believe that an adjustment to portfolio strategy, rather than market-timing, provides substantial risk reduction and less volatile future portfolio returns that may better suit your current needs.

As always, we appreciate the trust and faith you place in our firm. Please call or write with any questions.

TURTLE CREEK MANAGEMENT, LLC
TURTLE CREEK TRUST COMPANY, LTA

Turtle Creek Management, LLC | 3838 Oak Lawn Ave | Suite 1650 | Dallas, Texas 75204 | 214-468-0100 | 214-468-0106 fax |
turtlecreekdallas.com