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DIVIDEND STRATEGY

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Market Commentary

Ten Year Anniversary of Financial Crisis Series: Part 2 Managing Market Mayhem

Why Worry? Three Approaches for Managing through Market Mayhem

We are now ten years removed from the fall of 2008, when the financial crisis began in earnest. There is no shortage of articles reflecting on this anniversary; many, while interesting, are just summaries told with the gift of hindsight.

But what good is reading about history if you can't use some of its lessons today? With the market recently reaching unprecedented highs, we've been looking back on that tumultuous time to reconsider the context and share what we've learned about being better managers and better advisors.

> Our first article **"Seeds of Crisis"** http://www.berkmgt.com/wp-content/uploads/2018/09/Casual-Friday_-Financial-Crisis-Rewind%E2%80%A6Lessons-Learned_-Gain-an-Edge-Through-Continuing-Education.pdf gives our take on the origins of the crisis and how relying on past data and simple rules of thumb may have been behind system crash and bad results for clients.

Getting Through Mayhem

Lehman's bankruptcy in mid-September may have been the official start of the crisis, but the carnage really began in October. October brought us words like credit crunch and seizure. Investors feared that other money market funds (besides the Prime Reserve Fund which held Lehman bonds) would "break the buck." Bank values were cut in half.

Investors – even large, established institutional investors – aren't rational actors when mayhem starts, and the wisdom of the commons goes right out the window. We recall that the first time Congress tried and failed to pass the Troubled Asset Relief Program, equity markets plunged 7% the next trading day. "Because it didn't pass we are doomed!" the market seemed to be saying. But when the Senate finally did pass it, the Dow had one of its biggest single-day losses, falling 348 points. "*Because it passed* we are doomed. Capitalism as we know it is over!" was the market's response.

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Learning Our Lessons

The crisis certainly impacted the performance of our Core Equity Strategy. But more broadly, it was difficult watching many of the holdings we had such faith in decline in value and hurt client portfolios. Berkshire is truly an "equity shop" and our partners have great passion for stock picking. So it was very disheartening to watch the confidence and faith just drain out of the US financial system from October of 2008 to March of 2009 and beyond.

But Berkshire had a couple advantages. The first is we are focused on the long-term – we believed a good strategy could overcome short-term losses with long-term gains. The second is that we understand fundamental value and company quality. We knew that some companies would survive the mayhem, so we set up buying parameters and price targets on great U.S companies we felt were now on-sale – especially those with a dividend component we felt would grow.

Berkshire is a fee-based, SEC registered advisory firm serving the portfolio management needs of high net worth and institutional clients. Over the past 30 years, we have successfully implemented highly focused equity, fixed income and balanced portfolios. Our guiding principle is a belief that success is achieved by combining rigorous, well-crafted investment processes with an exceptional level of client service and attention to detail. Asset Management with a Difference... Diligence, Integrity, and Focus.

Dividend Highlights

- Dividend growth can often provide transparent insight into a company's fundamentals and vitality.
- Dividend growth can provide an attractive stream of increasing cash flow to satisfy many financial objectives.

And finally, we understand the value of communication. We did our best to explain what was happening. We listened to the fears of our clients. We gathered tangible evidence of why we felt that time presented, on balance, more opportunity than risk.

How Do *You* Help Clients Through Mayhem?

The advisors we've talked to who experienced the crisis have told us similar things about what helped them endure that stretch, and about how they helped guide clients to recover and prosper from the long bull market that has followed. Here are important takeaways for advisors today:

Talk tangibly about risk, and do it early. We believe the first part of a winning strategy is to continually remind clients to **expect** corrections, not try to side-step them. It's not news equity investing involves short-term risk, but particularly after a long bull run, the potential for losses starts to feel a little abstract. One way to focus your client's attention is to talk – now – about one-year scenarios using historical data. Demonstrate how equity heavy allocations performed in 2008, and ask if they could "stomach" that type of volatility. If not, their equity allocations are too high. Keep showing different blend equity portfolios with high quality bonds (which tend to hold their value when stocks are down) until you can get a workable, one-year worst case scenario the client can live with. Do this effectively today and watch how little your phone rings during the next correction.

Have a strategy going in. Get advance agreement with your client about potential market scenarios that might cause you to make changes to their investment plan – specifically, about curbing exposure to high-flying sectors, or taking advantage of new opportunities as prices decline. Example: "If stocks continue to decline by another 15% percent, let's agree to move 10% of your bond portfolio into high quality equities at depressed prices."

It's got to be done in advance because, if there is a decline, you probably won't want to do it! Everyone talks a good game about buying low, but low prices and good news rarely coincide. Proactive conversations about disciplined rebalancing are key to keeping clients on track.

Be realistic. Speak honestly with your client that you won't catch the bottom or the top of these large cycle changes. The Nasdaq looked expensive through the third quarter of 1999…then went up nearly 50% in the fourth before it began its famous crash. Those who rebalanced to value looked very silly as growth kept rising (similar to today?).

For those brave souls who allocated more money to equities in October or November of 2008 – and stuck with it! – They were rewarded handsomely over the years but first endured a gut wrenching drop. Buffett wrote his famous editorial "Buy American. I Am." *(https://www.nytimes.com/2008/10/17/opinion/17buffett.html)* Scale your positions so you can keep averaging down.

Keep 'em focused. It's natural for clients to read the bad news, see big declines in value, and get angry about the wrong things. "Diversification doesn't work!" "Sell my stocks!" "Fire that manager!"

But keep your focus on *why the overall plan* is still on track to meet long term goals. We believe investing for cash flow is a powerful technique during times of crisis. As long as you can demonstrate that dividends are flowing and covering a good part of annual cash needs, clients are more likely to stay on track and avoid knee jerk changes to the plan. In that sense, dividend investing may act as a client retention tool. - Investing for Cash Flow

And if they seem determined to sell, here is another great technique. Pull out their statement and say "Sure we can sell. Mr./Mrs. Client, look down this list of great American companies *you own* and tell me which one is down for good and we can sell those. Which one? Microsoft? Cisco? JP Morgan? Johnson and Johnson?" Whatever their feelings about the market, chances are they will realize that it would be unwise to sell the great individual businesses they own. ("Hat-tip" to an advisor friend in South Carolina for this one!)

Too often, client communication is built around what some benchmark is doing. But in reality, the only benchmark that matters is the rate of return that gets each client to their goal with the least amount of risk. Most everything else is chasing dots. Don't be afraid to keep reinforcing key messages. Stay true to your core principals despite changing winds. Knowing what works over the long term is the value you bring as an advisor.

Selling into a panic is rarely a good idea. A few smart (or maybe lucky souls) got out of the market in the middle of the crisis sparing a large draw down. But many of those failed to get reinvested and missed a record bull run. I recall one very well respected strategist who was spot on in calling for the crisis then predicted he would buy equities after a 70% drop. Many quarters after the market bottomed, he was still sticking with his call. There is a reason why the market timing "Hall of Fame" is an empty room. And let's not forget how the media is "incentivized to sensationalize." Boring doesn't sell. Each correction brings its unique set of concerns but walking clients through past corrections and recoveries can offer powerful, sensible perspectives. And remember: things are rarely as good or as bad as they might appear on the news.

Birth of a New Strategy

The crisis of 2008 came after a decade of underperformance for value stocks. As bad as the crisis was, we knew that values were very compelling. In some cases, we were early in that call.

But by sticking with our principals and leaning on our experience, in the heart of the crisis we were able to upgrade portfolio quality with names we had covered throughout our career. The stocks from this idea list eventually became the heart and soul of our Dividend Growth Strategy (first launched May 2009) – the portfolio we are so fortunate to manage for you today.

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