

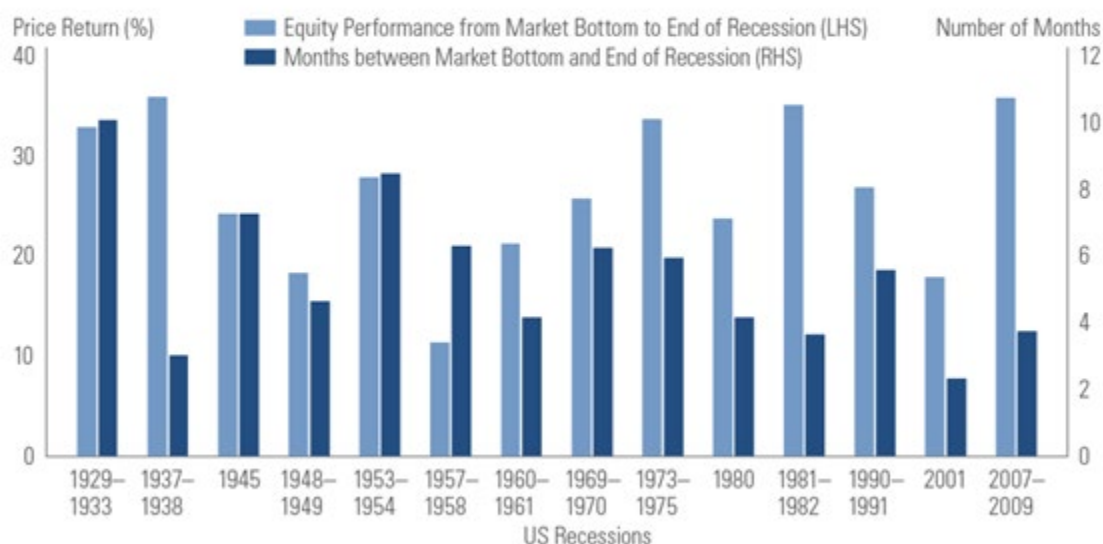


Given the events of the last six weeks, sitting down to a keyboard to tap out thoughts that might be considered illuminating seems daunting. This is especially true given a clientele-readership which has largely been forced to sequester themselves with the media for weeks on end rather than going about their usual daily business. Our efforts here will therefore not center on pulling out bits of data—as we usually do—which may foretell the economic, and by implication, the market’s path forward (PMI’s, yield curves, valuations, etc.). We cannot and will not ignore the *big* data, of course, but in the midst of March’s furious bear market, we feel that forward perspective is best related on a more theoretical and philosophical level, rather than a fundamental and statistical level (as both fundamentals and statistics are yet to be settled facts at this point—even for the first quarter). We beg you not to mistake our replacement of facts and figures with theory as lacking conviction. In the near term, we see circumspection in our comments as the only responsible communication, as the facts and figures will be dictated by the fate of a microbe.

CCR Wealth Management advisors have collectively navigated through nine market crashes. We normally write in the *majestic plural* (i.e. the “Royal We”), conveying the firm’s outlook and investment direction. Today we will occasionally slip into the first person to share specific experiences collected over the last three bear markets. But first, some definitions: **Bear Markets** occur when the major market indices decline 20% or more from their previous highs. The S&P 500, which fell roughly 34% from its February 19th high of 3386 to its recent low of 2237 on March 23, entered bear-market territory on March 11th. You may have heard (sequestered with the media, as you are), that this was the most rapid decline into bear-status that the US stock market has ever made. Since 1929, the average bear market has seen a decline of 39.50%. The most recent bear markets saw a decline of 49% (dot com bubble) and 57% (financial crisis). **Bull Markets**, in contrast, occur when stocks rise by 20% or more from the lows of the previous bear market. The S&P 500, standing at 2789 as we write on April 10th, is currently over 24% higher than the March 23rd lows—we are certainly in bull market territory at his time, by definition. This may have escaped you, of course, as it has most of the media.

April 10, 2020

Chart of the Week: S&P 500 Index Recovery in Recession



Source: Bloomberg and GSAM. As of April 10, 2020.

We are not calling the bottom! We are sticking to the facts. This bull may yet prove to be short-lived, and sometimes bottoms need to be “tested”. But like everyone else, including the television prognosticators, the newsletter writers, the “experts”—and of course your plumber, we will only know in hindsight whether the bull market began two weeks ago—or will begin two months from today. The larger point we are trying to convey, is we have been thinking about tomorrow (with the utmost conviction that it exists) since the arc of time will continue to require your financial management, be it to fund retirement, education, legacies, or other goals.

As fast and furious as the bear descended upon us last month, so was the government’s response. We think investors should take heart in this significant contrast with the last bear market! The Fed’s response to the financial crisis (2008-2009) as it unfolded began with tepid rate cuts in late 2007. In 2008, we entered the recession with the Fed Funds rate still over 4%. It took another *12 months* for the Fed to bring interest rates to 0% (December of 2008)—and another three months after that to bring about quantitative easing. In all, it took nearly 2 years to bring the full force of the Federal Reserve to confront the banking and liquidity crisis. Similarly, Congress dithered in the fall of ’08 with their debate of the TARP provision (Troubled Asset Relief Program) and other, less effective fiscal stimulus efforts after that (Cash for Clunkers). In contrast, the Fed brought rates to effectively 0% in two moves between March 3rd and March 15th. In three weeks

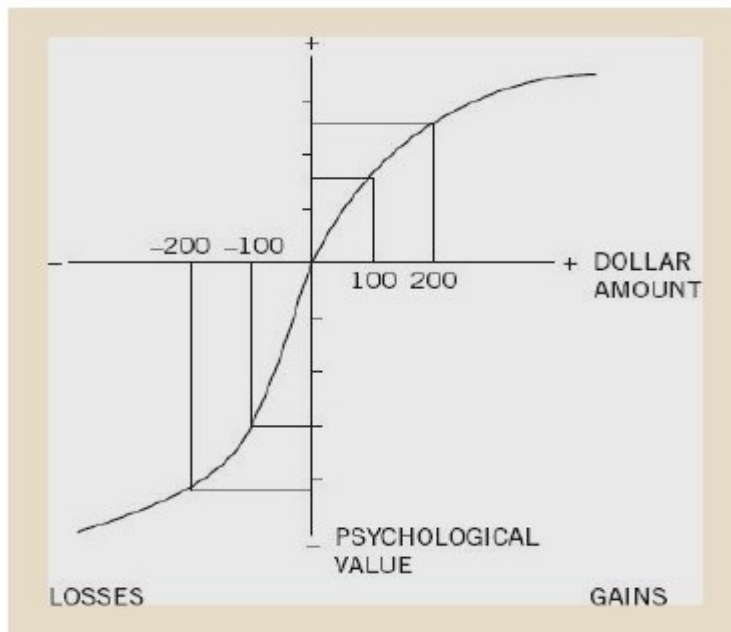
the Fed also restarted quantitative easing with an open-ended, unlimited asset purchasing program, reduced reserve requirements for banks, expanded asset purchases to include commercial mortgage backed securities (CMBS), restarted its Term Asset Backed Security Loan facility (TALF), and has allowed municipal bonds to be held as collateral in their Money Market Fund facility. All this is on top of a myriad alphabet-soup of credit and lending facilities both to banks and even directly to businesses (lending directly to businesses by the Fed is truly unprecedented, but this crisis has truly erased precedent). The Fed is now the lender of last resort, including to municipalities.

Congress and the White House have also responded quickly and appropriately (with further fiscal stimulus to come). The \$2.2 trillion CARES Act addresses direct payments to individuals, bolsters unemployment benefits, relaxes 401(k)/retirement rules, and supports payroll protection for workers displaced by Social Distancing—among other provisions. We know that many of our clients are already availing themselves of these programs.

Never has a government intentionally shut-down its economy, so it is no surprise these massive provisions (again, with more to come) have materialized so quickly. It is also true that much of this “playbook”—especially the monetary provisions—had already been written some 11 years ago, which aided the rapid implementation.

In “The Theory of Moral Sentiments” (1759), a precursor to later works such as the Wealth of Nations” (1776), Adam Smith explores human society as being modelled on not only judgement and reasoning, but on our innate sense of concern for not only ourselves, but our neighbors (we adopt this today to include our customers, our clients, and our patients). In it, Smith refers to the asymmetry between joy and sorrow. We are distressed more by setbacks in wealth, status, or professional achievement than we ever feel satisfaction at the advancement of any of these elements we seek to pursue in life. This sentiment is described by Smith as innate to human sociability—but it is also, perhaps, a precursor to **Loss Aversion** in Behavioral Finance studies.

Loss Aversion, first identified by Amos Tversky and Daniel Kahneman (read: Thinking Fast and Slow (2011), written by Nobel Prize winning economist Daniel Kahneman) describes in significant detail the tendency of people to feel distress at financial losses significantly more than they feel joy with financial gains of the same amount. “Entry points”, or cost basis, becomes the focal point for investors, and it requires short-term thinking to “keep score” relative to this reference point. This has certainly been evident in my conversations with clients over the previous three significant market events, this one being no exception. Loss Aversion is evident when clients insist on first knowing not what the recent events’ impact has been on their retirement goals, or how best to prepare for a future different than the one previously assumed, but what the current



“losses” are—in either dollar or percentage terms. In fact, in several recent conversations with multiple clients, there has been an insistence early on of knowing what the returns have been not over the course of the last year (despite a history of portfolio reviews that cover this period), but what the returns have been from the market’s high’s (Feb 19th). This time period, of course, is irrelevant to any of their portfolio’s funding goals. *Effective portfolio management is impossible if played as a game of Musical Chairs.*

The principal reason that Loss Aversion is so destructive a behavior is that it has a strong influence on choices investors make. Loss Aversion’s net effect almost always results in buying high and selling low (though not always in that order). **Investors are more likely to bail-out of asset allocations when returns are framed as losses, rather than setbacks on the journey.** To-date, many clients have 12 month returns in excess of the 2018 calendar year’s outcomes. While there is no way of knowing if this will remain true, holding portfolios through 2018 enabled the returns experienced in 2019.

Vernon Smith is a professor at Chapman University and the 2002 Nobel Laureate in Economics. In an April 5th column in the Wall Street Journal, Dr. Smith writes, “*As this crisis unfolds, don’t think of the decline in labor and product markets; rather think of the churn, growth and survival that is happening. We are neither a feeble society nor a feeble economy. If, beyond your*

neighbor, you have leftover compassion, think of those in North Korea and Venezuela. They don't need a pandemic to know what it's like to live with empty store shelves".

CCR Wealth Management's last market-brief outlined our own playbook during this crisis. Early on we ensured multiple months of liquidity for clients who receive regular distributions from their portfolios. We have aggressively farmed tax-losses using swaps in taxable accounts. We have also taken the opportunity presented by the sell-off to further tilt our portfolios into growth-markets. On this last note Mr. Chapman writes:

The hastened decline of old patterns of service will be more than matched by the growth of mail order, delivery, takeout and related services. Growth firms in these areas are already benefitting from transportation technologies with low transaction costs that match buyers to sellers in real time, place and circumstances. The businesses lost in quarantine will tend to be small and young, as will those that are gained. Today's larger firms were in many cases the small firms of the 1990s. They found ways to serve customers and escape bankruptcy after the dot-com bust. They matured.

To this we would add, if brick-and-mortar retail was on life-support before this crisis, a large bet on its return is likely a waste of resources. Look around today and notice where the commerce *is* happening. This, most likely, is the way forward.

Other steps CCR took in the final years of the last, extended bear market have prepared us well for this downturn, if not for an outright pandemic. The elimination of discrete high-yield funds and the significant reduction/elimination of non-US developed market equities (primarily European and Japanese) have served us well. These steps were made by looking ahead. Of course, no one has a crystal ball—but believing in the cyclicity of markets as we do, preparations when most agree the cycle is “long in the tooth” would naturally weed-out the most vulnerable investment classes. Then, as now, we continue to look ahead.

An irony in this current crisis is CCR's timing with our foray back into emerging markets in late January—specifically in China and the surrounding Asian markets. In January we outlined the thesis behind this allocation, a thesis which is replete with the characteristics of US businesses surviving (some even thriving) in today's environment. As we described it—our intention was not to buy into “national economies”, but rather to focus on the growth of economic sectors benefiting from today's, and likely to benefit from tomorrow's technologies. Ironic indeed that this investment, looked at on a year-to-date basis, significantly outperforms the S&P 500 and most other equity components of our otherwise US-centric model portfolios. While perhaps counterintuitive, we think this should help investors to focus on looking at the *Way Forward*

rather than the endless crisis coverage on television. We quote a weekly market update from Zacks Investment Management, published last week:

China's experience with COVID-19 will no doubt look starkly different than the West's experience. Because China was able to effectively lock down Wuhan and deploy tens of thousands of tests—while using surveillance technology and AI to track infections and movement—they were able to stifle the spread of the virus after three months. Today, gauges of China's manufacturing activity are showing strong rebounds, and official reports show that traffic in Beijing is close to being back to normal during the workweek (Wuhan's traffic is also increasing, but not as much). Additionally, some 98% of major industrial companies across China have resumed operations, and nearly 90% of people are back on the job. Shopping malls in Wuhan—the original epicenter of the crisis—also reopened this week. These are positive developments that show the virus can be constrained, but China is resuming production in a world that currently lacks demand.

No crystal ball—but our intuition holds that the CARES Act and the Federal Reserve maneuvers designed to “pause” our economy will ensure that pent-up demand will be preserved while the “curve is flattened”.

Of Media and Modelling

Taking an occasional dig at the media is a hallmark of CCR's Outlooks—so let's not let this opportunity go to waste. Unfortunately, our interpretation of the “news”, bombarded as we are every day, tends to fuel our behavioral biases when it comes to investing. The media is a tool, of course, which can help us to make informed decisions. The media may be your quarantine partner, but it is not necessarily your friend. I have preached for years that understanding the media's business model is crucial to effectively filtering the wheat from the chaff. Happily, as Americans, we do not need to tolerate “state-run” media. Privately owned news outlets, however, require revenue. Delivering the “news” is a cost. Like the inventory on a balance sheet, this cost must be offset by revenue, which hopefully exceeds the liability. My standard refrain has been that Media channels are in the business of selling Viking Cruises, Chevy Trucks and E-Trade accounts...they are *not* in the business of providing the public with the best, most accurate, and least-varnished information they can. If you operate a 24-hour (or even 12-hour) “news” broadcast, you need eyeballs on your advertisers! And as we know, there is plenty of competition for these eyeballs.

A recent headline on a popular News outlet we check into read: **“Grim Milestone: US Deaths from Coronavirus Exceed Italy's”**. The US death-count attributed to COVID-19 reached 20,506

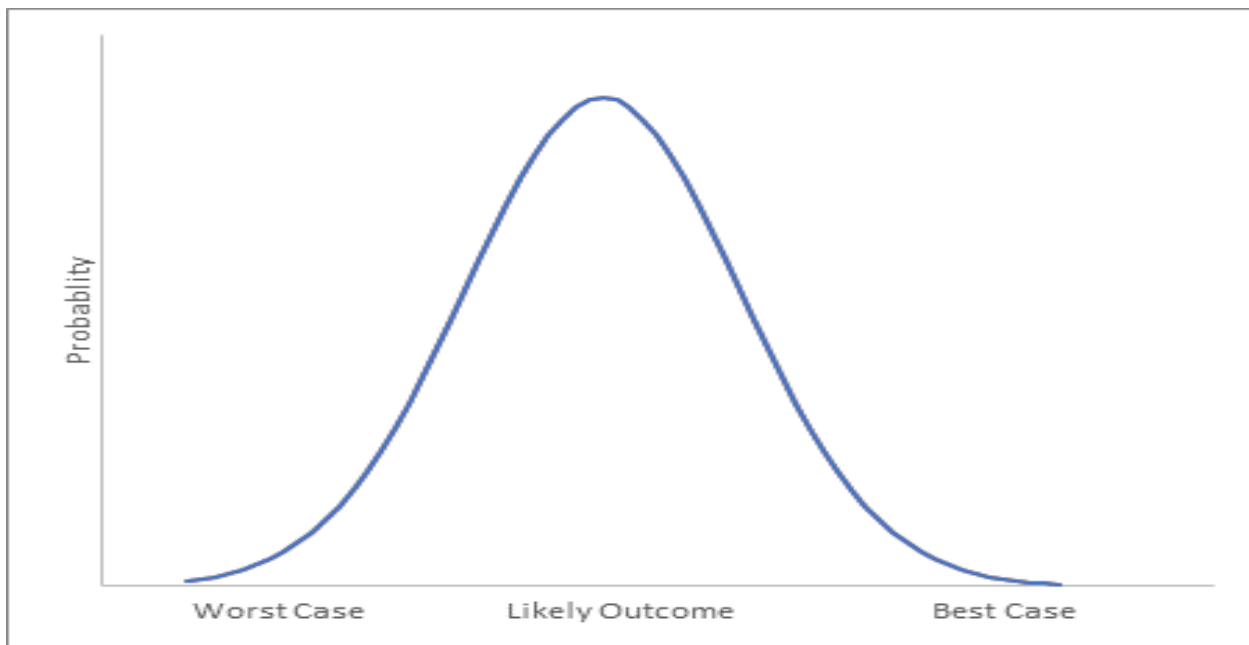
according to Johns Hopkins University, surpassing Italy's 19,468 deaths. The Italian population is roughly 60.4 million, while the US is over 327 million. **Framing Bias** is another Behavioral Finance term which describes how investors tend to make (sub-optimal) decisions based on *how* information is presented, rather than on the facts themselves. All media now seem to have an hourly "body-count" to deliver—often through "push notifications" on your phone. Buried in the story (if people even bother to get past the headlines) is the fact that the US death rate from the virus remains a small fraction of Italy's experience. The "Grim Milestone" is, in fact, a milestone of the media's own making. But the constant bombardment of this kind of "news" takes its toll on investors' collective fortitudes.

"You don't understand..."—they explain. This has been a common retort during recent conversations, and has been followed with *"we're going into a depression"*, or *"the supply chains have been broken"*, or *"this isn't just a demand problem, it's a supply problem as well"*. We know these calls are often motivated by recent media interviews or articles—we ourselves monitor multiple sources daily as part of our profession. *"If it bleeds it leads"* is today's media mantra. CCR implores you not to let the last broadcast be the one to separate you from your financial plan. We reiterate our advice of a month ago—trust your allocation. Avoid Framing Bias by multi-sourcing your media intake—and force yourself to seek out the positive stories out there which abound, though they tend not to pay the bills for the "news" outlets.

Prepare yourselves in the coming quarter against media devices specifically designed to pique your emotions and hijack your frame of reference. Earnings season is upon us. Economic data (unemployment, productivity, survey data) we know will be bad. Very bad. "Breaking News" most often isn't. "Historic", "Unprecedented", and other adjectives are used every day—even prior to the current crisis—to describe events which otherwise have no meaningful impact on your portfolio's long-term funding goals. In fact, we will go so far as to say the coming earnings reports are irrelevant. A constant diet of this type of coverage can lead to two other behavioral biases, which many financial professionals themselves need to guard against: **Illusion of Knowledge**, and **Illusion of Control**. A stock analyst who collects more data than their peers may easily fall into the trap of believing they know more. But much of what they may know is irrelevant. Confidence intervals become too large, and overconfidence seeps into the process, usually leading to negative outcomes. Similarly, as we shelter in place, a constant barrage of headlines, interviews and crisis coverage (curated by producers incentivized by ad sales) can give us the illusion that we are well informed—that we are more certain about what the future brings than we truly can or should be. Illusion of Knowledge often gives rise to the Illusion of Control. Again—the only control we have in the short term is whether to scrap our long-term financial plan.

On February 25th we sent out an e-mail as the market was just beginning its decent into bear status. In it, we said “CCR remains vigilante and respectful of what we do not know about the COVID-19 outbreak”. While more is known today—even more questions seek answers today (we were not self-quarantining in February). We sense an increasing tension between “Flattening the Curve” and restarting the economy.

Rightfully, we have given a major platform to our scientific experts to influence policy on both a national and State level. Avoiding hospital and emergency-room overload has been the primary goal of our collective sacrifice. But we must also understand that there is likely a cost/benefit limit to our voluntary self-quarantine. Like economists, analysts, and statisticians, scientist use models to organize data in order to begin to understand the phenomenon of a pandemic. Over time, as knowledge is gained, models are adjusted to fit the new data. While we may be closer to “flattening the curve” of this virus’ spread, we are likely a long way from a vaccine—if one can



be developed. Models map probabilities. Models, *over time*, hone most likely outcomes. But models also map out least-likely extreme outcomes—both best-case and worse-case scenarios.

Today’s models of COVID-19’s path can be assumed superior to those of a month ago. But these models, including their earlier versions, are largely responsible for forming policy. We hope policy evolves with the models. Leave it to the press, however, to sensationalize “left-tail”, worse-case scenarios. Two weeks ago, on “CBS This Morning” as the WSJ points out, “U.S. Surgeon-General Jerome Adams complained about a press that runs with projections ‘based on

worse-case scenarios'. He was talking about ventilators, but his point applies across the board. Deborah Birx, coordinator for the White-House coronavirus task force, said the same regarding apocalyptic forecasts not backed by data about hospitals having to issue Do Not Resuscitate orders."

CCR Wealth Management recognizes that this is ultimately a health crisis, not a financial crisis. We have confidence, based on actions already taken, US leadership from the Federal Reserve to Congress will continue to take the necessary steps to ensure it doesn't become a financial crisis. While we will continue to look forward, it is likely some of us, our friends, neighbors or family may be directly affected by this virus. Our thoughts are with our own colleague, Kevin, as his father was recently diagnosed and has been in an ICU. We will close with the closing of a recent GMO whitepaper written by James Montier:

I leave you with a story relayed by Abraham Lincoln:

It is said an Eastern monarch once charged his wise men to invent him a sentence, to be ever in view, which should be true and appropriate in all times and situations. They presented him with the words "And this, too, shall pass away." How much it expresses! How chastening in the hour of pride! How consoling in the depth of affliction!

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