SUREVEST

Spring 2020

Quarterly Commentary

Surevest Wealth Management | 2425 E. Camelback Road, Phoenix, AZ 85016 | T 480.272.7116 | F 480.272.7118 | info@svwealth.com

Q1 2020

By now it is well telegraphed that COVID-19, a true black swan event, resulted in the fastest 30% sell-off ever, even exceeding the declines experienced during the Great Depression[i].

Rather than just recap the quarter, we wanted to take this opportunity to update our clients on what our investment committee has been working on to address this decline by making sure our clients are well prepared for the inevitable recovery. We will share how the three lessons learned from this latest event, coupled with 20 years' worth of data, will influence asset management going forward. We will also discuss why today's market dynamics prove that investors must shift further away from the old buy and hold strategy, to a more modernized approach to asset management. Finally, we will review our framework for making investment decisions and how we believe it is more relevant today than ever.

What we will not address in this commentary are any technical issues relating to the virus itself. Let me be clear, one life lost to any preventable disease is far too many, and while we are not insensitive to the human side of this virus, we are simply not qualified to speak on that matter. Therefore, we will refrain from discussing the health implications of the disease in this or any further communications.

That being said, what we are qualified to comment on is the economic impact we will face; strategic shifts companies must make to thrive, and the changing market dynamics that investors will need to adjust to in order to achieve acceptable investment returns in the future.

It is important to note that our view regarding asset management is not necessarily the consensus in the industry. At most wealth management firms, investors will continue to hear the same story; stay the course, invest in the index, and don't worry. However, the past 20 years' worth of data proves that logic is flawed. Those who continue to stick to an outdated, passive strategy will be sorely disappointed over the next decade. I believe the stock market is still one of the greatest places to grow and preserve wealth. With that said, the strategy needed to succeed has evolved.

Indexing has not been the Golden Ticket Everyone has Touted

You probably have heard "don't waste your time on investing in individual companies, just buy and hold the index and you will do great." The problem is, while that is the easiest story for financial advisors to sell to their clients, that advice has failed for both growth and income investors. Times like these are a great inflection point to prepare your recovery strategy. We suggest that coming out of this decline, there should be some changes investors make to expedite that path forward and avoid the pitfalls of the past two decades.

The Results of the Past Two Decades

Example 1: Growth Investor

If you invested in the S&P 500 20 years ago, reinvested every dollar of dividends, never took a dime out, and stayed the course, you would have had a whopping 4.78% annualized return as of March 31, 2020 (white line on the chart below). If you didn't reinvest the dividends, that return dropped down to 2.76% over 20 years! To put this into perspective, a portfolio of investment grade bonds, without much risk, would have returned 5.08% (green line). Diversifying through small and mid-companies as well as internationally, didn't fare much better. The ACWI Total Return Index, which includes different company sizes and regions, did even worse, with the return dropping to 3.22% over that same period (pink line).

Example 2: Income Investor

For people at or near retirement, who were looking to pair the traditional 60.40 stock bond portfolio with a 5% annual withdrawal, a portfolio approach touted by the industry, were devastated. We tested the conventional 60.40 framework (Scenario One) against a more thoughtful portfolio that is developed with securities that are more supportive of income distributions (Scenario Two). The difference is very telling; an investor in Scenario One would have a current portfolio value of $480,305, while an investor in Scenario Two would have a current portfolio value of $2,158,367.

SCENARIO ONE			
DATE	START VALUE	END VALUE	DISTRIBUTION
3/31/00	$ 1,000,000.00	$ 920,063.03	$ 50,000.00
3/30/01	$ 870,063.03	$ 889,928.03	$ 51,125.00
3/28/02	$ 838,803.03	$ 753,395.70	$ 52,275.31
3/31/03	$ 701,120.39	$ 864,012.32	$ 53,451.51
3/31/04	$ 810,560.81	$ 846,837.65	$ 54,654.17
3/31/05	$ 792,183.48	$ 855,072.49	$ 55,883.88
3/31/06	$ 799,188.61	$ 876,986.48	$ 57,141.27
3/30/07	$ 819,845.21	$ 820,015.54	$ 58,426.95
3/31/08	$ 761,588.59	$ 597,066.94	$ 59,741.56
3/31/09	$ 537,325.38	$ 714,311.45	$ 61,085.74
3/31/10	$ 653,225.71	$ 727,918.22	$ 62,460.17
3/31/11	$ 665,458.05	$ 720,083.17	$ 63,865.53
3/30/12	$ 656,217.65	$ 721,099.09	$ 65,302.50
3/28/13	$ 655,796.59	$ 741,548.46	$ 66,771.81
3/31/14	$ 674,776.66	$ 741,760.55	$ 68,274.17
3/31/15	$ 673,486.38	$ 685,971.41	$ 69,810.34
3/31/16	$ 616,161.07	$ 680,732.15	$ 71,381.07
3/31/17	$ 609,351.07	$ 663,439.01	$ 72,987.15
3/29/18	$ 590,451.86	$ 634,677.36	$ 74,629.36
3/29/19	$ 560,048.01	$ 556,613.70	$ 76,308.52
3/31/20	$ 480,305.18		

SCENARIO TWO			
DATE	START VALUE	END VALUE	DISTRIBUTION
3/31/00	$ 1,000,000.00	$ 1,139,792.44	$ 50,000.00
3/30/01	$ 1,089,792.44	$ 1,252,493.77	$ 51,125.00
3/28/02	$ 1,201,368.77	$ 1,112,323.74	$ 52,275.31
3/31/03	$ 1,060,048.42	$ 1,317,847.27	$ 53,451.51
3/31/04	$ 1,264,395.76	$ 1,356,001.32	$ 54,654.17
3/31/05	$ 1,301,347.15	$ 1,384,040.62	$ 55,883.88
3/31/06	$ 1,328,156.73	$ 1,470,457.13	$ 57,141.27
3/30/07	$ 1,413,315.86	$ 1,389,362.12	$ 58,426.95
3/31/08	$ 1,330,935.17	$ 1,119,125.65	$ 59,741.56
3/31/09	$ 1,059,384.10	$ 1,445,759.43	$ 61,085.74
3/31/10	$ 1,384,673.69	$ 1,544,794.88	$ 62,460.17
3/31/11	$ 1,482,334.71	$ 1,640,977.35	$ 63,865.53
3/30/12	$ 1,577,111.83	$ 1,805,552.53	$ 65,302.50
3/28/13	$ 1,740,250.03	$ 1,935,130.23	$ 66,771.81
3/31/14	$ 1,868,358.42	$ 2,084,150.13	$ 68,274.17
3/31/15	$ 2,015,875.96	$ 2,115,664.53	$ 69,810.34
3/31/16	$ 2,045,854.19	$ 2,173,029.22	$ 71,381.07
3/31/17	$ 2,101,648.15	$ 2,279,434.79	$ 72,987.15
3/29/18	$ 2,206,447.65	$ 2,403,867.77	$ 74,629.36
3/29/19	$ 2,329,238.41	$ 2,234,675.93	$ 76,308.52
3/31/20	$ 2,158,367.41		

Data Source: Bloomberg. Scenario One and Two assume first Year Distribution is 5% of the starting portfolio value ($1,000,000) and taken at the end of the year. Subsequent distributions are adjusted for inflation at 2.25% and taken at the end of each year. Figures are not calendar annual returns, rather annualized as of the end of March for each year. This was done to provide the most current data available. This tables illustrates how a 60/40 portfolio would have performed over the last 20 years. Scenario One assumes 60% S&P 500 TR and 40% US AGG Index TR. Scenario Two assumes 60% S&P 500 Dividend Aristocrats TR and 40% US AGG Index TR. Past performance is no guarantee of future results.

What We Learned from the Past 20 Years

Observation One

We realized that money needed over a 3- 5 year period should be isolated away from the stock market and placed in more suitable areas, such as government or muni bonds, money markets and CD's. These types of securities have lower returns than stocks, but they also come with significantly lower volatility, which makes them an ideal investment when withdrawals are needed from the portfolio. An investor never wants to be forced to sell their equities because they will inevitably be pressed to part ways with stocks at the worst time to raise cash. We call this a bad sequence of return risk. To illustrate, we came up with two hypothetical portfolios that both averaged 7% over 30 years; however, one portfolio had bad sequence of returns (left table), while the other experienced good sequence of returns (right table). If you look closely, both portfolios had the same returns, but in reverse sequence. Yet the portfolio with the bad sequence of return ran out of money in Year 27, while the portfolio with good sequence of returns ended up with $2million after 30 years. This outcome shows why money needed over 3-5 years should never be invested in the stock market.

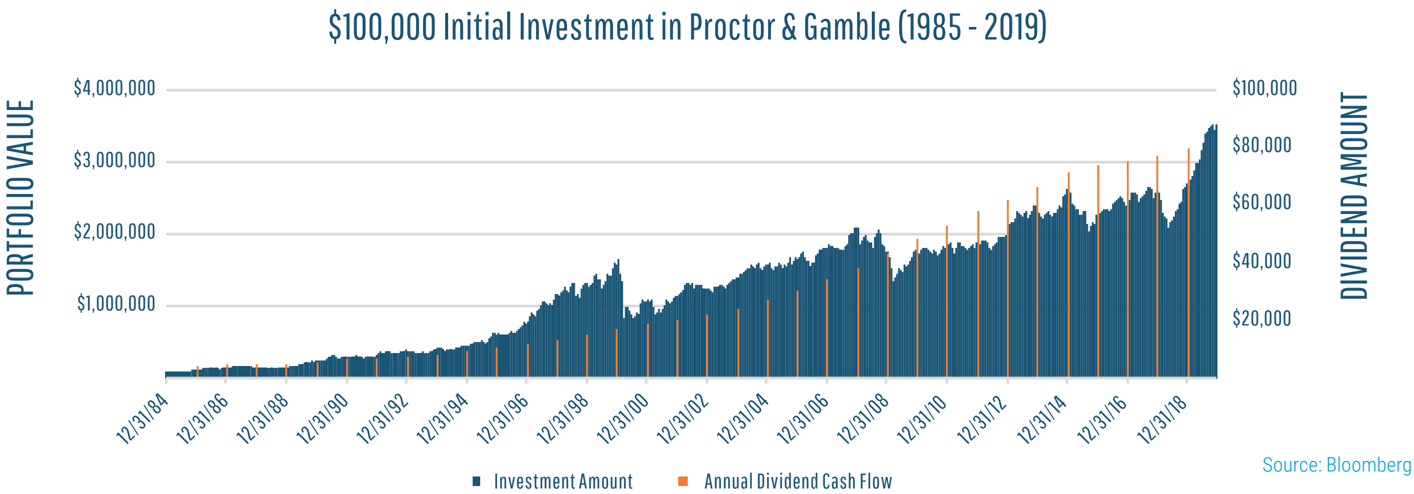
BAD SEQUENCE OF RETURNS				
YEAR	START VALUE	RETURN	END VALUE	DISTRIBUTION
1	$ 1,000,000.00	-10%	$ 900,000.00	$ 50,000.00
2	$ 850,000.00	-8%	$ 782,000.00	$ 51,125.00
3	$ 730,875.00	-5%	$ 694,331.25	$ 52,275.31
4	$ 642,055.94	11%	$ 713,224.80	$ 53,451.51
5	$ 659,773.29	15%	$ 758,739.29	$ 54,654.17
6	$ 704,085.12	8%	$ 760,411.93	$ 55,883.88
7	$ 704,528.05	3%	$ 728,735.43	$ 57,141.27
8	$ 671,594.16	13%	$ 759,962.02	$ 58,426.95
9	$ 701,535.07	3%	$ 722,581.12	$ 59,741.56
10	$ 662,839.56	15%	$ 762,265.50	$ 61,085.74
11	$ 701,179.75	4%	$ 729,226.94	$ 62,460.17
12	$ 666,766.77	2%	$ 680,102.11	$ 63,865.53
13	$ 616,236.58	16%	$ 714,834.44	$ 65,302.50
14	$ 649,531.94	2%	$ 664,799.12	$ 66,771.81
15	$ 598,027.31	17%	$ 702,612.95	$ 68,274.17
16	$ 634,338.78	3%	$ 653,368.94	$ 69,810.34
17	$ 583,558.60	8%	$ 630,243.29	$ 71,381.07
18	$ 558,862.22	7%	$ 597,982.58	$ 72,987.15
19	$ 524,995.43	6%	$ 556,495.15	$ 74,629.36
20	$ 481,865.80	7%	$ 517,836.91	$ 76,308.52
21	$ 441,528.39	7%	$ 473,881.97	$ 78,025.46
22	$ 395,856.51	13%	$ 447,317.85	$ 79,781.03
23	$ 367,536.82	-6%	$ 347,112.97	$ 81,576.11
24	$ 265,536.87	-6%	$ 249,604.66	$ 83,411.57
25	$ 166,193.09	13%	$ 187,110.09	$ 85,288.33
26	$ 101,821.76	18%	$ 120,149.68	$ 87,207.32
27	$ 32,942.37	-8%	$ 30,313.71	$ 89,169.48
28	$ (58,855.78)	12%	$ (65,893.54)	$ 91,175.79
29	$ (157,069.33)	18%	$ (185,341.81)	$ 93,227.25
30	$ (278,569.06)	20%	$ (334,282.87)	$ 95,324.86
	AVERAGE	7%		

GOOD SEQUENCE OF RETURNS				
YEAR	START VALUE	RETURN	END VALUE	DISTRIBUTION
1	$ 1,000,000.00	20%	$ 1,200,000.00	$ 50,000.00
2	$ 1,150,000.00	18%	$ 1,357,000.00	$ 51,125.00
3	$ 1,305,875.00	12%	$ 1,462,026.86	$ 52,275.31
4	$ 1,409,751.54	-8%	$ 1,297,259.38	$ 53,451.51
5	$ 1,243,807.88	18%	$ 1,467,693.30	$ 54,654.17
6	$ 1,413,039.13	13%	$ 1,590,883.76	$ 55,883.88
7	$ 1,534,999.87	-6%	$ 1,442,899.88	$ 57,141.27
8	$ 1,385,758.61	-6%	$ 1,308,752.66	$ 58,426.95
9	$ 1,250,325.71	13%	$ 1,412,868.05	$ 59,741.56
10	$ 1,353,126.50	7%	$ 1,452,278.62	$ 61,085.74
11	$ 1,391,192.88	7%	$ 1,495,044.95	$ 62,460.17
12	$ 1,432,584.78	6%	$ 1,518,539.87	$ 63,865.53
13	$ 1,454,674.34	7%	$ 1,556,501.54	$ 65,302.50
14	$ 1,491,199.04	8%	$ 1,610,494.97	$ 66,771.81
15	$ 1,543,723.16	3%	$ 1,590,034.86	$ 68,274.17
16	$ 1,521,760.69	17%	$ 1,787,892.86	$ 69,810.34
17	$ 1,718,082.52	2%	$ 1,758,465.88	$ 71,381.07
18	$ 1,687,084.81	16%	$ 1,957,018.38	$ 72,987.15
19	$ 1,884,031.23	2%	$ 1,921,711.86	$ 74,629.36
20	$ 1,847,082.50	4%	$ 1,920,965.80	$ 76,308.52
21	$ 1,844,657.28	15%	$ 2,121,355.88	$ 78,025.46
22	$ 2,043,330.42	3%	$ 2,104,630.33	$ 79,781.03
23	$ 2,024,849.30	13%	$ 2,291,277.44	$ 81,576.11
24	$ 2,209,701.34	3%	$ 2,285,626.06	$ 83,411.57
25	$ 2,202,214.49	8%	$ 2,378,391.65	$ 85,288.33
26	$ 2,293,103.32	15%	$ 2,637,068.82	$ 87,207.32
27	$ 2,549,861.50	11%	$ 2,832,501.59	$ 89,169.48
28	$ 2,743,332.11	-5%	$ 2,606,165.50	$ 91,175.79
29	$ 2,514,989.71	-8%	$ 2,313,790.53	$ 93,227.25
30	$ 2,220,563.28	-10%	$ 1,998,506.95	$ 95,324.86
	AVERAGE	7%		

The data illustrated is hypothetical and not actual results. Both scenarios assume a starting value of $1,000,000 and a 5% initial distribution at the end of each year that is adjusted for inflation at 2.25%. The returns for the Bad Sequence of Returns were randomly selected using the Microsoft Excel random function that assumed a normal distribution with a mean of 10% and standard deviation of 20%. The returns for Good Sequence of Returns are the same as the Bad Sequence of Returns, but in reverse order. Past performance is no guarantee of future results.

Observation Two

While the direction of stock prices is impossible to predict in the short run, dividends provided by companies are much more predictable. We observed that companies with generous and committed dividend policies have outperformed their counterparts significantly. An example is Proctor & Gamble who has paid a consecutive dividend over the last 129 years and has increased its dividend for 63 consecutive years.[ii] The chart below displays how volatile the stock has been over the last 35 years (blue), but their dividend has consistently increased (orange bar) throughout all the up and downs of the stock.

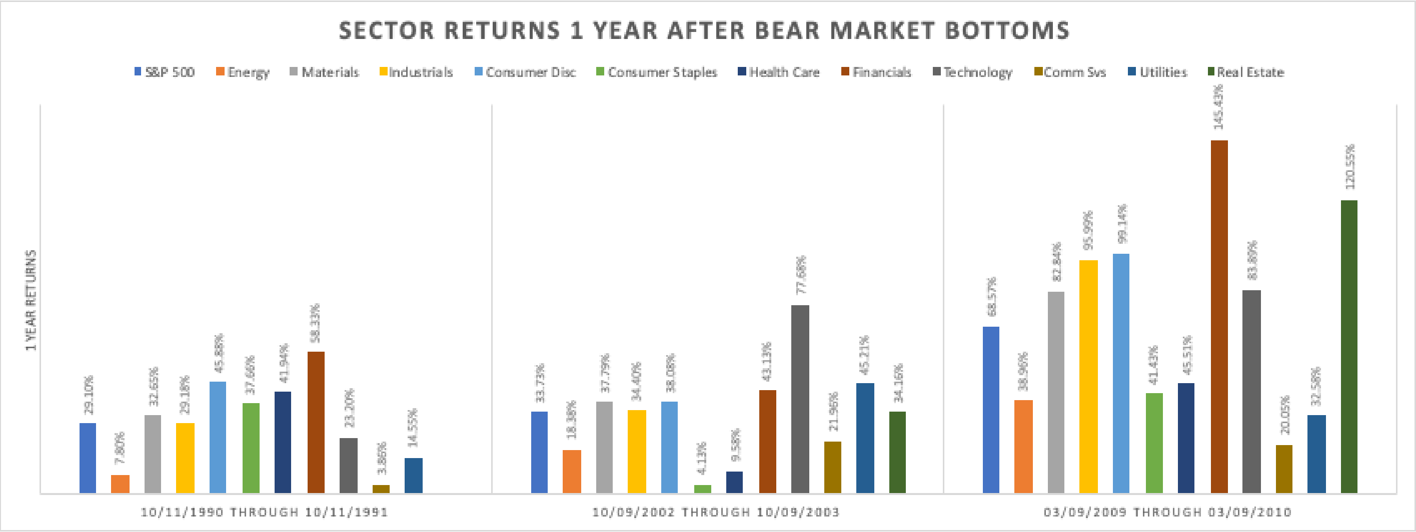


Source: Bloomberg

To illustrate the outperformance over the last 20 years, we compared a portfolio of companies that have consistently paid and increased their dividend to the S&P 500. The difference is astonishing, the portfolio of dividend paying companies (pink line) beat the S&P 500 (green line) by almost 100%.

Observation Three

While the total returns over the past 20 years were meek, rallies were powerful! By being tactical, an investor had the potential to outperform the index. This requires a buy discipline, and more importantly, a strategy to systematically take profits and position in the portfolio to take advantage of the expected market environment. Looking at the last three Bear Markets, the S&P 500 returned on average 43.8% one year after the bottom. Financials and Technology averaged 82.3% and 61.59%, respectively. While Consumer Staples and Utilities returned an average of 27.74% and 30.78%. To put this simply, staying the course produced subpar results.



Observation Four

Private Markets have grown tremendously. For long-term growth strategies, investors should consider private markets for the potential to generate returns greater than what public markets have provided. As of the end of the third quarter 2019, the most recent data available, the US Private Equity Index outperformed the S&P 500 by an annual rate of 5.38% over the last 20 years.[iii]

These four lessons set the stage for what we believe should be four fundamental pillars of modern asset management.

4 Pillars for Modern Asset Management

1 Planning

Financial planning that emphasizes personal cash flow and balance sheet is essential today. An investor must have a detailed financial plan which includes a complete personal balance sheet and cash flow analysis to understand how their portfolio should be constructed and managed. This is not referring to an online calculator, but rather a detailed personal analysis performed by a CERTIFIED FINANCIAL PLANNER™. This type of customization is a key element that has allowed our clients to stay the course in this downturn, and in most cases, become opportunistic while others panic.

2 Dividends & balance sheets matter

In particular, it is important to invest directly in companies with strong balance sheets that support the ability to maintain and even grow their dividend, even during bad economic periods like the one we are experiencing now. Investors must have transparency in what they own and the ability to analyze each individual company in real-time. The profiles of these companies have generated returns far superior to the S&P 500 index and we believe that will continue.

3 Active management is becoming a necessity

Stock gains come and go. A 30% gain today can be a 20% loss tomorrow. Remember, stocks like Amazon, Google, and Facebook are growth companies and do not pay dividends. The only way to make money is to buy low and sell high. Algorithmic trading has caused markets to move at lightning speed. This means investors need to be more tactical with their growth stocks by taking profits through a systematic and disciplined approach.

4 Private markets are the new IPO

Private markets have become a huge landing pad for institutional assets. While private markets have grown, US markets have shrunk from 8000 in 1998 to about 3600 today.[iv] For alpha generating investments, it is becoming increasingly necessary for investors to consider the private markets for a portion of their portfolio.

Navigating the 4 Pillars with Surevest's Personalized Asset Segmentation Strategy (PASS)

At Surevest, we developed a proprietary framework by making customized investment decisions called Personalized Asset Segmentation Strategy (PASS). PASS was originally designed for the firm's Ultra High Net Worth clients who are taking portfolio withdrawals to support their lifestyle during retirement. Over the past couple of years, we have discovered that it creates a more appropriate framework in which to manage all investment objectives in today's market environment. This is also a much more intuitive structure for investors to understand and plan around. PASS is rooted in what is called a Liability Driven Investment approach or LDI; utilized primarily by large pension funds and endowments. PASS has 4 tiers of assets with unique mandates, which are managed separately from each other, but work together to achieve our client's long-term growth, cash flow, and liquidity needs. Depending on each client's objectives, the allocation among the tiers will vary.

TIER 1

Addresses our client's liquidity and income needs which are typically isolated for a period of 4+ years away from the market. This amount is determined by analyzing the cash flow needs in their financial plan. We use safe assets such as bonds, CD's, and money market accounts that are liquid and able to be distributed to meet cash flow needs. This Tier is essential at times like this; affording our clients the peace of mind in knowing that several years' worth of income is shielded from short-term market swings such as in today's climate. Our clients are never forced to sell into a panic. During this crisis our Tier One assets held up remarkably well. Our largest allocation was in U.S. Treasuries, so in most cases, PASS investors saw their Tier One investment prices increase.

TIER 2

This tier is comprised of only income paying assets which can be used to make additional purchase into growth assets for growth investors or help supplement distributions for income investors. A large portion of Tier Two is invested in companies with a strong track record of paying and increasing their dividend during challenging times. While over the long run, the stock price will likely increase, the volatility surrounding the actual price is very unpredictable. On the other hand, the cash flow needs of investors must be very predictable; therefore, this tier is managed for income over price appreciation. During this crisis, we replaced one of our dividend companies that we identified as having a weakening balance sheet and was at risk to maintaining its dividend.

TIER 2 - Continued

We added two new companies that we believe have the balance sheets and business model to thrive in this environment. Those companies were UPS and Microsoft, which we view as being very well positioned to maintain and or increase their dividend during this time. While we have seen price declines on some assets in TIER Two, our cash flows from these investments continue to be strong; generating the yield we need to keep our clients on track to meet their distributions, which in-turn will support their lifestyle. For growth investors, this income is used as new money being reinvested to purchase stocks at bargain rates.

TIER 3

Pillar Three is designed for long-term growth and capital appreciation. Unlike TIER Two, few companies in Tier Three pay dividends; therefore, capital appreciation is the primary objective. In our planning strategy, these are assets we count on being invested for a minimum of 5 years; as a result, volatility is not a large concern, unlike with Tier One and Tier Two. These investments tend to be large growth-oriented companies like Facebook and Amazon, small up and coming companies, and international companies. During times of market volatility, Tier Three assets tend to see the largest swings; this time was no different. With the large discounts we saw placed on large US based companies, we used this opportunity to shift Tier Three assets away from international markets in favor of high-quality US growth companies. We believe coming out of this crisis, our TIER Three assets are set to have a remarkable run and we will look to capitalize on what we expect to be above average price appreciation in the coming 12 to 24 months.

TIER 4

Tier Four focuses on illiquid investments, such as opportunistic real estate, private equity, and private credit. Liquidity is important, but many times, assets such as real estate or investments in private companies, require time to mature and therefore, are not as liquid as publicly traded stocks. In turn for the lack of liquidity, investors demand a greater rate of return in this asset class. Looking over the last 20 years, the IPO market is not what it was in the 1990's. For instance, companies like Amazon would have never gone public so early in their business cycle if they were able to raise the amount of money we are seeing being raised in private markets today. This means that investors looking for early stage exponential growth need to look away from public markets and shift those investments to private markets. For investors with the balance sheet and risk tolerance to do so, we believe this is where those long-term opportunistic assets should be allocated. We partner with some of the worlds most respected alternative asset firms to help deploy those opportunities for our clients. In times like this, strong balance sheet private equity firms will have opportunities to deploy cash for investors that come around only once in a lifetime.

Looking Forward

We are certainly in unprecedented times. There will undoubtably be some short-term pain as a country, but it is our belief that we will emerge stronger than ever. There will be new industries born and the entrepreneurial spirit of the US will develop new vaccines, cures and industries to combat this dark period in our history. We have been hard at work to reposition our client's portfolios to maximize what is likely to be a powerful rally when this virus is behind us. Importantly, we have been restructuring our portfolio to favor companies we believe are best positioned to succeed in an economy and market that will be changed by this event. This period reiterates to us all that the only constant is change and we must adapt to succeed. As Darwin said, "It is not the strongest of the species that survives, but the most adaptable." At Surevest, we will continue to digest new information daily. We are leveraging all the capabilities of our new partner in CI Financial, while working diligently to come out of this period stronger than ever by maximizing results for our clients.

We will continue to keep you updated weekly on the markets, and as always please reach out to your personal advisor with any questions or concerns.

Thank you for your confidence and support.

Disclosure
Clients and employees of Surevest own shares of all companies mentioned. This is not a recommendation to buy or sell any securities. Speak with your financial advisor before making any investments or acting on any topics discussed. Surevest Wealth Management is a Registered Investment Adviser. Advisory services are only offered to clients or prospective clients where Surevest Wealth Management and its representatives are properly licensed or exempt from licensure.

Robert J. Luna, CIMA®, AIF®
CEO & Chief Investment Strategist

Luis Galdamez

Luis Galdamez, CFA®, CFP®, ChFC®, AIF®
COO & Director of Investments

[i] Source: CNBC Site: https://www.cnbc.com/2020/03/23/this-was-the-fastest-30percent-stock-market-decline-ever.html
[ii] Source: PG Investor Site: https://www.pginvestor.com/file/Index?KeyFile=402267330
[iii] Source: Cambridge Associates: https://www.cambridgeassociates.com/wp-content/uploads/2020/02/WEB-2019-Q3-USPE-legacy-Benchmark-Book.pdf
[iv] Source: Bloomberg Site: https://www.bloomberg.com/opinion/articles/2018-04-09/where-have-all-the-u-s-public-companies-gone