How to Help Avoid Getting Clobbered in the Next Bear Market

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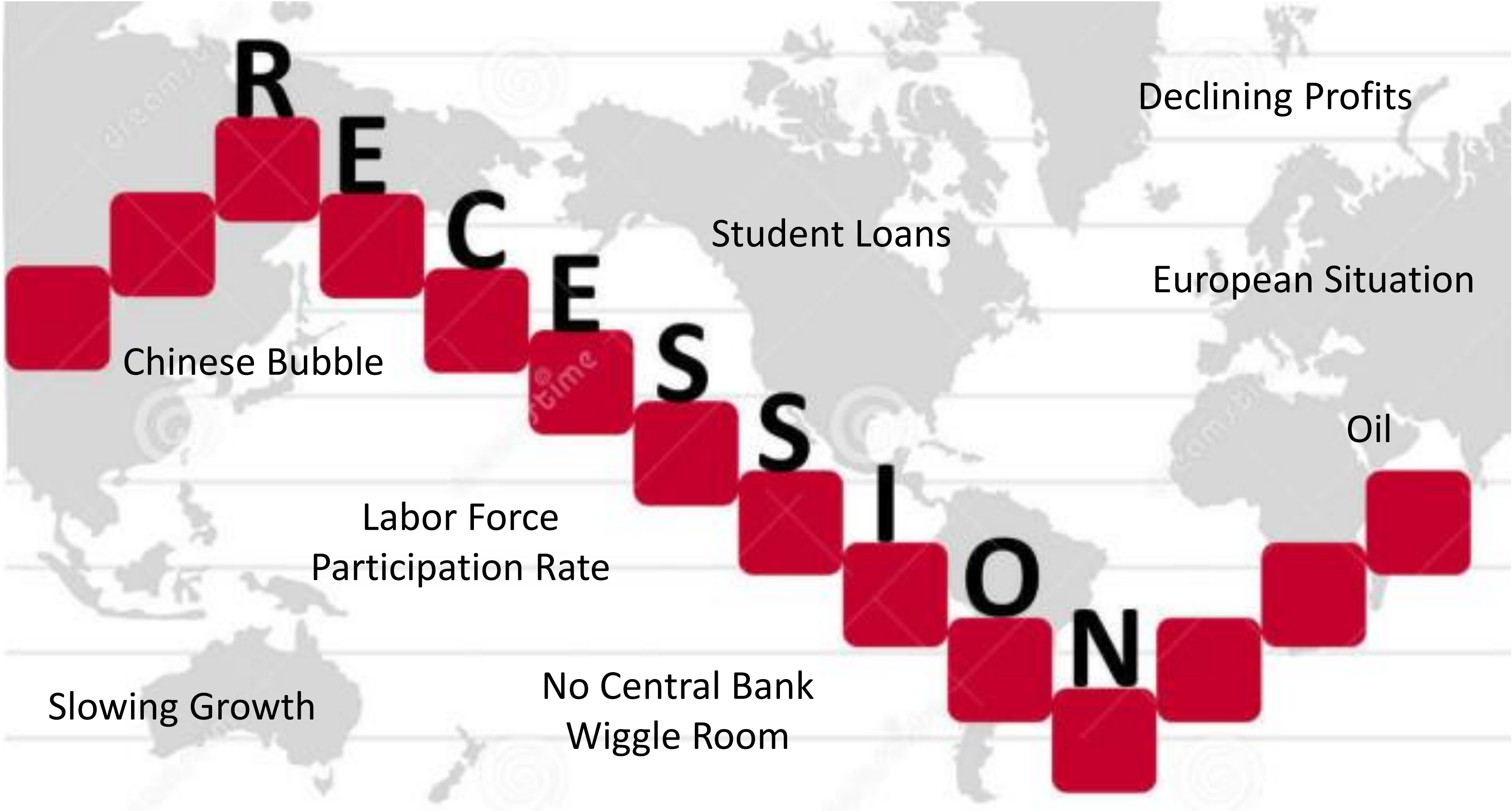
Is the next recession around the corner?



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We don’t know, but we have suggestions

Jonathan E. Tunney, CFA – Founder and Managing Partner
Jonathan (Jono) founded Atlas Capital in 2003 after holding numerous treasury positions at Hewlett-Packard. He holds a BA in Economics and Political Science from Stanford University, an MBA in Finance from the Anderson School at UCLA, and the Chartered Financial Analyst designation.

Kenneth J. Frier, CFA – Partner and Chief Investment Officer
Ken Frier joined Atlas in 2015 with more than 25 years of capital markets experience including CIO roles at Hewlett-Packard, Stanford Management Company and the UAW Retiree Medical Benefits Trust. Ken holds a BS in mathematics from the University of North Carolina at Chapel Hill, an MBA from the Stanford University Graduate School of Business and the Chartered Financial Analyst designation.

Albert J. Gutierrez, CFA – Partner and Head of Fixed Income
Albert (Bert) joined Atlas in 2010 and has more than 30 years of capital markets experience at firms including SCM Advisors, American General Investment Management, and Conseco Capital Management. Bert holds a BS in Economics from The Wharton School, University of Pennsylvania and holds a Chartered Financial Analyst designation.

The last two recessions led US equity investors to lose about half their asset value

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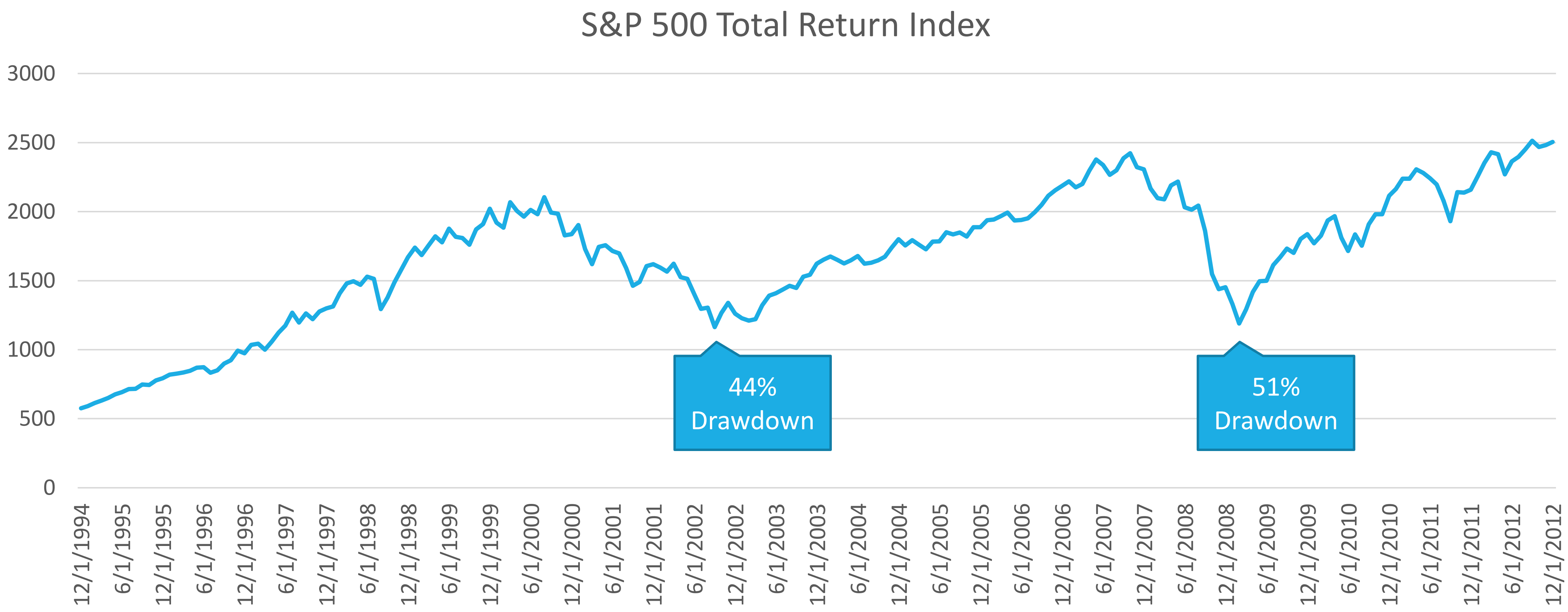

Source: Bloomberg

The stock market generally predicts recessions better than economists do

ECONOMISTS

- There have been seven US recessions in the last fifty years
  - Number forecast by the consensus of economists: **zero**
- In the past 15 years there were 220 instances of economic growth changing from positive to negative at countries around the world
  - Number forecast by the consensus of economists: **zero**

THE STOCK MARKET

- There have been seven US recessions in the last fifty years
  - Number where there was a 15% fall in the S&P 500 within one year of the recession start: **seven**
- There were five other times the S&P 500 fell 15% or more where there was no recession within a year

Neither track record is ideal, but which is better?

Past performance is not necessarily indicative of future results.

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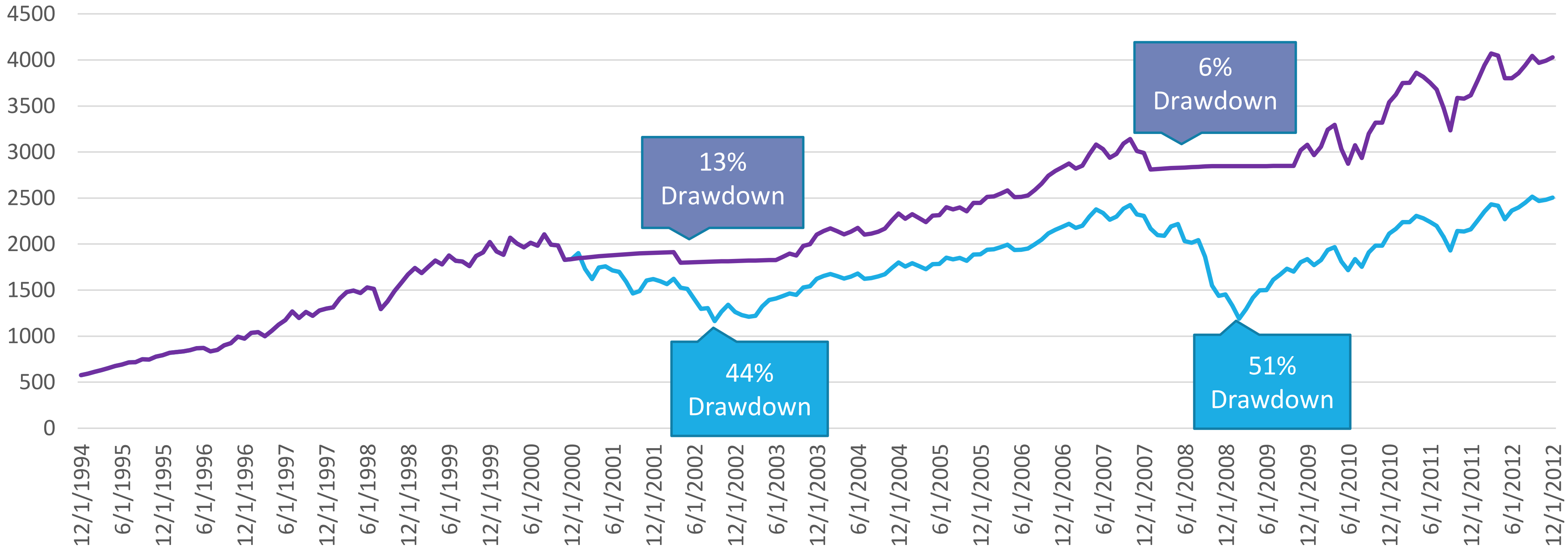
What if you owned stocks only when the prior year return was positive, and Treasury bills otherwise?

S&P 500 Total Return Index



Source: Bloomberg

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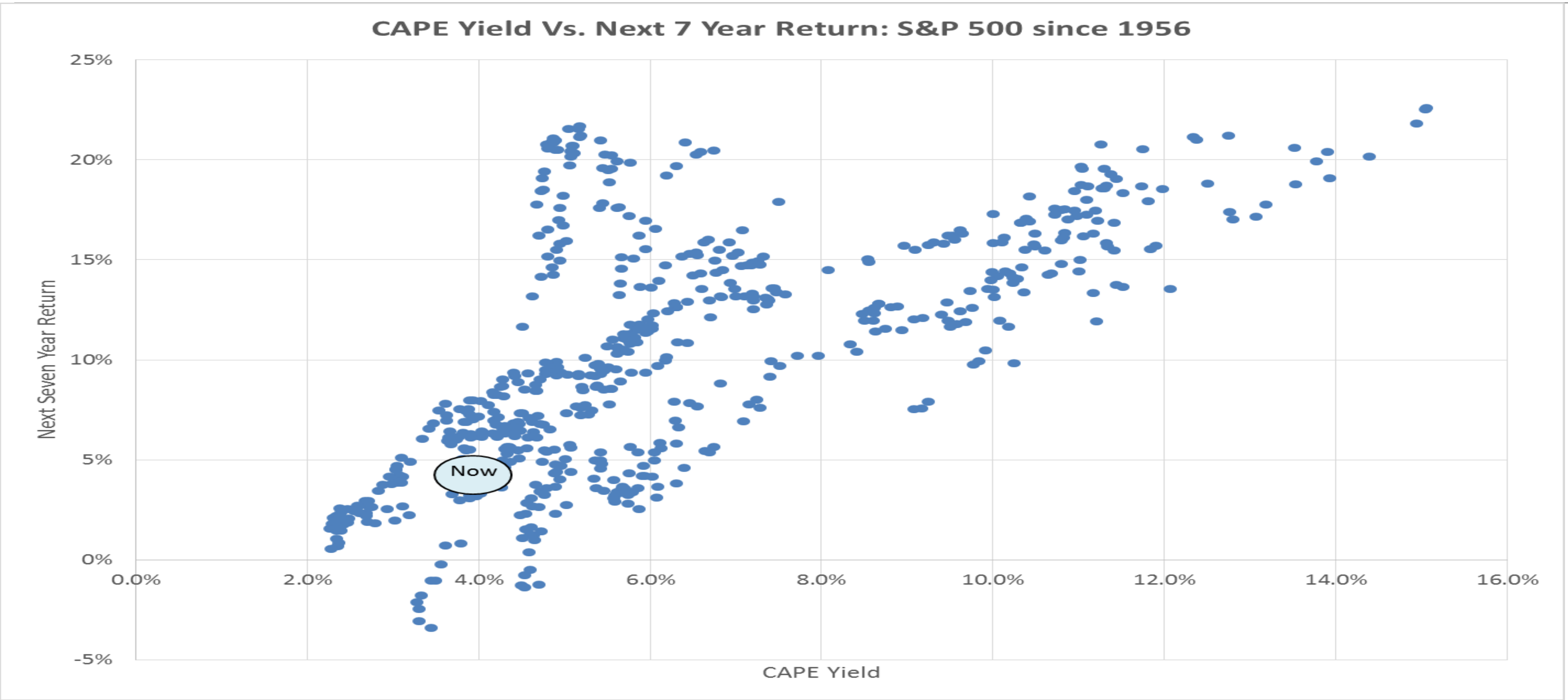
Future stock market returns tend to be better when prior returns are positive

- The chart is based on S&P 500 data since 1960
- It shows the average return for the next three months as a function of whether the prior one year return was positive or negative
- The 1.1% per quarter advantage can be helpful to portfolio results

Past performance is not necessarily indicative of future results.

Valuation matters also



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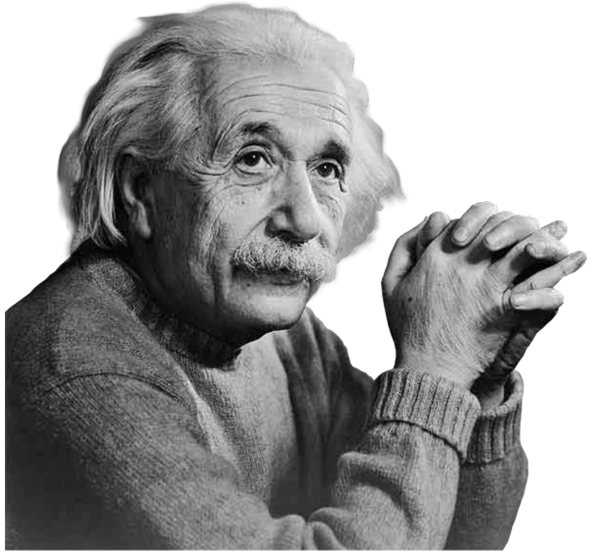
The three big questions

The most important questions faced by global equity investors:



1. I know that equity risk is the most dominant risk in our portfolio. Is it a relatively attractive time to have global equity investments in my portfolio? If not, what's a good way to avoid big losses in the next market downturn?
2. Global economies seem to be diverging. How should I allocate my equity investments across geographies?
3. How should I manage the currency risk of investing outside my home country?

Addressing the 3 questions

Invest globally

- Diversification across geographic markets provides the opportunity to benefit when there are attractive markets outside the home country.

Create alpha from beta management

- Use ETFs or futures to achieve equity beta cheaply
- Generate return (alpha) from systematic beta management – informed choices about which stock markets to own
- Separation of beta and alpha is often under-appreciated and under-utilized by investors

Take risk only when rewarded

- ***Determine "bad neighborhoods***": Examine valuation, momentum, fundamentals, sentiment, risk and currency impacts for each market
- ***"Water the flowers, not weeds":*** avoid bad markets
- ***"Correlation matters"***: When too many neighborhoods turn bad, move assets to short-term fixed income to avoid contagion risk

Five step process of analysis

1. **UNIVERSE SELECTION**: Analyze forty-eight segments of global stock market, four tiers of weighting based on market capitalization, equal weight within tiers

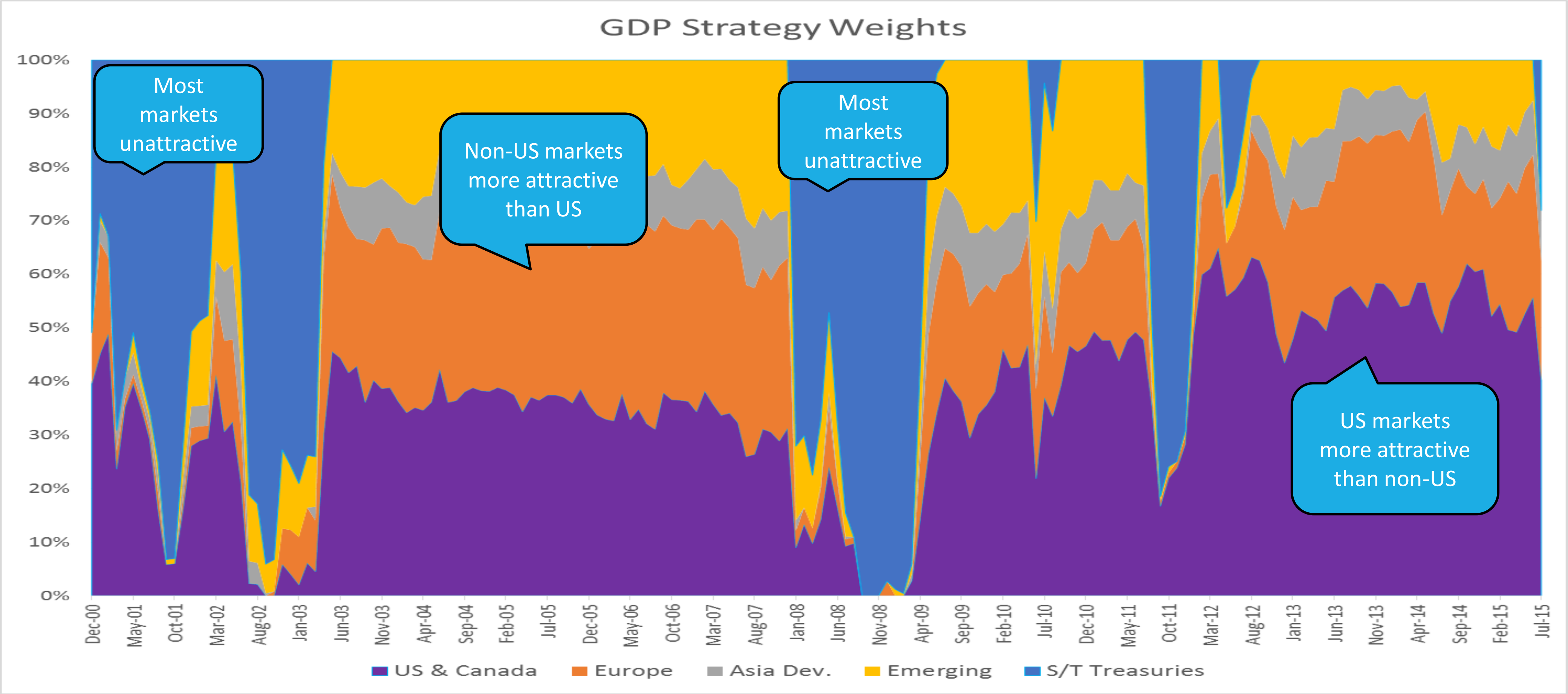
2. **NEIGHBORHOOD SCREEN**: Exclude countries/sectors that exhibit bad neighborhood characteristics (based primarily on value and trend)

3. **VALUATION ASSESSMENT**: Evaluate remaining countries/sectors based on economic fundamentals, risk, expected return and historical valuation metrics

4. **PORTFOLIO WEIGHTING**: Re-weight remaining countries/sectors based on risk and valuation outlook. If too few "good neighborhoods", some allocation to short-term fixed income.

5. **CURRENCY MANAGEMENT**: Aggregate and evaluate major currency exposures. Hedge currency risk if value and trend indicate hedging desirable.

Be dynamic as market attractiveness changes



What are the bad neighborhoods today?

North America Developed:
US Sectors:
- Consumer Discretionary
- Cons Staples
- Energy
- Financials
- Health Care
- Industrials
- Technology
- Materials
- Telecom
- Utilities

S&P 400 mid cap
S&P 600 small cap
Canada

Europe Developed:
Austria
Belgium
Denmark
Finland
France
Germany
Ireland
Israel
Italy
Netherlands
Norway
Spain
Sweden
Switzerland
UK

Asia/Pacific Developed:
Australia
Hong Kong
Japan
Korea
Singapore

Emerging Markets:
Brazil
Chile
China
Frontier 100
India
Indonesia
Malaysia
Mexico
Philippines
Poland
Russia
S Africa
Taiwan
Thailand
Turkey

Black: at/over market weight, Purple: below market weight, Red: highest risk.

Summary

- Stock market performance can be a *leading* indicator of economic weakness
- Stock markets are particularly dangerous to own when they are falling *and* valuation indicators are unappealing
- It is potentially worthwhile to:
  - Divide global stocks into numerous country/sector markets
  - Drop out of the “bad neighborhoods”
  - Adjust weights to “good neighborhoods” based on value
  - Be willing to own cash if insufficient good neighborhoods

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