CENTURION COUNSEL
MARKET COMMENTARY
Q3 2018

The 10-year Treasury yield recently yielded 3.23%, the first time above the July 2011 high of 3.22%. The nonfarm payroll report, including upward revisions to July August, and September 2018, showed job growth of 220,000, which was much different than the headline print, while the unemployment rate is 3.7%. This means that economic growth remains strong, with only a slight whiff of inflation. As we have stated all year the biggest worry we have are the FAANG stocks (Facebook, Amazon, Apple, Netflix and Google), we were concerned that they flew too close to the sun and would eventually fall back to earth. It appears that they may finally entering the inevitable downward spiral (rest assured that our clients do not own these companies).

All markets move in cycles with many investors trying to guess when a cycle will change. We view cycles as a chance to buy low and sell high, as sectors fall in and out of favor. It's not just individuals who try and deny that markets, and the economy, move in cycles but also the Federal Reserve and government agencies. The Congressional Budget Office (CBO) is currently estimating the next 10 years of growth in the economy at a steady 2%. This in spite of growth estimated to be between 3-4% this year as we are already approaching the longest economic growth cycle in history in spite of the Federal Reserve hiking rates. It is highly unlikely the economy will remain recession free for another decade. It is also important to note the CBO did not predict the recessions in 2001-2002 or in 2008. In fact, in 2000, the CBO predicted the U.S. would be running a $1 trillion surplus by 2010. They were only off by $2 trillion when 2010 finally rolled around.

What is clear is that both markets and the economy not only cycle, but cycle together. However, knowing when these cycles will occur isn't that simple. Timing markets is next to impossible. We all know when summer is coming, that is the easy part of the predication, what we don't know is when will the first hot day occur. You might know that the equivalent of a market winter is coming. But you don't know when it will hit and you don't know how severe it will be.

Strategic Asset Allocation

At Centurion, we use Strategic Asset Allocation, a portfolio strategy that involves setting target allocations for various asset classes and rebalancing quarterly. The portfolio is rebalanced to the original allocations when they deviate significantly from the initial settings due to differing returns from the various assets.

In Strategic Asset Allocation, the target allocations depend on several factors, such as the investor's risk tolerance, time horizon and investment objectives, and may change over time as these parameters shift. Strategic Asset Allocation is compatible with a buy-and-hold strategy, as opposed to tactical asset allocation (timing the market) which is more suited to an active trading approach. Strategic and asset allocation is based on modern portfolio theory, which emphasizes diversification to reduce risk and improve portfolio returns.

Suppose 60-year-old Mrs. Smith, who has a conservative approach to investing and is five years away from retirement, has a strategic asset allocation of 40% equities / 40% fixed income / 20% cash. Assume Mrs. Smith has a $500,000 portfolio. The dollar amounts allocated to the various asset classes at the time of setting the target allocations would be: equities $200,000, fixed income $200,000 and cash $100,000.

In one year's time, suppose the equity component of the portfolio has generated total returns of 10%, while fixed income has returned 5% and cash 2%. The portfolio composition is now: equities $220,000, fixed income $210,000 and cash $102,000.
The portfolio value is now $532,000, which means the overall return on the portfolio over the past year was 6.4%. The portfolio composition is now: equities 41.3%, fixed income 39.5% and cash 19.2%.

Based on the original allocations, the portfolio value of $532,000 should be allocated as follows: equities $212,800, fixed income $212,800 and cash $106,400.

Thus, $7,200 from the equity component has to be sold to bring the equity allocation back to 40%, with the proceeds used to buy $2,800 of fixed income and the balance of $4,400 allocated to cash.

Note that while changes to target allocations can be carried out at any time, they are done relatively infrequently. In this case, Mrs. Smith may change her allocation in five years, when she is on the verge of retirement.