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INVESTMENT THOUGHTS

AUGUST 2018

NAVIGATING PAST TRAPS

Lobster dinners are a traditional rite of summer. Delicious food enjoyed with friends is hard to beat — unless of course, you are the lobster. It would have preferred alternative plans that did not involve a large pot and folks wearing bibs wielding stainless steel crackers. Unfortunately, the lobster came across a lobster trap, an uncomplicated device that is easy to walk into but the funnel design makes it so it cannot walk out.

As investors, we are usually much smarter than lobsters. We do not stroll into cages, even if they contain something good to eat. However, the investment waters contain hidden traps that can catch unwary investors by surprise. These traps, if not understood and properly navigated, may undermine our ability to meet our financial goals. I would like to discuss two of the traps that hurt investors when liquidity dries up and volatility increases.

In the investment world, liquidity describes the ease of buying or selling an asset without affecting its price. It works much like a lobster trap. It is easy to enter investments when there is plenty of liquidity but when it disappears, it is difficult to exit them without accepting a lower price and losing money.

The potential for many segments of the markets to become illiquid has increased since the financial crisis a decade ago. Ironically, this is an unintended consequence of safeguards put in place to strengthen the banking system and promote financial stability. The Dodd-Frank Wall Street Reform and Consumer Protection Act and

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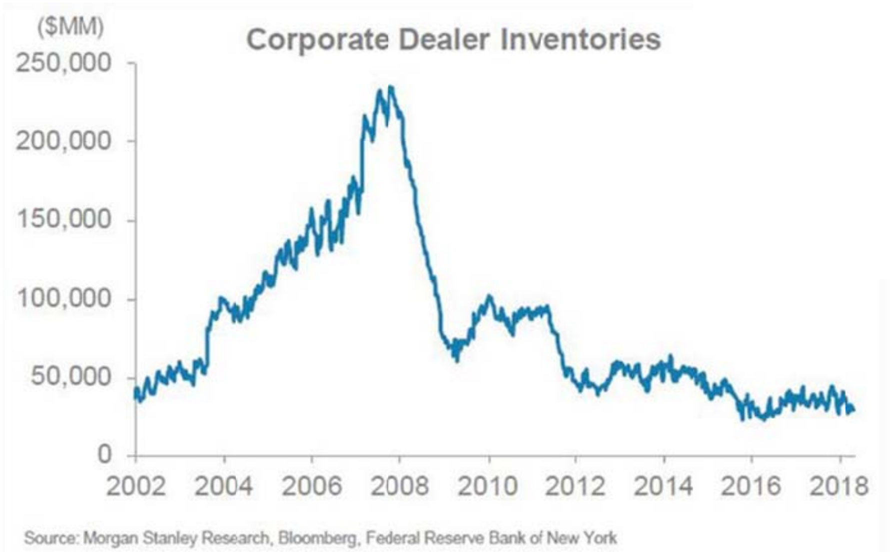
the Basel III regulatory framework increased the amount of capital banks must hold on their balance sheets. This left less capital for trading, forcing banks to curtail their role as market makers. As a result, they no longer hold large inventories of securities on their books. This diminishes their ability to take the other side of trades and absorb supply and demand imbalances. The following chart shows the sharp decline in the banks' inventories of corporate bonds since 2008.

Chart #1



Funds that offer daily liquidity but hold too many illiquid securities are the first trap. These vehicles can fall rapidly when investors head for the exit at the same time. The implosion of the Third Avenue Focused Credit mutual fund in 2015 was a dramatic example of this. After the fund dropped 45%, Third Avenue halted investor redemptions because it could not sell enough illiquid securities to pay back its investors. It took 2 ½ years to liquidate the rest of the portfolio and make a final distribution to its clients.

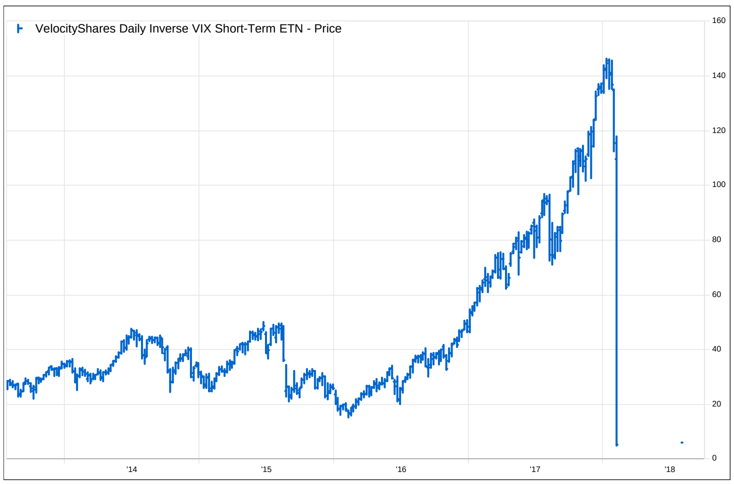
After this alarming event, the Securities and Exchange Commission designed new rules requiring fund companies to categorize holdings in one of four liquidity buckets. While this new information will be helpful, it is not a silver bullet. Unfortunately, full implementation will not occur until mid-to-late 2019. Many investors will not read the disclosures. It will still be a daunting task to stay on top of nearly 10,000 mutual and exchange-traded funds. While most funds have ample liquidity, some will continue to pose serious risks to investors.

The second trap is abandoning investments out of fear when market liquidity dries up and volatility increases due to events that will not influence the fundamental value of investments. As Warren Buffett once put it, the "capricious and irrational behavior of stock prices can make investors behave irrationally as well." Once investors sell, it is hard to get back in as the market rises.

The Dow Jones Industrial Average's over 3,000-point drop in just 10 days beginning in late January was an example of such capricious stock price behavior. While a modest rise in wages and budding trade tensions initially bothered investors, the decline accelerated sharply on February 5. This was the same day a quantitative strategy known as "short volatility" unwound rapidly. Had investors lost their nerve and sold assets during this period, they would have missed the 1,500-point rebound that occurred before the end of the month.

The short volatility trade is a bet that market volatility will stay low. Although investors use complex options or volatility indexes to execute the strategy, it works much like an insurance contract. Investors earn a premium for providing others with protection from a rise in volatility. These premiums are often very attractive because people tend to overpay for protection. In retrospect, it seems foolish that investors stuck with this strategy as we entered 2018. We had just exited the least volatile year for equities since the 1960s and the Fed was reversing the policies that had contributed to the equity market's smooth ride. Although the February plunge of two exchange-traded-notes (see one below) made the headlines, there was much more money tied up in the trade that did not garner as much attention.

Chart #2



This was not the first bout of market volatility of this kind nor will it be the last. The past included events such as Black Monday, Long Term Capital Management's demise, the Quant Quake in 2007 and the Flash Crash of 2010. Algorithmic trading by hedge funds and other institutions, according to some estimates, has tripled since 2009. Many of these strategies are sound and just trying to do what a good investor would do systematically. However, the proliferation of these automated machine-based trading strategies, combined with less reliable liquidity conditions, will likely lead to future episodes of volatility.

Unfortunately, we cannot prevent the next illiquidity-driven bout of volatility. However, we can take the following steps to increase the odds that we will safely navigate past these traps:

1. Look under the hood:

It takes a lot of time and effort to sort through the array of nearly 10,000 funds available to find the best choices. Many people select funds much as they do automobiles. They consider brand name, function, style and performance. This is a good start, but we also like to look under the hood to get a better understanding of a fund's inner workings. When researching a bond fund's liquidity profile, we consider factors such as the credit quality, coupon rates and liquidity assessment scores of its holdings. We also ask fund companies about their liquidity management practices during meetings.

2. Have a solid plan:

A well-defined investment approach built with your goals and feelings about risk in mind will help you cope with market volatility. It will also help you keep your focus on what is most important, taking the right steps to increase the probability of success. We (and most of our clients) define success as ensuring your wealth may assist you in living a happy and fulfilling life.

At Ledyard, we spend a great deal of time asking our clients questions, listening and understanding so we can develop customized plans to help them meet their goals. We check in often to make sure these plans are still appropriate and make adjustments when necessary.

3. Be ready to take advantage of volatility:

When fear grips us, our natural inclination is to run and hide. While this is advisable when being chased by a large angry bear, it is not so helpful when investing. Market volatility often creates opportunities to improve portfolios. We develop estimates of intrinsic value for many companies based on fundamental factors such as their competitive position, growth potential, financial position and valuation. We often find that our estimates of intrinsic value are not sufficiently above a stock's current market value to make purchasing a stock worthwhile. During periods of volatility, however, stocks may drop to levels that are more attractive and we can add them to portfolios.

Some lobsters live 45 - 50 years and grow to over 30 pounds happily scurrying about the ocean's floor. If these wise old crustaceans were able to give survival advice, I am sure they would be direct and to the point; avoid the traps! This advice is certainly applicable to investors as well.

I hope you enjoy the rest of the summer!

Best regards,

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