October 2018

Here we are just a little more than three-quarters of the way through 2018. While many might regard this as a rather unusual year for the stock market, it really hasn't been all that unusual. This is true even though the market is now experiencing its second downturn of greater than 5% in 2018 (per the S&P 500 Index, as in the following discussion). This is completely normal. As we noted in our quarterly letter from six months ago: "Our firm's Chief Market Strategist Bill O'Grady recently reported that over the last 90 years the stock market has *averaged* 3.4 corrections of 5% or greater *per year*. Over the same time frame the market also averaged 1.1 corrections of 10% or greater per year." On January 26th of this year the market peaked and proceeded to fall just over 10% during the next couple of months. After that the market recovered and then exceeded the January 26th high. After peaking at a new high on September 20th the market then declined about 8%. "What is *happening* here?" Nothing strange at all. In fact, this sort of market volatility is completely normal. What was unusual was that for almost two-years prior to January 26th we had no sell-offs of even 5%!

As we've pointed out on numerous occasions, we welcome the return of normal volatility because it gives the opportunity to buy shares of great companies at discounted prices. We play the long-game here at Confluence. By that I mean we make investments on behalf of our clients that are intended to be in place for many years. In some of our equity strategies we've held some stocks for a decade or two. We believe that long-term investing is not only tax-efficient, but it just works better for investors whose time horizons are also long term. Thus, day-to-day or even month-to-month volatility doesn't cause us to change our long-term strategies; in fact, we expect the volatility and plan to take full advantage of it.

Many regard a "normal" bull market as one where all stocks appreciate together. "A rising tide lifts all ships," is a phrase you may have heard. That is often the case in a new cyclical bull market emerging from a recession or in a world of low interest rate policy. But, in the sort of world we're in now, it's not unusual to see the performance of many stocks and sectors diverge. What is that world? It's a world of more rapid economic growth and rising interest rates. In economic climates like this one, investors tend to chase stocks of fast-growing companies and eschew those with high dividends. This is normal at this point in the cycle.

Well, then, shouldn't an investor try to "move around" the market, selling what's out of favor this year and buying what's in vogue? If only it were that easy. It's actually not only difficult but creates great risks to long-term performance. But what if it were easy, and what's out of favor this year were stocks of outstanding businesses owned for many years at low cost bases? Would it make sense to sell those and pay the taxes for a fling with lesser businesses that are popular vehicles this year? And what if you don't get back into your outstanding long-term stocks soon enough and have to pay up for them? You see where I'm going with this, I hope. While some see investing as trading from one fast horse to the next fast horse at just the right time, we see good long-term investing as more of a marathon, won by the ownership of great companies for many years, even if they lag in some years.

This is a year when many of the best companies whose businesses are protected by some of the widest moats are lagging the market. On the other hand, stocks of other great businesses are doing just fine this year. That's what divergence in the stock market means. We've seen it before, and it doesn't bother us at all because, as noted above, we take a long view of the business of investing.

We appreciate your confidence in us.

Gratefully,

Mark A. Keller, CFA
CEO and Chief Investment Officer

This letter was prepared by Mark Keller of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change. This information does not constitute a solicitation or an offer to buy or sell any security.