JAG
CAPITAL MANAGEMENT LLC

QUARTERLY COMMENTS
1st Quarter 2018

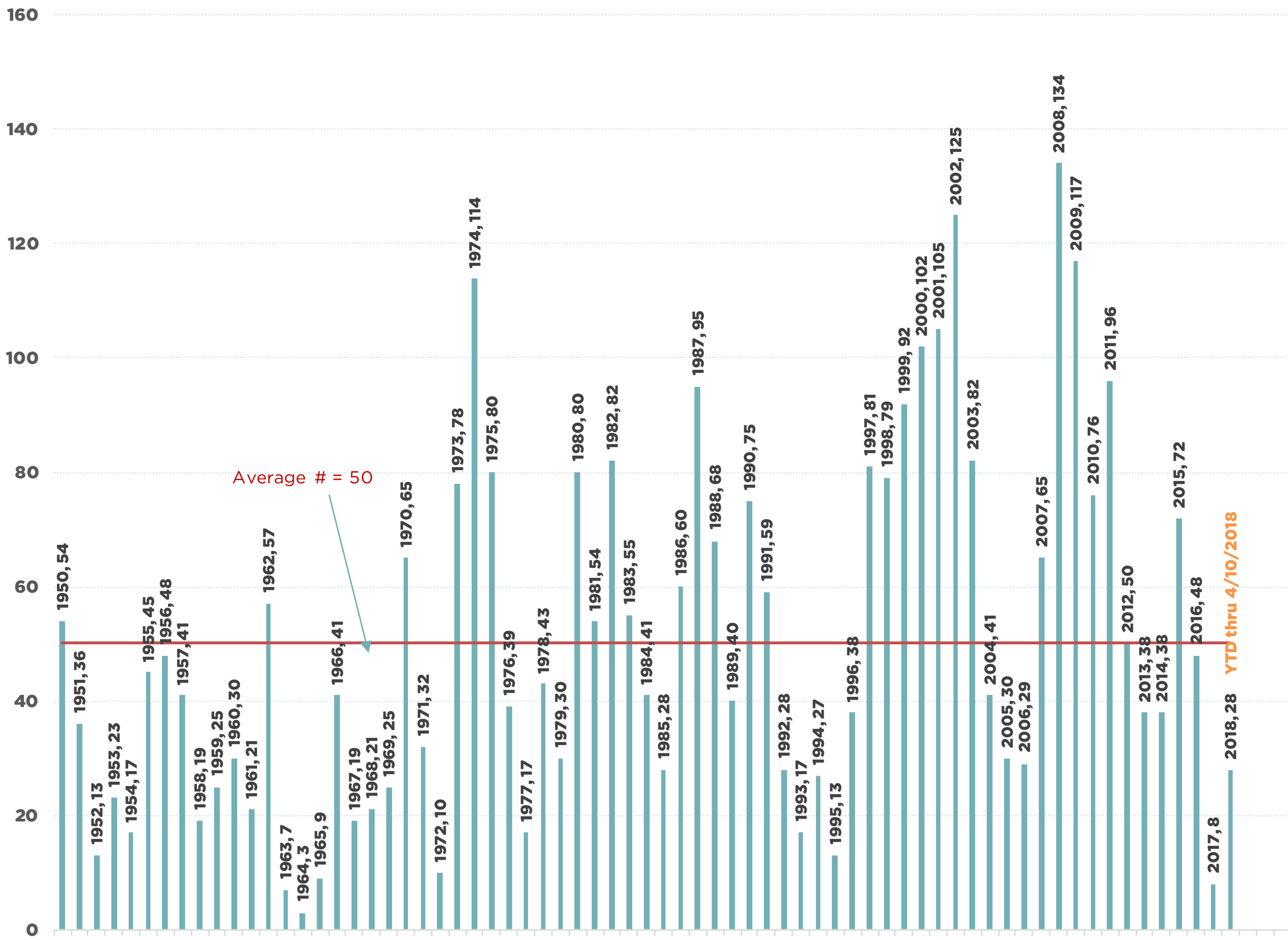
1st Quarter 2018: A Visit From An Old Friend

Norm Conley | CEO & CIO

Market volatility has returned from an extended vacation, resulting in a roughly 10% correction for the S&P 500 since its January high and a -.8% decline for the 1st quarter of 2018. This was the index's first 10% correction in two years, and it broke a streak of nine consecutive quarterly gains dating back to the 3rd quarter of 2015.

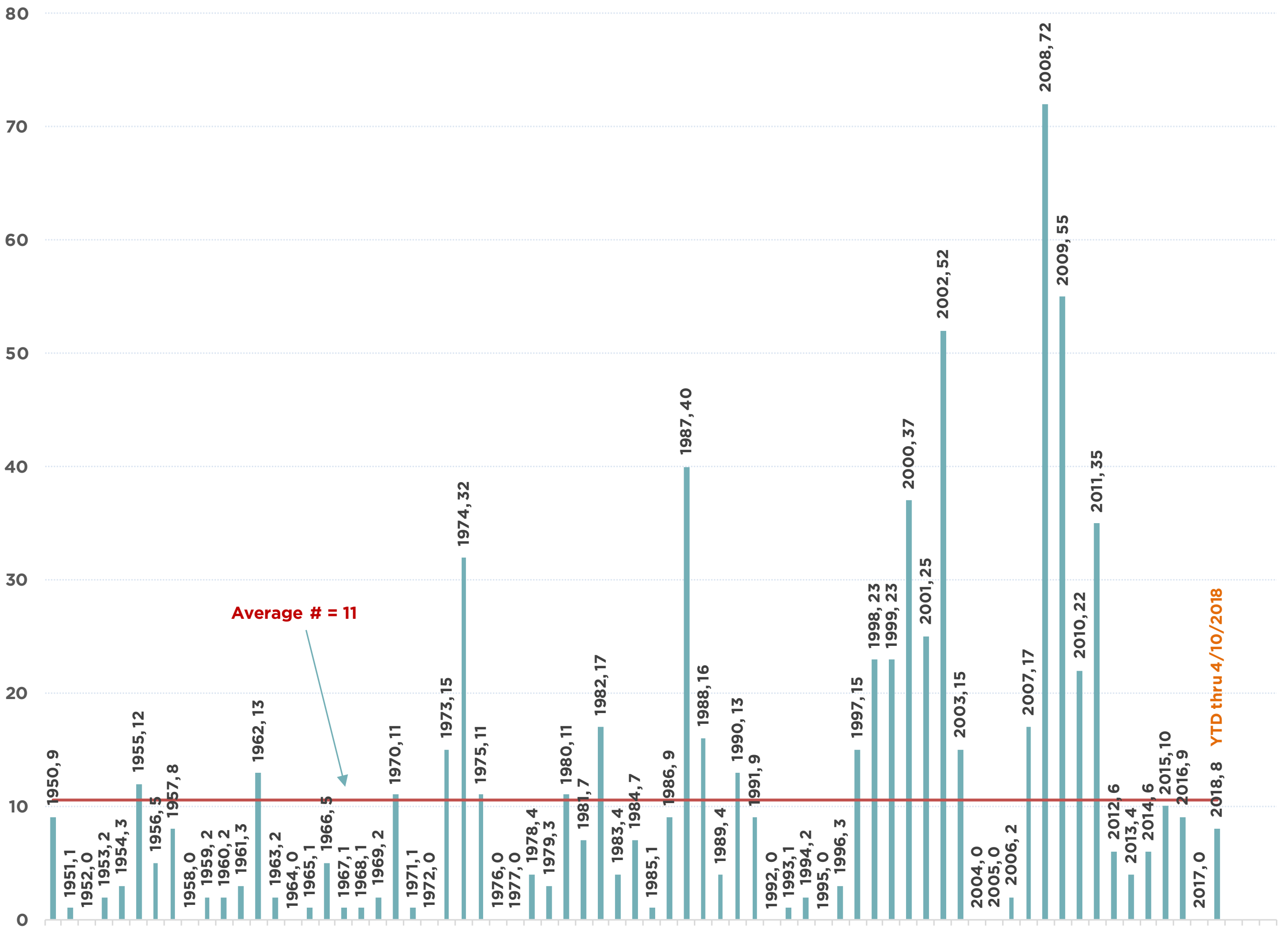
For context, we should note that last year's stock market performance was unusual for both its strength and smoothness. The S&P 500 returned 21.8% in 2017, delivering its best year since 2013 and its third-biggest yearly gain since the end of the 2008-2009 financial crisis. Meanwhile, the index experienced only eight daily price moves of at least 1% in all of 2017, the fewest since 1972. By way of comparison, in all calendar years since 1950, the index has experienced an average of 50 daily swings of at least 1% (up or down) and eleven single-day moves of at least 2%.

Total Number of 1% Moves Up or Down in the S&P 500 by Year



Source: Bloomberg, JAG Capital Management

Total Number of 2% Moves Up or Down in the S&P 500 by Year



Source: Bloomberg, JAG Capital Management

So far in 2018, stock investors have been subjected to a turbulent ride. Just through the first week of April, the S&P 500 has already experienced 28 daily moves of at least 1% and eight daily moves of 2% or more. While there is some truth to the old tongue-in-cheek Wall Street adage that proclaims, “Everyone can accept unlimited (upside) volatility,” we humans tend to greatly dislike downside volatility. In fact, as first described in 1979 by Nobel Prize-winning economist Daniel Kahneman and his colleague Amos Tversky, the behavioral principle of Loss Aversion compels us to abhor losses roughly twice as much as we enjoy the equivalent amount of gains. Some psychologists believe that this tendency is rooted in our evolutionary profile. Consider that our distant ancestors often found themselves on the edge of finding enough food to survive. In that kind of harsh environment, the loss of a week’s worth of food could mean death. On the other hand, gaining an extra week of food would not necessarily translate into an additional week of life (especially prior to the development of food storage and preservation techniques).

“The market was volatile.”

Successful investors know that price volatility is an essential component of producing competitive long-term returns. At the risk of oversimplifying finance theory, the fact that stock prices tend to exhibit lots of short-term undulations is a big part of the reason that stocks tend to generate superior long-term returns when compared to low-volatility assets like cash and bonds. Warren Buffett put it thusly in his 2014 annual shareholder letter:

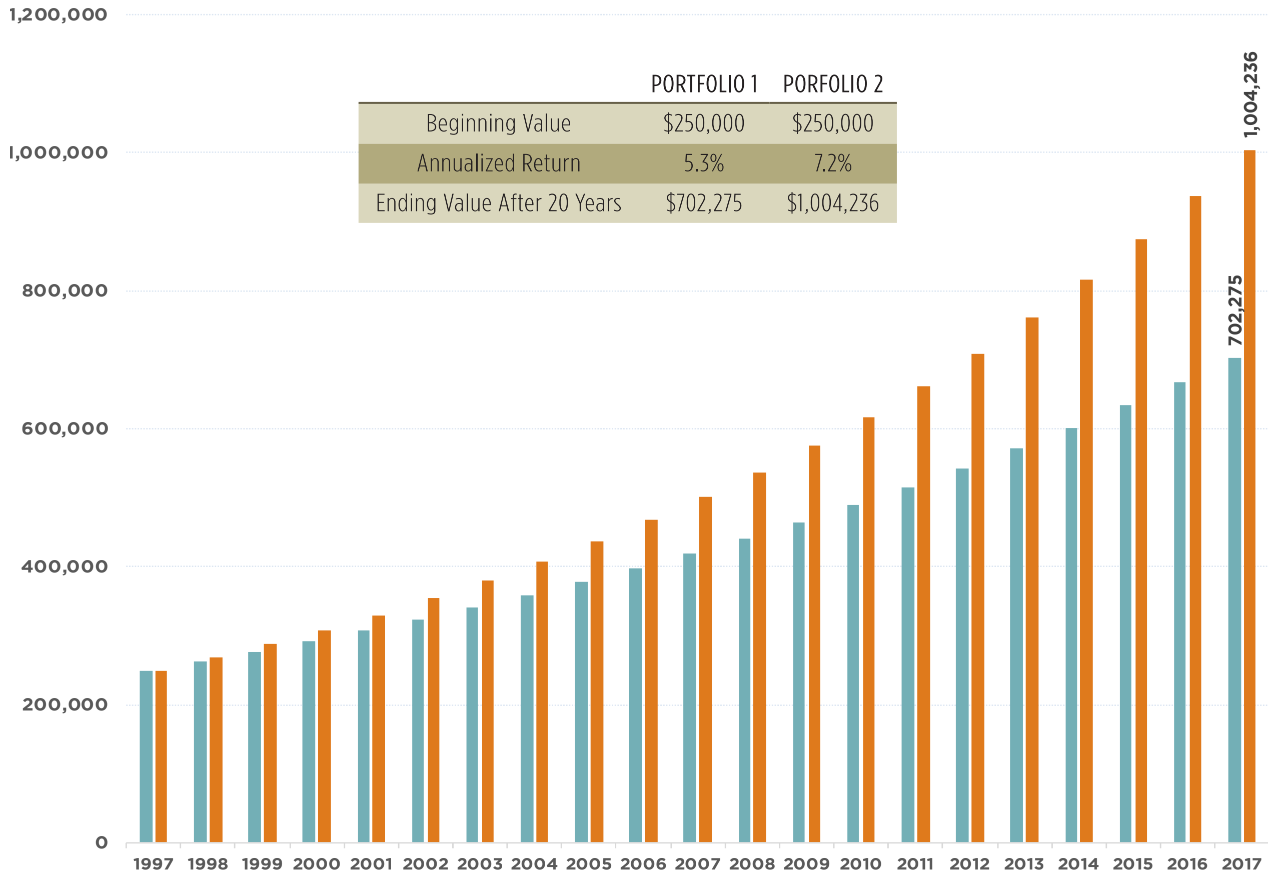
"It is true, of course, that owning equities for a day or a week or a year is far riskier (in both nominal and purchasing-power terms) than leaving funds in cash-equivalents. For the great majority of investors, however, who can - and should - invest with a multi-decade horizon, quotational declines are unimportant. Their focus should remain fixed on attaining significant gains in purchasing power over their investing lifetime. For them, a diversified equity portfolio, bought over time, will prove far less risky than dollar-based securities... If the investor, instead, fears price volatility, erroneously viewing it as a measure of risk, he may, ironically, end up doing some very risky things."

Unfortunately, many investors react poorly to the emotional swings caused by short-term price movements. Extensive evidence shows that they make short-term decisions that run contrary to their long-term goals, including over-trading and/or re-jiggering their portfolio exposure to stocks at inopportune times. This type of behavior can have very negative long-term effects on an investor's overall performance.

"I don't get it. First you can't sleep because you're not in the market and now you can't sleep because you are."

Since 1994, the research firm DALBAR has scrutinized the effects of investor decision-making by calculating average investor returns in stock mutual funds (including both actively-managed funds and index funds). The findings they describe in their 2018 Quantitative Analysis of Investor Behavior Report are telling. Over the past 20 years ending 12/31/17, the S&P 500 produced annualized returns of 7.2%. But over the same period the average equity fund investor earned only an annualized return of 5.3%, for a return deficit of almost 2% per year. And remember – DALBAR's methodology calculates the returns earned by the average investor. Although this implies that some equity fund investors earned more than 5.3% per year between 1997 and 2017, simple math tells us that some must have earned less. This has significant consequences, especially in the modern world in which pensions are endangered species and most individuals saving for retirement are in charge of building their own retirement nest eggs through 401k plans and IRA accounts. Thanks to the magic of compound interest, these seemingly small differences in annual returns compound into huge value divergences over long time horizons. Note that at an annualized return of 5.3%, a portfolio with an initial value of $250,000 would grow to more than $700,000 in twenty years. That may not sound so bad, until one considers that investing that same $250,000 at an annualized rate of 7.2% would grow to over $1 million over the same timeframe.

Growth of a $250,000 Portfolio Over 20 Years at an Annualized Rate of 5.3%/yr (blue bars) and 7.2%/yr (red bars)



	PORTFOLIO 1	PORFOLIO 2
Beginning Value	$250,000	$250,000
Annualized Return	5.3%	7.2%
Ending Value After 20 Years	$702,275	$1,004,236

Source: JAG Capital Management

According to DALBAR, the majority of investor underperformance is caused by psychological factors, specifically over-trading and market-timing. As they describe it:

"While underperformance is not due entirely to irrational investor behavior, there are two behaviors for which evidence shows time and time again that fall outside of what would be generally accepted as a prudent investment strategy. The behaviors are the tendency to move into and out of investments too frequently and the tendency to time the market. The data shows that the average mutual fund investor has not stayed invested for a long enough period of time to execute a long-term strategy. In fact, they typically stay invested for just a fraction of a market cycle.... Over the past 20 years, equity mutual fund investors have seldom managed to stay invested for more than four years."

It seems obvious that 2018 will be a topsy-turvier year than 2017 was, and that investors will be faced with more emotional stimuli this year than last. From DALBAR's work and our own experience, we know that volatility increases the odds that many investors will make short-term decisions that run counter to their long-term goals. With that in mind, we will do our best to help our clients stay on course as we "navigate the noise" together.

No one knows for certain where stocks will trade over the remainder of 2018. But at the same time, successful investing is a game of probabilities rather than certainties. In that light, we note that projections for corporate earnings have continued to climb over the past several months, while at the same time stock prices have fallen by roughly 10%. Higher earnings and lower stock prices imply that stocks have become materially cheaper than they were in late 2017. These points, combined with generally favorable domestic economic data and less-euphoric investor sentiment, leave us feeling mildly more bullish on the prospect for equities than we were just a few months ago.

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