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Quarterly Newsletter - April 2019

April 15, 2019

Dear Client,

What a difference a quarter makes. As we reported in our last letter, the S&P 500 fell 13.2% in the fourth quarter of 2018. First quarter of this year it has come roaring back and is up 13.65%. U.S. stocks had their best January in 30 years. In December, it looked like the longest bull market in U.S. history was going to come to an abrupt and painful end. Flip the calendar and we are off to the races again.

Unfortunately many investors paid the price for not sitting through this volatility. Dalbar, a company that studies investor behavior, looks at the flows in and out of mutual funds. In 2018, they calculate the average investor did twice as poorly as the S&P. In an attempt to beat the markets and protect themselves from a decline, they sold out and waited for better days. When the better days came they were still out of stocks thinking the market would continue to fall which only further reduced their potential wealth. They shot themselves in the foot with fear induced bad market timing. We have shared Dalbar studies in the past. The results are always the same. Investors cannot get out of their own way.

Loss aversion is a main motivator behind market timing mistakes. Studies in behavioral economics suggest the potential for losses has twice the psychological power as gains. This was demonstrated in a coin toss test conducted by renowned psychologists Daniel Kahneman and Amos Tversky. They presented participants in the study with the following bet: If the coin lands on tails, you lose $100. If it lands on heads, you will win $150. The majority of the participants would not accept the offer. The fear of losing $100 was greater than the hope of gaining $150. What most individuals overlook is if you flip the coin enough times, there is a high probability you will end up ahead (statistically over a large sample you will win the same number of times as lose and since winning gathers more than losing costs, you come out ahead; but that doesn't mean there isn't a chance for a long string of losses before the wins start).

Losing is a rational fear. When the markets start to fall and your portfolio value decreases fear overwhelms both greed and market history. Media outlets fuel this fear with stories of how bad things are and how much worse they will get. You feel pain. Will you be able to retire? Will you run out of assets? When faced with fear, the human instinct is to run. And that is what many investors do. They get out of the markets. No more losses. No more pain. This might provide immediate relief, but as the Dalbar study shows, it typically makes things worse. Now that they are in cash, when do they get back in? Typically only after the market recovers and then the losses are locked in.

Instead of following his/her instincts and running, an investor needs to take a step back and take a longer-term perspective. We have enclosed a graph to help us with this point. The graph shows the CRSP-10 Index from 1926-2018. CRSP stands for Center for Research in Security Prices. The CRSP-10 Index measures the total U.S. stock market and includes all the securities listed on the New York Stock Exchange, American Stock Exchange, and NASDAQ trading platforms.

The graph sorts the years the CRSP-10 had a positive return (marked in blue) and the years the CRSP-10 closed with a negative return (marked in red). It should jump out to you that there is a lot more blue then red. In fact, since 1926, the CRSP-10 has had a positive year 74% of the time over the 93 year period shown. Not only are there more positive years, but the gains in those positive years are much greater than the losses in the negative years. You must be willing to accept losses in those down years in order to experience the gains in the positive years but the odds of a positive year are much greater than winning a coin toss. Of course, past performance is not a guarantee of future results.

But investors must always keep in mind ?losing? carries more cost to some than to others depending on their individual financial and life circumstances. While volatility should be embraced, not eluded (you would not have the level of wealth you have without it), if you don't have the time to wait for recovery or the means to withstand market downturns then that should impact the level of risk you take in your portfolio. If you are uncomfortable with the volatility you are experiencing in your portfolio as it relates to your circumstances, contact us. Through your financial plan we can take a holistic view of your situation and reassess your risk tolerance.

The U.S. markets might be off to a fast start this year, but many of the problems that were hampering the markets in December remain. Brexit is still evolving, trade wars are continuing, immigration policies are still unclear. The big losses might well come back. Uncertainty and volatility will always be there. Do not act irrationally. The markets will reward you if you stay invested.

It's that time of year again when we are required by law to send you our Privacy Policy statement and inform you that our SEC disclosure document, form ADV, has been updated and is available at all times upon request. Call us and we will send you a copy. The form is also available on our website for electronic download.

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