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Facing the Future with Optimism and Courage
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What's Going On? 2018 Edition

The lack of volatility over the past couple of years set investors up for a shock when stocks fell 5% on Monday. At its low point last week, the S&P 500 Index was 10.2% below it's all time high set on Jan 26th. This is the latest reminder that good times in the stock market don't last forever. Lost in all the noise was the fact that the index is still up 13% over the past 12 months. There was no clear-cut catalyst for the decline, which came despite improving corporate earnings, strengthening global economic growth, low inflation and historically low unemployment. Market volatility not caused by an identifiable geopolitical or economic event is usually the result of the frantic trading of short-term institutional investors and their computers. Their investment time horizon is measured in fractions of a second—yours is measured in decades. Unfortunately, there isn't a stock market were only long-term investors are allowed to participate.

Financial journalism, which avoids complex analysis like Superman avoided kryptonite, had to find a single, identifiable external cause for the decline so, in unison, its talking heads insisted that the selloff was caused by the likelihood that the Federal Reserve will raise interest rates from miniscule levels to historically low levels in 2018. This is the latest example of the myth that permeates financial journalism – that the economy is incapable of sustaining itself without government help, in this case the Federal Reserve's low interest rate policy. Interest rates are rising because of better than expected economic growth. This is good news, not a reason to sell stocks. Expect more volatility as we see the return of real interest rates. Eventually, volatility will decline and stock prices will reflect a growing economy and higher corporate earnings. Until then, we'll be in a strange time when good news is bad news for stocks.

It's almost impossible to identify the reasons for daily moves in global stock markets where about 85 million trades are made each day. By attempting to do so, the financial media confuses more than it enlightens and inflicts financial harm on investors who succumb to the temptation to "do something". Most of what you see, read or hear in the financial media is designed to ignite emotions and frighten the most people possible so that they'll tune in again tomorrow. The financial media doesn't know you, care about you, and doesn't care if you fail to achieve your long-term financial goals. They care about advertising revenue, which will be proportional to the number of eyeballs, ears and clicks that they can generate. Long-term investors don't need the financial media's short-term advice. Responding to market volatility with: "this too shall pass" has been a more profitable strategy than responding with: "this time it's different."

Simply stated, the stock market goes up, then it goes down and then the cycle repeats itself. The upward trend of stock prices has frequently been punctuated by unexpected and unpleasant short-term declines. Since 1946, the average intra-year drawdown in the S&P 500 Index has been 14%. Since the beginning of the current bull market in March 2009, there have been 23 declines in excess of 5% and we've just experienced the fifth decline of 10% or more – the last of which occurred in Jan/Feb 2016. All were accompanied by "the end is near" reporting before becoming inconsequential and forgotten. In the long run, volatility doesn't harm your portfolio but it can play havoc with your emotions in the short-term. Panic selling in reaction to current events has never been a winning investment strategy and it's essential to focus on long-term returns to keep short-term price declines from rattling you. Wise investors accept the inevitability of market volatility and ignore the pundits who never saw the decline coming but are now telling us what will happen next.

The performance differential stocks have yielded over safer, fixed income investments is called the equity premium. Historically the equity premium has been earned in just a handful of days. Unfortunately for market timers, these days have occurred near terrible days - during times of extreme market volatility like we saw this past week. There's no reason for long-term, goal focused investors to trade away the long-term return of their portfolio just to avoid the short-term discomfort of temporary losses. Stocks are more volatile than the economy or the earnings of companies because of investors' emotions. Historically, stocks have rewarded long-term investors for enduring periods of unpleasant volatility. Be disciplined and keep saving and investing according to your long-term plan. Time heals all drawdowns.

In the short run, movements in stock prices can be wild and irrational – because investors can be wild and irrational. It's probably true that our wired culture's instant access to stock prices increases day-to-day market volatility. Last week provided good evidence of that as individual investors withdrew $30 billion from domestic stock funds in just the first three days of the week. If you're going to invest in stocks, you must accept the fact that there will be unpredictable, periodic bouts of volatility accompanied by temporary price declines. If you can't accept this fact, you're not an investor, you're a saver and are doomed to suffer the loss of purchasing power in your savings over the long run.

Corporate profits and household net worth are at record highs. Home prices have rebounded and inflation is still low. How and when the current stock market funk will end no one knows -- which will not prevent the media's talking heads from pretending that they do. Stay optimistic. Eventually, today's headlines will become notches on a timeline of things long forgotten. We'll all be better off if, instead of listening to the noise of the financial news, we take some quiet time to count our blessings.

Desert Musings

My wife and I are enjoying the warm Phoenix weather. That means it's time for my annual desert musings.

In the long run, rising interest rates don't hurt bondholders – inflation does. According to the Federal Reserve, the ideal rate of inflation is 2%. I would've thought that the ideal rate of inflation is 0%? What am I missing?

In all asset classes and over all time periods, most active managers underperform comparable index funds. This has nothing to do with economics, it's mathematics. Twenty years ago, index funds didn't exist in many asset classes. Today, investors have access to inexpensive index funds in almost all asset classes. An advisor who recommends an actively managed mutual fund must believe that it will outperform a comparable index fund. This belief is usually based on past performance, is contrary to prudent expectation and cannot be considered to be in a client's best interest.

A disciplined rebalancing strategy eliminates the need to listen to forecasts.

Most illiquid investments are highly commissioned. Illiquidity presents an added investment risk that isn't worth taking because liquid investments have served investors well.

A single-family home is not an investment, it's an ongoing expense masquerading as an investment in the minds of some.

Too many financial advisors propagate the malignant fiction that they know something about the future. Why do they do this? Could it be that they'd rather appear certain and eventually be proven wrong than to admit that they have no idea what the future holds? Uncertainty is the permanent reality in investing and diversification is the best remedy to counter our ignorance. The most shocked and surprised investors in the next bear market will be those clients who believed that their advisor could protect them from what was coming.

Here's what you need to know about the next bear market. No one knows when it will arrive, no one knows what will cause it, no one knows how much the stock market will decline, no one knows when the market will begin its recovery, and no one knows how long it will be before the market fully recovers. When it is over, the permanent uptrend of stocks will resume and the opportunity cost of being out of the market will grow with each passing day. I hope this helps.

Complex investment products are designed to transfer assets from clients to Wall Street. For Wall Street, complex investments are profitable – even if they don't work out as promised in the long run. A great example is the now infamous VelocityShares Exchange Traded Note (ETN) called the Daily Inverse VIX (XIV). Somehow it attracted $1.9 billion by promising to make money when stock market volatility is low. It's down 96% in the past 2 weeks. The financial firms with those touchy-feely commercials that claim to care about you did everything in their power to quash the Department of Labor's fiduciary rule that would have legally mandated that they always act in the best interests of their clients.

Prohibition would have been impossible without a federal income tax. In 1910, 30% of federal government tax revenue came from taxes on alcoholic beverages. Understandably, proponents of prohibition supported a federal income tax. In 1913, the 16th amendment to the Constitution gave Congress the authority to levy a federal income tax. In 1920, the 18th amendment to the Constitution outlawed the production, transportation and sale of alcoholic beverages.

Over the long-term stock returns reflect economic fundamentals. Simply stated, stock returns = real earnings growth + dividends + inflation. The speculative component that is a factor over the short-term disappears over the long-term and is one reason why the trading mentality is doomed to failure in the long run.

Typically, do-it-yourself investors make these three mistakes. The first is to shift focus from their financial goals to the stock market during times of market volatility when they equate volatility with permanent loss. The second mistake is not understanding that price and value are inversely proportional. In other words, as the price of an asset increases its value decreases and the risk of owning it increases. The third is to confuse speculating with investing. If most of your investing thoughts begin with the phrase: "What if?" rather than: "It's likely", you may have crossed the line between speculating and investing.

The stock market has a way of humiliating speculators who are the most confident; especially those who don't realize the part luck played in their past investing successes.

You need to learn a lot to be a successful do-it-yourself investor. Unfortunately, the most important lessons we learn in investing usually involve losing money. To become a successful investor, it's more important to avoid making big mistakes than finding the best investments.

One thing I know about your financial future is that it will turn out better if you practice deferred gratification today. Unfortunately, deferred gratification is a tough sell.

Whatever is being presented to investors as the latest, greatest investment idea has, most likely, seen most of its upside.

A century ago, Jesse Livermore was a well-known stock trader and speculator. One of his most famous quotes is: "*There is nothing new in Wall Street. There can't be because speculation is as old as the hills. Whatever happens in the stock market today has happened before and will happen again.*" A century later, these words are still true.

Relative skill, not absolute skill, determines a fund manager's performance. There are many more intelligent, hard-working fund managers today than in the past, making outperformance less likely over the long-term. In its latest *Persistence Scorecard*, S&P notes that of the 371 actively managed domestic stock funds that were top quartile performers for the five years ending September 2012, only 25% produced top quartile performance over the next five years – exactly what we expect from random chance. Consequently, investors have no way of knowing if the winners were skilled or just lucky. Even more disheartening for proponents of active management is that 34% became bottom quartile performers or ceased to exist.

The S&P 500 returned 21.8% in 2017 and 182 of the companies in the index outperformed the index - including 49 that were up at least 50%. On the other hand, there were 125 stocks in the index that were down for the year. To outperform the S&P 500, all an active fund manager had to do was overweight the winners and shun the underperformers. Yet the Vanguard 500 Index Fund outperformed 67% of actively managed domestic large cap funds last year.

Stocks don't go down because the news is bad. Stocks go down because the news was unexpected.

The reason you should own bonds in your portfolio is to lower portfolio volatility – not to generate real returns. Bonds act as insurance to offset stock market volatility. This makes investment grade corporate bonds and US Treasury securities more valuable to investors when stock valuations are high.

The interest paid by a bond fund is proportional to the default risk of the bonds in its portfolio. The bond market is very efficient at pricing debt risk. When clients seek higher income when interest rates are low, many advisors fail to mention that you can't get more yield unless you take more risk. This omission might be because the advisor doesn't understand the added risk that accompanies higher yield or is committing consumer fraud by keeping mum.

I came across a study that analyzed the monthly closing levels of the S&P 500 Index for the 1,103 months from January 1926 to December 2017. If you pick any month at random, there was a 75% likelihood that the index was higher one year hence, an 84% likelihood that it was higher three years hence and an 88% likelihood that it was higher five years hence. There was little or no difference in these results if the month chosen was one in which the index ended at an all-time high. This is why, when asked if I think that the market is too high, my response is: "Compared to what?" Investors who wish to capture the return of stocks over the long-term are best served by sticking with their investment strategy and avoiding portfolio tinkering in response to short-term noise.

Everyone cannot beat the market. Therefore, any strategy that appears to do so, once it becomes well-known, must fail.

Fools and forecasters have an abundance of confidence, but wise investors are not so sure.

Fear, greed and perspective are in constant battle in the minds of investors. Unfortunately, perspective usually comes in third place.

Q: How can you tell if a market or economic forecast is full of hot air? A: It contains decimal points.

A 2016 study of retiree spending habits found that, except for those of modest means, retirees on average were spending less than they could afford and wealthy retirees were spending less than half of the amount that their resources would support. Some retirees have trouble making the transition from saving to spending. After years of thrift, they have developed a reluctance to spend, which makes it difficult for them to loosen their purse strings and enjoy the benefits of all those years of saving for the future.