

Here We Go Again!

Last year, stocks marched steadily higher with only minor pullbacks. It was a year that lacked volatility and annual returns exceeded long-term averages in most domestic and international equity asset classes. The largest peak to trough decline in the S&P 500 Index was just 7% - an unusually small decline. As I noted in the January issue of this newsletter, last year's calm markets and high equity returns were *"a gift from on high for which thoughtful men and women must pause and give thanks."* But wise investors understand that periods of low volatility and high returns are not permanent.

Volatility creates uneasiness in many investors and catastrophic financial journalism can unsettle even the most steadfast heart. News organizations don't attract eyeballs, ears or clicks by speaking in a whisper. So, we shouldn't be surprised by headlines proclaiming imminent doom. In the past week, the S&P 500 Index fell about 13% from its all-time high, set on Feb 19th. This is the latest example of what stock market investors must learn to accept - that unpleasant surprises happen more often than we'd like, usually from events that no one saw coming.

The average intrayear decline (peak to trough) in the S&P 500 Index since 1980 - about the time I started investing - has been just under 14%, according to JP Morgan. Since 1980, the S&P 500 experienced intrayear declines greater than 10% in 22 years, yet it finished with a gain in 13 of those years. Stocks fell more than 12% in 2015, 13% in 2016 and 20% in 2018. These declines have been all but forgotten by investors because stocks recovered relatively quickly.

The stock market goes up and down (thankfully, more often up than down) and although its natural to be disheartened by this latest spike in volatility; it's a normal part of stock investing. The ability to maintain composure during times of market volatility is what separates successful investors from disappointed investors. The three most important attitudes to maintain during sharp market declines are optimism, patience and discipline. This is easier said than done. Our natural inclination is to "do something!". Unfortunately, that something usually involves portfolio tinkering based on fear or speculation, which is likely to have a detrimental impact on your portfolio's long-term performance. Panic selling has never been a successful investment strategy. Historically, patient investors who owned diversified portfolios, remained optimistic, and ignored the noise have been richly rewarded.

It is during times of volatility when having a written financial plan that contains an investment strategy and portfolio appropriate for your goals, time horizon and risk tolerance proves its value by helping you look past the headlines and stay invested. A good financial plan will contain a range of possible outcomes, typically using a Monte Carlo analysis, that factors in the inevitable ups and downs of asset returns. Understanding the range of your portfolio's possible annual returns can help you deal with short-term volatility. The time to make portfolio changes is when your financial goals or circumstances have changed, not when stock prices have changed.

Investing in common stocks is fraught with uncertainty and comes with the substantial risk of periodic, temporary principal loss. Although sudden declines aren't unexpected, they can be unnerving to investors who focus too much on the short-term. This market decline should be a wakeup call for investors. For those with a well thought out financial plan and a low-cost diversified portfolio - it is mere noise. But you still must develop the discipline to ignore the noise. As John Bogle said, *"The courage to press on regardless - regardless of whether we face calm seas or rough seas, and especially when the market storms howl around us - is the quintessential attribute of the successful investor."*

A fact rarely mentioned in the financial media is that no one can make sense out of the market's day-to-day fluctuations. Not before or after the fact. This must be kept a secret because if it became known, the financial media would lose most of its audience. It has its Chicken Littles on speed dial, and whenever stocks decline more than 1% in a day, they appear everywhere; giving us insightful sounding opinions that are subject to change by this time tomorrow. But few, if any, have a predictive track record that outperforms coin flipping. When the market is calm, investors are content to take advice from the voice inside their head. When volatility spikes they become anxious and seek advice from forecasters. Unfortunately, the insight that forecasters offer is often just the voice inside their heads. Nobody knows how widely the coronavirus will spread or what effect it will ultimately have on the global economy. This gives the media a golden

opportunity to predict the worst in big font headlines. Scary headlines designed to attract eyeballs, ears and clicks provide no answers, peace, comfort or solutions to investors.

The Wall Street Promise Machine focuses on maximizing return but rarely explains the level of risk needed to achieve high returns. Few investors understand the downside risk of their portfolio. Sound diversification is fundamental to risk management. I like to think of diversification as panic insurance. By diversifying, we expect to increase long-term returns by limiting short-term losses. The simplest diversification model allocates a portfolio between stocks and bonds. Stocks are often further sub-divided into domestic and international. Bonds can be subdivided into government, corporate, municipal, foreign and high yield. Diversification eliminates the possibility of making a killing in the market, but it also decreases the probability that you will be killed by the market. Protect yourself from the market's inevitable volatility by keeping an appropriate balance between equities for long-term growth and fixed income assets for near-term needs. Stocks performed horribly last week but bonds did their job by acting as shock absorbers during the stock sell-off, dampening portfolio volatility for those investors with significant holdings of government and investment grade corporate bonds.

Investors have instant access to stock market updates that allows them to monitor their portfolio's performance on a minute by minute basis. This seems like a reasonable, responsible thing to do but all the evidence indicates that paying too much attention to your portfolio will likely harm, not help, its long-term performance. What most investors consider to be useful data is just noise. Unfortunately, ignoring the noise is difficult because we're all plugged in all day long. So, it's time to filter out as much of the noise as possible. Institutional investors obsess over minute-by-minute swings in stocks prices, but long-term investors don't need a stock market app on their smart phone.

The finance industry employs thousands of people whose job is to worry about risks in the markets. And there is never a shortage of things to worry about – geopolitical risk, corporate earnings, valuations, interest rate changes, inflation, monetary policy, political dysfunction, etc. Much of the financial services industry likes to pretend that they can avoid uncertainty by seeing what's ahead. If you think some manager, advisor, or strategy can provide the upside, avoid the downside and evade stock market volatility, you have been deceived. The future is unknowable There's never been, nor will there ever be, a day when the "experts" give a clear signal about whether it's time to put more money into the market or take your money out.

It might help if you broaden your investment philosophy. Rather than looking at your portfolio as an investment in individual securities or various funds, think of it as your investment in the global growth of the free enterprise system. Current woes aside, the worldwide expansion of the free enterprise system will continue. Around the globe, millions have been unchained from the bondage of poverty in the last two decades. This expansion in global prosperity will continue, even if interrupted at points along the way.

Individual investors have one great advantage over the professional investors whose relentless trading determines stock prices. When volatility spikes, professional investors tend to overreact, because they're emotional human beings just like you and me. In their continual quest to bring more assets under management, they live and die by how their short-term performance compares to that of their competitors. You have no such concerns. You have the luxury of exercising patience and are not obligated to act on your emotional responses to the latest stock market activity.

No one controls the financial markets. No one can predict what will happen next - it will be driven by news – especially unexpected news; whether good or bad. This shouldn't worry you because the things that determine long-term financial success have little or nothing to do with the news. The things that are most crucial to your financial future are things that you can control - how much you save and spend, how much investment risk you take, how much you pay in investment costs and taxes, how well you understand the basics of investing and – most critically at a time like this – how you respond emotionally to stock market volatility.

If you're still in your accumulation years and contributing ongoing salary deferrals into your retirement plan, recent events have a silver lining for you. While nobody likes to see their portfolio's value decline, market downturns provide an opportunity to invest at lower prices.

Most of us find it hard to avoid recency bias. Our opinions and emotions are heavily influenced by what has happened recently. A little perspective might help. Instead of focusing on the huge gains enjoyed over the past decade, investors are agonizing about the relatively modest losses suffered this year. This is predictable because studies in behavioral finance suggest that we feel twice as much pain from losses as the pleasure we receive from similar gains.

This chart from Michael Batnick shows the performance of the S&P 500 Index since the end of the financial crisis. As can be seen, there have been many Reasons to Sell over the past 11 years, all of them head-fakes.

Reasons to Sell



Here's a question about perspective. When looking at this chart did you focus on the coronavirus decline and say, "Oh no!" or did you focus on the 431% return of the S&P 500 since March 2009 and say, "Oh wow!"?

Stock market declines commonly result from increased uncertainty about the future. The coronavirus outbreak is causing worry and uncertainty among governments, companies, and individuals about its impact on the global economy. Times like this can be difficult, because we don't know how long they will last. But try not to lose sight of your long-term goals. Remember that stocks have higher expected returns than other investments because of the additional risks and volatility that stock investors must bear. Without unpleasant bouts of volatility, stocks wouldn't yield higher returns than less volatile assets.

By staying focused on the big picture and the long term, today's noise will become less of a distraction. Amid the anxiety surrounding the coronavirus, decades of financial history and long-term investing principles remain our best guide. The secret to long-term wealth accumulation is to consistently fund a portfolio that is prudently allocated and globally diversified. Stick with a long-term view. Keep your expenses as low as possible by using index funds or index exchange traded funds. Then allow the powerful forces of compounding, dollar cost averaging and the expanding free enterprise system to work for you. The long-run gains will likely be bountiful for those who stand their ground. No one knows if stocks will continue to decline or rebound in the weeks ahead. But of one thing I am certain - - This too shall pass.

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