Q4 2017 Market Commentary

During my financial planning meetings, I will often say to clients "Pretend you and I are sitting here when you're 90, and you tell me that you had experienced everything in life that you desired. Can you describe for me what you would say?" I use this line of questioning to help people envision and define the things that are most important to them. Through this knowledge we can develop an appropriate plan for achieving those stated goals. I recently got to thinking about using the same technique of time-travel to assist in defining client attitudes towards market risk.

Currently we sit at or near all-time highs on the various stock market indices. Volatility is low and complacency amongst investors has set in. The dreaded "this time is different" has begun to creep back into the narrative and investors are starting to act as though nothing can end this Bull market. Given that "this time" is never actually different, these circumstances prompt us, as your advisors and investment manager, to review your holdings and reallocate for that future day when things must inevitably recede. As they will. Because the best time for all investors to review risk and their tolerance for it is when there is very little apparent risk in sight.

Remember the 1990's? Year over year the markets made sizable, double digit returns. It made worthless companies worth billions. It made rock stars out of stock analysts. In March of 2000, with the S&P 500 selling at 32x earnings, the bubble burst and started the significant Bear that lasted from March until October of 2002. Exacerbated by the traumatic events of September 11th, the index declined over 49 % peak to trough. If you could go back and speak to your past self in 1990 would you tell yourself that the investments to be made that decade were not fundamentally sound? That they were based on promises of a new digital era that, while it exists today, was not the growth engine for any company that put ".com" in front of its name? Would you tell yourself that real earnings and fundamentals did actually matter? Would you tell yourself that the major decline felt at the end of this speculative cycle would create a monetary policy situation that would itself, years later, create another bubble in housing?

Now think back to October of 2007 when the S&P 500 is selling at 23x earnings. A real estate boom has fueled a bubble in financial products derived from mortgage loans and within a year that bubble will burst. Those mortgage derivatives will become worthless, forcing Lehman Bros. into bankruptcy, Merrill Lynch into a shot -gun wedding with Bank of America after a $51 billion loss, and taxpayers into shelling out $6.8 billion dollars to bail out AIG. No one understood at the time what has caused the financial infrastructure to collapse in on itself, we simply saw the market selling off every day. From peak to trough that Bear, which lasted from October of 2007 to March of 2009, saw the S&P 500 lose 56.4 % of its value. How did you feel during that time? Were you ok? Were you panicked? Were you lying awake at night wondering if all the things you had been planning and investing for were now doomed to failure?

While these historical examples can be difficult to revisit, reviewing how we felt during the depths of two of the worst bear markets in history, occurring only about 8 years apart, can help us step back and recalibrate our risk tolerance.

As the indexes reach new highs, investors tend to become complacent, to believe that their money is not really at risk. The default assumption is any interruption in the march to new highs will be very short lived and so if they do not increase their stock holdings on every little dip, they feel they have missed out somehow.

And every time the market does in fact recover to march higher, these same investors will feel even more sanguine, questioning why they ever worried and expanding their exposure. And when the market finally takes a breather and begins to fall, they will only see another a short-term dip in a long-term uptrend. If the dip turns into a deeper decline, investor that have recently bought more stocks will feel they cannot sell, because now they are down and maybe even at a small loss. They will wait for the market to turn around, because they know that it must.

And if the decline sinks into Bear market territory, a panicky unease will settle into investors' minds. They will convince themselves that it is going to zero, by the same mechanism that they had previously convinced themselves markets wouldn't fall, and they will sell in an attempt to avoid losing everything – and lock in their losses just in time to see the bottom again.

This not to say we are set up for some similar event at this time, but reviewing that kind of potential drawdown helps to avoid complacency. Understanding how you felt during those periods is a good indication of your true tolerance for volatility, and how you reacted then is likely to be very similar to how you will react again. For all the math of the market, and our focus on earnings and economic growth, the major driver of momentum is emotion. Good times feel good, and we all want to be on that ride. Bad times feel scary, and we all want to avoid that experience. As such our emotional reaction to positives and negatives can encourage us make bad investment decisions if we find ourselves overextended in terms of risk. The higher we go on the indexes, and the farther away we get from the last major drawdown, the less we feel the pain of that event and the more we justify extending out our risk even further.

So as an exercise, assume you could go back to 2008 and have a conversation with your past self. What would you say? Would you talk about how the economy survived and rebounded and the markets made back all it had lost and more? Or would you talk about the need to be more conservative in long term outlook and investment philosophy? Would your present self, knowing that paper losses had been eliminated, tell your past self to stay invested and not make rash decisions and consider selling at the bottom?

And what would your past self say to your present self? Would you have said that it's great to know the market would rebound but you still feel sick to your stomach, or would you have said that knowledge makes you much more comfortable and you can now ride things out? Would your past self tell your present self that the stress of watching your savings shrink in a downturn is not worth the extra return?

Now take this a step further and imagine if your present self could talk to your future self. Would your future self ask you to let a financial plan drive the allocation based both on your reactions to different market environments as well as your need for growth, or would your future self suggest you go with your gut, and let how you feel about your investments dictate your decisions?

By going through this exercise, we can try to create a realistic set of expectations and investment parameters, which can help resist the pull of rationalization in both up and down markets. Examining how you felt in those moments when there seemed to be no end to the sell-off, and also how you perhaps feel now, eight years removed from the last instance of said feelings, can give us some insight into how your tolerance for risk will change based upon the current conditions of the market. Are your feelings and attitudes about investing consistent, or do you find that you react very differently between good periods and bad?

If your feelings are fairly even then your stated tolerance for risk is true and the way your portfolio is currently allocated is probably correct. If the way you feel in a Bear market is significantly different than the way you feel in a Bull market, however, then we should determine exactly how much downside is bearable before we look to how much upside is desired (or even how much is truly needed).

By digging in deep to one's tolerance for risk, and honestly reviewing one's emotional experience in good and bad times, investors can begin to better understand what is realistic for risk exposure and then understand what long term returns could be expected out of the risk adjusted portfolio.

As Advisors, working through these kind of reflective examinations helps us match up the financial plan, and the returns needed to reach the stated goals, with actual expected returns based on risk tolerance. If the expected returns are less than those needed to accomplish a client's goals, we will need to alter the plan somehow – by making changes to the saving strategy, extending the time frame for reaching goals, or adjusting the goals themselves. If we find the expected returns based on risk tolerance are higher than the plan's target return, we would then have a discussion about possibly reducing the stock exposure and the overall risk being taken in the portfolio.

The optimal portfolio will help provide a client what they need, without undue risk to what they already have. With the notable performance of the stock market recently, many clients now have a bit more than we had anticipated for the year and as such we feel this is a good time to take advantage of an opportunity to lock in some gains and shore up our planning as our past selves and present selves agree that the best time to act is when it seems no action is necessary.

If you having questions about your tolerance for risk, or would like to discuss how your investments line up with your target return reach out at your convenience by email at julia@nstarfinco.com and steve@nstarfinco.com, or by phone at 800-220-2161.

Take Care,

Steven B. Girard
President

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