DON'T TAKE THE BAIT

Global Financial Private Capital

SYNOPSIS

- There is a saying that stocks go up in escalators and down in elevators. Since the presidential election last November, it feels like this old adage may no longer apply.
- A large allocation to stocks should not be completely predicated upon an investor's expectations for future returns.
- Discipline is one of the biggest challenges for investors, but it is also one of the most crucial elements to achieving long-term financial objectives.

EMOTIONAL RIDES

There is a saying that stocks go up in escalators and down in elevators. Since the presidential election last November, it feels like this old adage may no longer apply.

The stock market has ripped, and the economic data continues to point to steady growth with low inflation. Historically, this has been a fantastic setup for future gains in stocks, and more bulls seem to be coming into the market each day as they anticipate higher prices.

In fact, it's as if the bears have been hibernating since President Trump's victory took the market by surprise. Those who claimed that the economic recovery was artificial seem to be having a harder time finding an audience who will listen.

Although this newfound euphoria may feel like reuniting with a long-lost love, the chart below should make any investor think twice about going "all in" to this market.

> *"The real challenge with diversification is having the discipline to stick to a plan..."*

This table uses basic math to drive home two very important conclusions. First, recovering from losses requires far more gains that the drawdown incurred. For example, if a portfolio were to fall 40%, it would need to rise by 66.7% just to break even.

Second, the length of time to recover from steep losses can take several years, and the financial crisis is the most recent example of this phenomenon. The Dow Jones Industrial Average index peaked at 14,164.53 on October 9, 2007 and then began the

RECOVERING FROM LOSSES		YEARS REQUIRED TO BREAK EVEN		
Loss	Gain Required to Break Even	Assuming Annual 5% Return	Assuming Annual 10% Return	Assuming Annual 25% Return
-20%	25%	4.6 Years	2.3 Years	1 Year
-30%	42.9%	7.3 Years	3.7 Years	1.6 Years
-40%	66.7%	10.5 Years	5.4 Years	2.3 Years
-50%	100%	14.2 Years	7.3 Years	3.1 Years

Source: Global Financial Private Capital, LLC. This chart is shown for illustrative purposes only and does not reflect an actual investment.

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downward spiral that pushed the index down over 50% at one point during the crisis. It took until March 5, 2013, or 5.5 years, to fully recover[1].

This table highlights why staying diversified is so important. Properly diversified portfolios are designed to help shield investors from unexpected events that often catch even the most savvy and sophisticated investors off guard. That's the beauty of diversification. An investor does not have to guess when something bad is going to happen because they are prepared at all times[2].

The real challenge with diversification is having the discipline to stick to a plan, and watching a stock market rip the way it has can very quickly infect an investor with something far more dangerous than fear and panic. These situations put investors at risk of becoming greedy.

Discipline is also one of the most crucial elements to achieving long-term financial objectives. We must learn to control our emotional responses and not do things like chase an investment just because it continues to climb higher. It's the difference between managing risk and taking it.

THE DOWNWARD SPIRAL

Do not interpret any of this as a warning about an impending market top or the beginning the next recession. Nothing could be further from the truth.

The innovation and entrepreneurship that is driving the world economy, particularly here in the U.S., has just begun. The advances in technology and medicine alone are going to change the world more than once over the next decade.

Furthermore, the last thing the Fed wants right now is another recession, so their shift in monetary policy over the last 18 months should not be interpreted as a desire to slow down the economy. If anything, this should only help it grow faster.

The point here is that building a large allocation to stocks should not be completely predicated upon an investor's expectations for future returns. Meaning, just because an investor thinks stocks are going to rip higher does not justify a shift in strategy to buy more stocks. Other factors must be considered such as age, risk tolerance, and income needs.

There are instances where a 100% stock allocation is justified and others where 0% is appropriate. It just depends. A 22-year old saving for retirement has a long runway so it makes a lot of sense for this individual to be heavily allocated to stocks. A major drawdown early on in her career would most likely not impact her retirement.

Why? Because stocks have earned around 10% annually over the long run, so even a 30% drawdown could be back to even in 3.7 years (per the chart above) as long as she does not sell into the panic.

However, a retiree living on income from investments should never put too much of a nest egg into stocks. Neither should a conservative investor. It doesn't matter what the market is doing or where anyone thinks it is going.

If an investor considers themselves to be conservative during times of stress, then that means they must also be conservative during times of jubilation. Changing risk tolerances based on market conditions almost always ends as follows.

A conservative investor wakes up one day and can no longer watch the market go up in his face, nor can he continue to watch his friends keep getting

[1] Source: Global Financial Private Capital, LLC

[2] Diversification does not ensure a profit or guarantee against loss

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richer by the day. He figures that the economy is strong and stocks feel safe because prices keep rising, so he goes "all in" by breaking away from his financial plan and shifting his entire portfolio into the stock market.

Eventually, something bad happens. Either a volatility spike over a meaningless event causes short-term traders to ring the register, or even worse, the economy overheats and the Fed raises rates to the point where a recession rears its ugly head.

The market falls hard and fast in the proverbial elevator, and the investor becomes fixated on understanding what is happening and why. He then turns to the worst possible source of information, the television, to gauge the severity of the downturn. Financial news networks do nothing but throw gasoline on this emotional fire and convince him that stocks are headed to zero.

After losing one too many sleepless nights, the investor just wants the pain to go away. He cannot watch his portfolio fall any further, so he makes the worst possible move at the worst possible time. He sells into panic and converts his short-term pain into long-term misery.

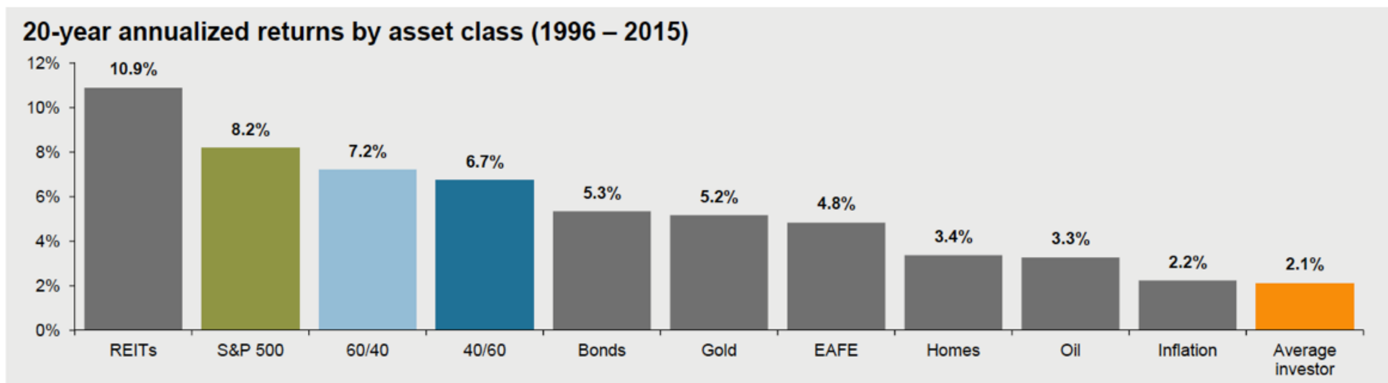
Making matters worse, the scars from watching his nest egg get whacked result in a distrust and hatred for stocks. Instead, he chooses to play it safe until the stock market calms down, which earns him such a small return that it takes even more years for his portfolio to recover (per the chart above).

By the time the market feels "safe" again, it will have already recovered after several years of strong returns climbing the proverbial escalator. Then, the cycle starts again. This exact scenario is what has fueled the orange bar in the sobering chart below.

The average investor (orange bar) earned a fraction of a balanced portfolio (both blue bars) over a 20-year period. Two big reasons why individual investors have seen such paltry returns are they chase performance and sell into panic just like our fictitious investor above.

IMPLICATIONS FOR INVESTORS

Still to this day, I get asked why so many people lost so much money during the financial crisis, and my answer remains the same. It wasn't the banks, rating agencies, hedge funds, or even the media. Plain and simple, investors lost money because they sold.



Source: J.P. Morgan Asset Management; (Top) Barclays, FactSet, Standard & Poor's; (Bottom) Dalbar Inc.
Indexes used are as follows: REITS: NAREIT Equity REIT Index, EAFE: MSCI EAFE, Oil: WTI Index, Bonds: Barclays U.S. Aggregate Index, Homes: median sale price of existing single-family homes, Gold: USD/troy oz, Inflation: CPI. 60/40: A balanced portfolio with 60% invested in S&P 500 Index and 40% invested in high quality U.S. fixed income, represented by the Barclays U.S. Aggregate Index. The portfolio is rebalanced annually. Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. Returns are annualized (and total return where applicable) and represent the 20-year period ending 12/31/15 to match Dalbar's most recent analysis.
Guide to the Markets – U.S. Data are as of December 31, 2016.

Index returns do not reflect fees or expenses. You cannot invest directly in an index.

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I could never prove it, but I would bet that in the overwhelming majority of cases of panic selling, if I were to look into each victim's portfolio before the depths of the crisis and compared their holdings to their risk tolerance and return objectives, the allocation to stocks would be way too high.

I have no idea what will happen to the stock market over the next six months. It could go up another 10% or it could fall 15%. The short-term movements in markets are fueled by emotions, and since emotions cannot derail $19 trillion economies, I don't feel the need for a crystal ball.

What I do know is that if stocks do continue to climb higher, the fear and panic that has persisted for all these years since the crisis will eventually get entirely replaced with greed and euphoria.

Those investors who are not suited for large allocations to stocks simply must not take the bait. Make sure that your asset allocation aligns with your risk tolerance and return objectives in good times and bad. There is simply no other way.

The bottom line is that discipline is what helps investors achieve their long-term goals, and it takes just as much discipline in a rising market as it does in a falling one to stay on course.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer,
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