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INVESTMENT ADVISORS

INVESTMENT PERSPECTIVE – FOURTH QUARTER 2018

"Saving is a great habit, but without investing...it just sleeps." - Author - Manoj Arora

STOCK MARKET RISK: GREATER BEING OUT THAN IN

In the last couple of newsletters, we discussed factors affecting equity market volatility and the need for patience in a long investment time horizon. We emphasized that while market volatility may feel like risk in the short run, this volatility provides long-term investing opportunities. In client meetings we are often asked *"Is the stock market going up more, or is this bull market over*?" This complex topic is by far the most discussed and is often misunderstood. In this *Investment Perspective* we discuss *risk* and *opportunity* *from an investor's perspective* with a view toward individual risk assessment and time horizon.

Risk, or the Perception of Risk?

"The biggest risk is not taking any risk... In a world that is changing quickly, the only strategy that is guaranteed to fail is not taking risks." - Mark Zuckerberg, CEO of Facebook

Investors are typically interested in both capital preservation and growth of their portfolio. Many believe they are eliminating risk by avoiding the stock market altogether or by specifying a low allocation to stocks to create a portfolio with little volatility. This is often perceived to be "safe."

However, in the long run, avoiding the equity market to maintain "safety" creates another very significant risk to the overall goal of protecting and growing wealth: *Purchasing Power Risk.*

Purchasing Power Risk is the risk that the *value* of wealth is eroded by inflation. Inflation has been relatively tame in the last several years but has begun to crop up again as the economy is near full employment, wages are growing, commodity prices are increasing, and global demand is strong. The July 2018 annualized inflation rate was 2.95%, but even in relatively low inflation environments, inflation slowly dissolves wealth – the average annual inflation rate in the last 10 decades has been 3.22%[1].

That doesn't sound too bad until we realize, at that rate of inflation, prices double roughly every 20 years: **today's dollar will be worth the equivalent of $0.50 cents in twenty years**. In a mere five years, $1.00 will provide ~ $0.83 cents of today's purchasing power.

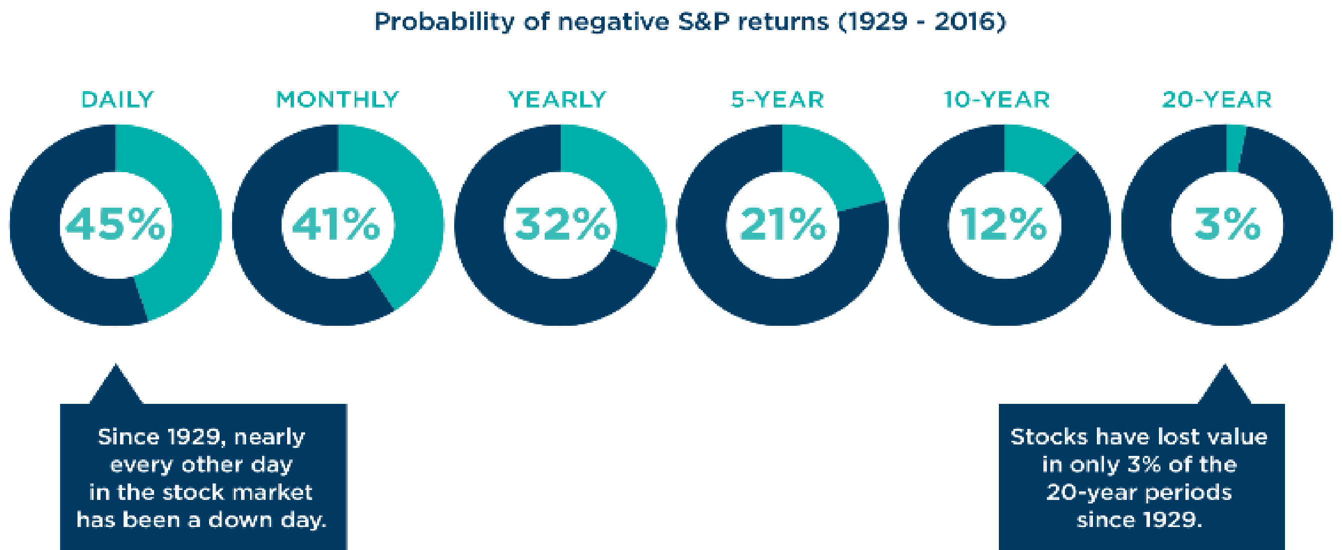
This rapid disintegration of purchasing power over time is truly a destruction of wealth. From an investment perspective, the supposed safety of "keeping money under the mattress" (or a bank account paying extremely low interest rates) is actually not so safe and is a very risky strategy relative to long-term preservation of purchasing power. To overcome the effects of inflation it is important for investors to have an adequate amount of investments that grow faster than inflation in their portfolios. *Historically over the long-term, equities outperform fixed income instruments like bonds, bank deposits and money markets, and grow faster than inflation.* Equity investing is an important part of wealth management – while also producing more volatility than the fixed income arena.

[1] Source: Inflationdata.com

Stock Market Volatility Does Not Equal Risk

"When an investor focuses on short term investments, he or she is observing the variability of the portfolio, not the returns – in short being Fooled by Randomness." – Author - Nassim Nicholas Taleb

Stock market volatility is much greater than that within bond markets or cash. While volatility is often unsettling in the short term, it does not translate to greater risk in the long-term. The following chart illustrates the importance of time horizon when investing in stocks:



Source: Bloomberg

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The above chart illustrates that historically, in any single day in the stock market, there is a 45% chance of a loss, and within any single month there has been a 41% chance of a market loss. However, within the last 80 years, in <u>any</u> 20-year period there has only been a 3% chance that the S&P declined in that period – or said differently, the market has been up 97% of the time with that investment time horizon. Normalized equity returns have been in the 5%-8% per year range historically, while the 10-year bond rate currently yields ~3.2%, roughly equal to inflation. **Conclusion**: With a goal of preserving purchasing power, portfolios should include an adequate allocation of stocks, or real wealth can be destroyed.

"There is an old Wall Street adage: 'You can eat well or sleep well.' If you invest in a diversified portfolio of stocks, over the long run, you will eat well. But, you will experience some sleepless nights when the equity markets are volatile." - Robert Johnson, American College of Financial Services

Investment risk is much greater than the month-to-month volatility of the stock market and investors with long-term objectives are better served to ignore short-term volatility and to focus on managing other risks within their financial plan, such as preservation of purchasing power and the risk of outliving savings. As your financial advisor, it is our objective to work with you to assess changes in risk tolerance and adjust your portfolios accordingly to maintain financial goals. This regular exercise balances short-term liquidity needs with those of long-term wealth preservation and growth.

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Conclusion: The portfolio management objective is NOT to eliminate market risk, but to manage it.

Mickey Mantle Investing

"If I knew I was going to live this long I would have taken better care of myself." - Mickey Mantle

Famous baseball slugger Mickey Mantle died at the very young age of 63 but expressed regret in his later years about how he had lived his life and is known for the above quote on longevity. In the last several decades, the lifespan of the average American has grown to 79 years, up from 70 years in 1970, given the improvements in lifestyle and healthcare.

This significant elongation in lifespan over the last several decades radically challenges traditional notions of appropriate equity exposure at various ages and investment time horizon. It is appropriate for some investors in their late 60's and even well into their 70's to continue to have significant equity exposure to adequately address wealth preservation over an elongated lifespan.

Overall, we believe investors often misinterpret risk and that a long-term strategy including an appropriate mixture of equity investments (stocks) is an important part of a long-term wealth preservation and growth plan. Getting back to the complex question posed in the first paragraph:

"Is the Stock Market going up more, or is this bull market over?"

We do not know. No one does. But *based on historical patterns, given a long-term time-horizon, it's generally better to be in the market not out of the market.*

We continue to invest in equities for several reasons, but mostly because the long-term normalized returns of equities significantly exceed long-term fixed income investments (e.g. 10-year US Treasuries at 3.2%) which barely preserve buying power and do not create significant value. While recognizing that some clients need a fixed income component of their portfolio for liquidity needs, we continue to favor shorter-term bonds in the current environment.

The broad U.S. equity market remains relatively inexpensive on a macro basis, at 17x 2019 earnings, and we continue to focus on purchasing quality companies at prices below their intrinsic value that we believe will perform well over the long-term.

If you want to discuss portfolios, risk, volatility, time horizon, or any new developments in your financial life, please do not hesitate to contact us.

Best regards,
Joe

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