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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Client FAQs: Your Latest Questions Answered

Q The stock market has done nothing but rise for many years now. Do you think that means the risks have gone down?

We are still experiencing what is being widely reported as the second longest stock market rally in history. We are well beyond average in both length and size of this rally. It may seem counterintuitive, but the longer a rally continues, the more risk actually INCREASES, not decreases. The notion of a "strong" market speaks more to the current momentum that stocks have rather than their future return potential. Put simply, stocks are riskiest when their price relative to underlying economic and corporate fundamentals is high and in contrast are probably the safest (over the long term) when their price relative to these fundamentals is low. More times than not, this means that after a long steep run in markets, risks are highest.

Since risk can be a very hard concept for most people to grasp, it's important to define it. In the context of expensive stock market valuations, we define risk as the dramatically reduced return potential over the following 10 years. This often means one or a series of steep price declines followed by recoveries that leave investors just about where they started – similar to the period from 1999 – 2009. When prices are high, this difficult process of getting back to average is the very definition of risk we're referring to.

Q Did you get a lot of calls from clients in February when investment values went down?

We tend not to get many client phone calls when markets decline and the first couple weeks of February were no different. We believe we have been keeping clients well informed about the potential for investment losses, especially in the stock market, so when we do hit rough patches, they are already prepared for them. We feel it's important to stress a big picture view of markets as well as what clients should reasonably expect to happen in markets going forward. Most know that markets could drop sharply at any time and the fact that their investment portfolios are prepared for this type of thing helps keep emotions in check. This is where having a strategy that is proactive and anticipates these types of market drops can keep us from reacting emotionally as we're going through them. In the end, what happens from day to day or week to week shouldn't matter so long as we're prepared.

The few clients who did call mostly asked if there was anything else we should do over and above what we're doing now. As a result of our planning and communication with these clients, these were largely inquisitive and constructive conversations rather than nervous ones. Some also called to see whether that 10% decline in 9 trading days was the beginning of something bigger that we've been talking about. We'll have to see about that.

Q **Where are the safe places to invest if I'm nervous about the stock market?**

As a reminder, there are no completely safe places to invest, as nearly all investments have the potential to lose value at times, but there are almost always some investments that are relatively safer than others. The first step in the process is to identify those places that are most expensive and therefore present the most risk of loss over longer holding periods. Currently those are the world's stock markets, particularly the US stock market.

The next step is to identify those places that offer more value from a risk/reward standpoint and that have a better chance of holding their value or appreciating over time. When stocks and other risky assets decline in value, especially over a short period of time, we expect the traditional safe havens like US Treasuries to hold up relatively well. Although US Treasuries also dipped initially in February, the worst stock market day saw Treasuries increase in value, which showed us that when real stock market fear hits, investors seem likely to still seek out those traditional safe havens. This next time around we believe it could be similar.

We also believe precious metals may have a chance to attract dollars that would be leaving the stock market looking for a better home, and we have recently added to those positions. In addition to being a traditional safe-haven asset that tends to attract capital in uncertain times, precious metals (along with other commodities) offer much better relative value than most other asset classes at the moment. As a result, shares in companies that mine for gold and silver also appear attractive. As we mentioned however, regardless of how attractive an investment looks over longer periods, the short term is anybody's guess. Investors have to expect volatility along the way. Unfortunately, it's just the reality of today's investment environment.

Q **If I am not invested in the stock market, am I missing out on these returns forever?**

Any investor who has not been 100% invested in the stock market since March 9, 2009 has missed out on some amount of stock market returns. However, everyone knows very few people should ever be 100% invested in the stock market. Therefore, we are going to miss out on some amount of returns during any period where the stock market outperforms other investment areas. Whether it's the U.S. stock market or something else, there will always be an investment that outperforms what we own – this is an important concept for investors to grasp. If the risk of an investment or asset class is too high, then we shouldn't own it in full. It's that simple.

However, although stocks have rallied considerably since 2009, historically they've also been really good about aggressively falling back to or below the starting points of rallies, especially on an inflation-adjusted basis.

For example, the last stock market crash, which bottomed out in March of 2009, reached a level first achieved in January of 1997, wiping out over 12 years of stock market growth. On an inflation-adjusted basis, it wiped out nearly 14 years of growth.

But that's not the worst; not by far. When the stock market bottomed out in December of 1974, it wiped out over 13 years of growth. However, on an inflation-adjusted basis, it bottomed out in July of 1982 and wiped out 81 YEARS OF STOCK MARKET GROWTH.

So even if you feel like not fully participating in the stock market has reduced your returns, the potential for a crash leading to a multi-decade loss of value is higher now than it's ever been, and taking less risk over this bull market could lead to a very important preservation of capital when the market does finally turn aggressively lower.

Q **Is the economy doing as well as it sounds like it is?**

It's been doing reasonably well, but the true picture isn't nearly as pretty as some would make it out to be. We've had growth, but it's been well below average. In addition, what growth we've had has taken incredible amounts of stimulus to produce.

There are numerous ways to assess the health of the economy. Some of these, like the unemployment rate and consumer confidence, point to the economic growth that has already occurred. Although they have been fairly strong recently, they are lagging indicators and are better at predicting the end of bull markets than the continuation of them.

The Institute for Supply Management's Purchasing Managers' Index, an indicator of the economic health of the manufacturing sector, also points to recent growth in the economy. Anything over 50 represents economic expansion, and it currently stands at ~60. Since this indicator is lagging however, it tells us more about what's already happened than what's to come. If anything, due to its cyclical nature, one could argue that economic activity is probably more likely to weaken from here than strengthen further.

In support of the argument for a weakening economy, the Atlanta Fed keeps a running "best guess" based on the same data the Commerce Department will use for the official estimate of Gross Domestic Product (GDP). A few weeks ago they were estimating annualized growth for Q1 2018 of 5.5%, but have since revised it downward numerous times to the most recent "guess" of 1.8%. With a couple weeks to go until the end of the first quarter, we'd be surprised if it wasn't reduced even further. The moral of the story: not only is GDP hard to forecast using traditional economic data, but if the Atlanta Federal Reserve is right, and GDP comes in at ~1.8% for the first quarter, this is anything but strong.

Finally, another indication the economy isn't in great health is the high amount of debt that has been used to fuel the past nine years of economic growth. Since the financial crisis, consumer, corporate, and government debt levels have all increased. U.S. government debt levels alone have ballooned from $10 trillion dollars to over $21 trillion dollars – more than double in roughly ten years. Given that government spending contributes to GDP, without this increase in debt, one could argue that the economy has actually been in decline. The fact that the economy is unable to grow without the use of unprecedented amounts of debt is troubling to say the least.