▶ Ask Cadence: Your Latest Questions Answered 1-5

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Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

Ask Cadence: Your Latest Questions Answered

Q If I haven't participated in the stock market gains over the last couple years, will my retirement be negatively affected as a result?

Put simply – no, and here's why. Think about it this way: Stocks at any point in time can be ranked on a scale of one to ten based on how expensive they are. The vast majority of the time, they'll score somewhere between 3 and 7 where they're neither cheap nor expensive. This is where one can have a traditional exposure to stocks based on the timeframe of their goals and risk tolerance. If stocks are scored below 3 and considered cheap, one might take a little more "risk" since over time prices stand a much better chance of being higher than lower. When price is low, there's a margin of safety.

On the other hand, when prices are over 7 one could be forgiven for having less exposure to stock since we know from history and basic math that at some point stock prices will settle back down. At present, U.S. stocks are scoring a 10 and they have been for the last couple of years. There is simply no margin of safety. In time, and we're seeing this play out this month just as it did in February, prices will begin reverting lower. Knowing when this begins and how it plays out is impossible, which makes participating in late-inning market gains extremely perilous.

So, in the context of valuation, missing a couple good years when markets are cheap or even fairly valued would be hard to make up. This is because at reasonable price levels, we have no reason to believe that large losses associated with mean reversion are coming. As a result, gains made from reasonable price levels usually stick and don't evaporate over longer periods of time.

However, and this is extremely important to remember, stocks are not currently cheap or fairly valued. Any gains markets have experienced lately will likely vanish when prices come back down to earth as they always have. For example, had one missed out on the final two years of the bull market leading up to 2007, it would have cost them 33% in gains. However, from the peak in October 2007 through the market's bottom in March 2009, the S&P 500 was down approximately -55%. So the question is, how important would those 33% in gains

have been to your retirement if you then went on to lose -55%? The answer is not very important. The total return (or loss in this case) from October 2005 until the market low in 2009 would have been -42% even after taking into account the 33% gain in the final two years of the bull market.

The moral of the story is when stocks or any investment for that matter are too expensive, the chances are good that upcoming losses will wipe out any gains made in the short term. No, your retirement has not been set back if you haven't fully participated in the stock market over the last few years. If anything, it may end up being more secure as a result.

If everything is down, even bonds, where should I invest?

In times of market turmoil, when stocks are down and bonds are taking losses it seems like there is no safe place to be. But as we've mentioned before, it is important to remember that every asset class can go up or down in the short term. So what should one do?

First, take a few steps back and look at the big picture. What are you saving/investing for and when do you need the money for that goal? Most goals our clients are investing for are long-term goals, so stick to your long-term plan and keep disciplined with your investment asset allocation. That means when you work with your advisor and re-balance, assets that have grown bigger than their original allocation are sold and assets that have dipped below their original allocation are bought. You may have heard the phrase, 'buy low and sell high'. That's what re-balancing does. While there are no guarantees re-balancing will immediately add to returns, often in the long run it does. And over the long term as assets go back to their historical average returns, your long-term goals will come into much clearer focus.

Second, resist the 'fight or flight' urge. 'Fight or flight' served our ancestors well who must have made the right decision back in the day or we would not exist today. But it is a bad investment strategy. When an asset is down, human nature says to run away or 'sell'. And when an asset has been running up, human nature says we are missing out so we must fight for it or 'buy'. A classic example of this is Bitcoin, which ran up in a little over a month from $5,857 a coin on Nov 12, 2017 to $19,343 a coin on Dec 16, 2017. At the time of this writing, one Bitcoin goes for about $6,400. Ouch! So forget what Mother Nature taught us to survive and resist the urge to 'buy high and sell low'. It's not a winning investment strategy.

Third, add some non-traditionally correlated asset classes or alternatives. Some examples are real estate, metals, managed futures funds, global macro strategies, absolute return funds, and long/short funds. The reason these assets can help is that they are not highly correlated to the market and can provide good diversification in times where both stocks and bonds may not be doing well. If you work with us here at Cadence, we've incorporated many of these strategies already in your portfolios to help you through times like we are going through right now.

In summary, unfortunately there are times where both stocks and bonds as well as other asset classes can be down at the same time. To navigate through this, keep the following good practices in mind:

- Focus on your goals and stick to your long-term plan
- Periodically re-balance – 'buy low and sell high'
- Resist the primal urge of 'fight or flight' to keep yourself from 'selling low and buying high'
- Have some non-correlated asset classes as a part of your portfolio mix

How high can rates go? Do we expect them to keep going up? Are rising rates always a bad thing?

There's much debate currently about the future direction of interest rates. As consumers, we certainly have an interest in rates staying low – it makes it easier to borrow and buy things that we either need or just plain want. On the other hand, as savers, we'd prefer if interest rates were high. The ability to get 5% return on a FDIC insured CD would be great for many retirees. Talk about mixed emotions. This is one of the reasons why the debate about where interest rates should be is often a spirited one.

What makes the subject all the more confusing is that there are different types of interest rates – short and long term – that are influenced by different factors. When it comes to the Federal Reserve and its interest rate policies, most of the work it does in raising and lowering interest rates is on the shortest of maturities. So, when the Fed raises interest rates, the result is an increase for rates that are very short term in nature.

How longer-term interest rates are affected by this is much less direct and predictable. Additional factors at work as we move further out in duration include credit-worthiness of the borrower, inflation expectations, growth expectations, currency value, etc. Although it's possible for central banks to influence longer-term interest rates via the direct purchase of bonds on the open market, this behavior isn't considered to be "normal" and its effects are far less direct and predictable than at the shorter end of the maturity spectrum. So, the Fed traditionally has more control over short-term rates. As such, just because the Fed is raising short-term interest rates, it doesn't necessarily mean long-term rates will go higher.

So where are longer-term interest rates going? Since there are many factors at work that are incredibly hard to predict, this is very hard to know. As we've seen this year, the 10-year U.S. Government bond yield has risen from ~2.40% to ~3.13% which has had a direct impact on things like car loans, personal loans, and mortgages. This is a fairly significant move that is likely attributable to some combination of stronger economic growth, higher inflation, and the deterioration of the fiscal situation in the U.S. In other words, all of these factors – or at least the perception that they are present – have lined up in the same direction to push rates higher.

What happens however if the economy slows and inflation forces ebb? In addition, what if U.S. stock markets start to contract sending capital in search of a "safer" place to hide out such as U.S. government bonds? There is a very real possibility that these things play out in the coming months and years which could very well exert downward pressure on interest rates here at home. If the demand for U.S. government bonds is high enough as a result of a stock market swoon and if inflation pressures ease enough due to a downturn in the economy, these forces could override the not so rosy budget deficit trends backing the very bonds in question. In this type of scenario, it's reasonable to think it would be very difficult for our economy to function successfully with rates much higher than they are now. Simply put, the fiscal situation at just about every level – consumer, corporate, and government – just isn't strong enough to be able to carry on at current levels with higher interest rates. Therefore, much like rates stayed lower in Japan for much longer than people thought possible, it's likely they do the same here at home.

This doesn't mean they won't bounce around in the shorter term. In fact, we fully expect them to as conflicting narratives play out within markets.

To what extent does news affect financial markets?

It may not surprise you that there is no perfect relationship between what the media reports and what the markets do. There are days where it seems like the news is good but the markets decline, and vice versa. So what is really going on?

The typical news delivery process is "Attract Attention – Convey Information – Influence Opinion". One of the big failings in this process is that frequently the information that grabs the headlines in an attempt to attract your attention isn't actually news, but noise. Research suggests that consumers of financial news media frequently over-react to noise by buying or selling when they shouldn't. An attention-grabbing headline might not lead to any real actionable information, yet action is taken anyway.

For example, consider the recent headline on CNBC "DOW loses 500 points". That makes quite the eye-catching headline, wouldn't you agree? But what do you do with that information? Do you sell? Do you perhaps buy? You can probably see that is not actually actionable information, yet many people will read a headline like that and buy or sell some stock. Likewise, true actionable information about a company's earnings or future prospects is frequently buried and does not come with catchy headlines. "Caterpillar Earns $0.01 Above Expectations!!" is not the kind of headline that gets written and put on the top page, but that has the potential to be news where the DOW headline is noise.

In recent times, two developments have magnified the effect news has on the financial markets. The first is algorithm-based trading, where supercomputers receive and process vast amounts of information and make buying and selling decisions in fractions of a second. These computer models have included more and more financial news stories as part of their inputs, and as a result have the ability to move the markets quickly, especially to the downside, before anyone knows what is happening. On April 23, 2013 someone hacked an Associated Press Twitter account and reported that there were explosions at the White House. Within moments the Dow had dropped 147 points, 1% at that time, and it took 7 minutes to recover. This may seem like a tornado in a teacup, but when people put stop orders on market-based indexes, an event like this can cause their positions to automatically sell out and not be in the market for the recovery; a 1% loss was locked in within minutes, but nothing really even happened. One or more computer algorithms processed that story, sold DOW positions which caused other algorithms to also sell, and by the time it was all sorted out, the damage was done.

Which brings us to the second media magnifying development over the past few years: social media. The account that got hacked in this case was not a major newspaper's site, but a Twitter feed. In years past, only major news sources were breaking stories. Now, just about anyone can do it, and this news can move the markets. On August 13, 2013, Carl Icahn made an announcement about his Apple position over Twitter. Within minutes, Apple stock shot up, gaining $17 billion in market cap, making Carl Icahn even wealthier.

Investment strategies should be based on the right mix of risk and reward based on the investor's risk tolerance, goals, and timeframe. News stories come and go, only to be replaced by more news stories that come and go. By the time the media reports on the next bear market, it will be too late for investors. Sticking to your investment strategy while the news and noise swirls around you is the best way to stay on course to your goals.

How does today's geopolitical environment influence markets?

There's no question that geopolitical headlines can affect markets on any given day. An escalation of tariff disputes with China, a change in tone coming from the European Central Bank (ECB), tension with our allies in the Middle East – all of these things have the potential to move markets. What's incredibly difficult to ascertain however, is in what direction. A funny thing happens in markets sometimes – news that should be bad for markets can have the opposite effect. In a world of central bank intervention where interests are strongly aligned with higher asset prices, sometimes bad news can be followed by, you guessed it, intervention. As a result, geopolitics can have very counter-intuitive effects on market movements in the short term.

Over the longer term however, what's most important is how these particular geopolitical themes might impact economic activity here at home and globally. Could an all-out tariff war with China lead to more expensive goods here at home which could hamper the U.S. consumer? Would a reduction in bond purchases from the ECB cause rates to rise toward more normal levels and thus cause disruptions in credit markets and the economy as a result? And how about tension with Saudi Arabia? Could that lead to less investment capital flowing into the U.S. and therefore less support for capital markets? Longer term, all of these issues present risk to the economy and markets.

Most important however is whether or not asset prices are vulnerable to begin with. Unless you're a first-time reader, you know very well that stock, bond, and real estate prices here at home are super expensive on a number of levels. So yes, they are vulnerable to any type of ripple caused by geopolitics or otherwise. This is the important point to remember. When asset prices are stretched, if it's not one of the potential risks that we see on our radar that causes problems for markets, it'll be another one that we don't see. When capital markets are priced for perfection, it's just a matter of time before something causes that first domino to fall.

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