▶ Losses Get No Respect 1-2

▶ Recent Market Dip In Context 2-3

ISSUE 6 | VOLUME 7 | DECEMBER 2018

Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Losses Get No Respect

When it comes to investing, everybody thinks about progress in terms of returns. This makes sense since without them financial goals are much harder to achieve, but very little time is spent thinking about losses and the role they play in achieving (or not achieving) those longer-term returns. Even when looking at most financial plans – whether simplistically crude or detailed – usually there's some assumption for returns achieved based on a pre-determined risk tolerance. Aggressive investors usually assume higher returns while those with a more conservative predisposition will assume lower, safer returns. We'll address the fatal flaw of assuming that aggressive equals greater return another time, but the point here is that the focus tends to be on the return even though losses often times determine whether or not that return is even possible. Losses get no respect, but they should.

Here's why they should and why investors should always think about how losses could impact their long-term return assumptions. First, the math behind losses works differently than most think. Since after a loss, one is left with a smaller amount of money than before, it takes a larger subsequent gain to get back to even. Not a big deal with small losses, but for larger ones the math gets crazy. A 10% loss requires an 11% gain to mend all the losses, but a 50% loss requires a 100% gain to make one whole again.

For example, if we start with $100,000, losing -10% leaves us with $90,000. To gain that $10,000 back from a new base of $90,000 requires an 11.1% return. Bring that loss to -50% and our initial $100,000 investment drops to $50,000. Gaining that lost money back on our new, significantly lower base of $50,000 necessitates a 100% return. Take it to a 60% loss and we're looking at a 150% gain to get back to even! Getting back to our $100,000 starting point from $40,000 demands a $60,000 investment gain. Yikes. Just to highlight how damaging this particular scenario would be, think about the fact that the additional 10 percentage points of loss (from -50% to -60%) would require an additional 50 percentage points in gain to get back to where you started (100% to 150%). It can take years to make 50% in markets

whereas a -10% loss can happen within days. Investors who don't take the time to grasp this concept are at risk of experiencing it first-hand.

In the real world, we've seen countless examples of this math play out throughout history. Most frequently markets experience smaller losses of the -5% to -10% variety. As we've discussed, these aren't a big deal. They're par for the course, to be expected, and easily recovered from. However, the largest of losses throughout history have been at the end of very prosperous periods where markets have performed at their best. These losses tend to be of the -50% or larger variety. These are problematic and extremely destructive when it comes to subsequent portfolio returns. One of the most recent examples is the dot com bubble of the nineties. When it popped, the S&P 500 dropped -50% and took roughly 13 years to recover. Worse, it took about 24 years for the Dow Jones Average to recover from it's 89% decline that began in 1929. That's a 0% return between 1929 and 1954! Keep this in mind; for an "aggressive" investor assuming a high return this 0% couldn't be farther from what he or she had in mind. The large loss up front destroyed any hope of averaging high returns going forward.

It's also instructive to look at how large losses can wipe out gains that investors have already achieved. By late 2008 after a -56% loss in the S&P 500, 127% of gains were wiped out taking the index back to where it was in late 1996 – 12 years prior. Going back to our extreme 1929 example, that -89% drop took the Dow Jones Average back to 1903 by wiping out ~800% of gains! That's 26 years of progress… gone.

Think about it this way. When markets are valued somewhere in the middle of their historical range, large losses are less likely. Investors will undoubtedly encounter lots of the smaller losses and even a few stomach-turning ones, but history has shown us that these losses probably won't last too long. Stock markets are generally predisposed to rise over time along with economic growth. However, and this is crucially important, when markets are valued expensively relative to their historical ranges, the likelihood of large losses goes way up. In fact, you'd be hard pressed to find a time in history when any asset market that's been extremely expensive hasn't come back down in price in dramatic fashion. You simply don't get the abnormally large ups without proportionally large downs. Losses of this variety are incredibly destructive not only to investment performance by the time they've played out, but more importantly goals, lifestyles, and the ability to maintain financial independence. So please, take them seriously. Think about them just as often as you think about returns. They're just as important a piece in the overall puzzle as returns themselves. They deserve respect.

Recent Market Dip In Context

With the S&P down -6% from its peak in September, some experts are talking about how previously expensive stocks are now cheap and represent a good buying opportunity. This 6% discount to what the price was not yet two months ago is now a bargain. Pardon us for being direct, but this is pure lunacy. It's an opinion/observation that is biased in so many ways – some at an unconscious level, others not. Either way, a 6% drop from extremely elevated levels is insignificant.

There are two points to keep in mind here. First, when the market as a whole is priced at more than 250% of its long-term historical valuation level (this should be no surprise to our readers), that means prices need to come down at least -60% to get back to AVERAGE, and since individual stocks represent the market as a whole, most stocks need to come down by this amount too. So, from a valuation standpoint, which has been the key determinant of long-term investment returns throughout the duration of market history, a 6% decline is literally a drop in the bucket. If what

we're experiencing right now is the beginning of the next bear market, which we're long overdue for, we could have much, much farther to go.

Second, and this is where the "funny math of losses" comes in, if we're expecting a larger decline, then what's remaining isn't as simple as subtracting what's already happened. For example, let's say we were expecting a -60% decline from the market peak to get back to average valuation levels. Starting at $100,000, that would take our (stock market) portfolio down to $40,000 by the end of the decline. Since the market's already down -6% from its peak, we would assume that we only have -54% to go, but that assumption would be incorrect because when it comes to losses, basic math has it out for us. The -6% loss takes our $100,000 down to $94,000, but if this is just one stop on the way down to $40,000, then we have $54,000 to go. A $54,000 loss on a new starting amount of $94,000 represents -57.5%, not -54%.

So, what does this mean in the real world with real money? It's simple. Buying the market or that hot stock because it appears to be on sale now that it's fallen in price by -5%,-10%, or even -20% could still lead to huge losses. Buying decisions should be based on forward-looking factors such as likely economic and market conditions ahead based on where we are in these respective cycles, as well as fundamentals such as valuations and whether or not they are appealing. They should never be based solely on backward-looking factors such as where the market or stock was trading. This is a recency bias trap that assumes where prices were made sense and was justified. In our example here, the price of the market and most stocks in it before the -6% drop did not make sense based on fundamentals and was absolutely not justified. A bargain, the market is not. Not yet anyway.

Important Disclosures

This newsletter is provided for informational purposes and is not to be considered investment advice or a solicitation to buy or sell securities. Cadence Wealth Management, LLC, a registered investment advisor, may only provide advice after entering into an advisory agreement and obtaining all relevant information from a client. The investment strategies mentioned here may not be suitable for everyone. Each investor needs to review an investment strategy for his or her own particular situation before making any investment decision.

Past performance is not indicative of future results. It is not possible to invest directly in an index. Index performance does not reflect charges and expenses and is not based on actual advisory client assets. Index performance does include the reinvestment of dividends and other distributions

The views expressed in the referenced materials are subject to change based on market and other conditions. These documents may contain certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected. Any projections, market outlooks, or estimates are based upon certain assumptions and should not be construed as indicative of actual events that will occur. Data contained herein from third party providers is obtained from what are considered reliable sources. However, its accuracy, completeness or reliability cannot be guaranteed.

Examples provided are for illustrative purposes only and not intended to be reflective of results you can expect to achieve.