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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Look Before You Leap: Getting More Aggressive At The Wrong Time Can Have Lasting Consequences

In our December 2013 issue of Clips, we discussed how safer investments such as bonds and alternatives have struggled, but that doesn't mean they're any less valuable to us going forward. They are there for protection against market turmoil which has and always will be a part of investing. We've seen the benefits of those types of defensive positions over the first month of 2014 very clearly as stocks ran into their first bout of difficulty in quite some time with the Dow Industrials down over 5% and the S&P 500 down over 3.5%. As opposed to facing losses, most of the traditionally lower risk investments that got beaten up last year were up nicely in January.

In our January Cadence Clips, we looked at long-term market cycles after adjusting the S&P 500 for inflation and deflation. Interestingly, what we observed is something that is very consistent with most of our other somewhat more complicated market research, which is that stocks are significantly overpriced relative to their longer-term averages. Put simply, this means that returns from stocks on a forward basis are likely to be much lower than what we've grown accustomed to and more important, what most investors are expecting and depending on. Although we hope we're wrong and we can sustain above-average growth rates indefinitely, basic laws of economic and market cycles as well as simple math suggest this can't continue, just as they've suggested this many times in the past. From a planning standpoint, this means that if we invest heavily in stocks and expect to earn 7, 8, or 9% returns in our portfolio, we may come up well short of our long-term goals. We believe it's wise to consider a different approach if we're depending on those types of returns to get us there.

So Where Does That Leave Us Now?

As wealth managers, we typically have two types of conversations with people at this stage in a bull market cycle. For most, after having a discussion about the current state of stocks versus their historical averages, they understand the risks that are inherent in investing too aggressively after so long a bull market cycle. Thus, they see the logic in being more conservative and focused on principal preservation. That doesn't mean it's easy for them to do it as stock markets continue to rise, but they see the logic in it. Others, no matter how long the conversation, simply can't help but feel that they're missing out on returns that will get them to their long-term financial goals faster. As much as they may sense that there's an unusually high degree of risk in increasing their stock exposure, the temptation is simply too great.

Unfortunately, most investors fall into the latter category at this stage in a stock market rally. It's human nature to harbor fear and concern after there's been a significant market downturn or crash and these feelings persist until that point where the market's been rising for long enough to finally convince us otherwise. Feelings of possible regret if we miss out on the opportunity to make money and greed are among a host of emotions at work. Finally we succumb, and oftentimes against our better judgment, jump into the market again or increase our allocation to stocks. Look at mutual fund flows at the end of previous bull markets – they always peak just before things get ugly. Look at real estate in 2005 and 2006 - chatter about flipping houses for quick profit and owning multiple properties for cash flow was at its zenith. We saw this same behavior in 1999, when people with no investment experience were talking with other people with similar lack of experience about making quick profit in technology stocks. The list goes on and on. The urge to get invested is typically strongest at the worst possible times.

Two Choices

So an investor today has two very difficult choices. Either they get conservative and start playing defense given they agree with our assessment of the market, or they jump on that wave and try to capture big gains while they last. Let's take a look at how each of those choices could play out over time for two different investing couples. To make for an easy comparison, let's assume their financial situations are identical and are as follows:

Both are age 54 and earn $170,000 combined per year, which allows them to save $22,100 per year into their workplace retirement accounts (this is comprised of 10% of their salaries plus a 3% employer match).

They plan on retiring at 65 and spending $55,000 per year which will increase by inflation at 3% each year.

They have a combined Social Security benefit of $40,000 which we'll assume increases at 1.5% per year, and a $500,000 nest egg in retirement accounts. They will pay an average of 20% in taxes throughout their retirement.

Fred and Wilma

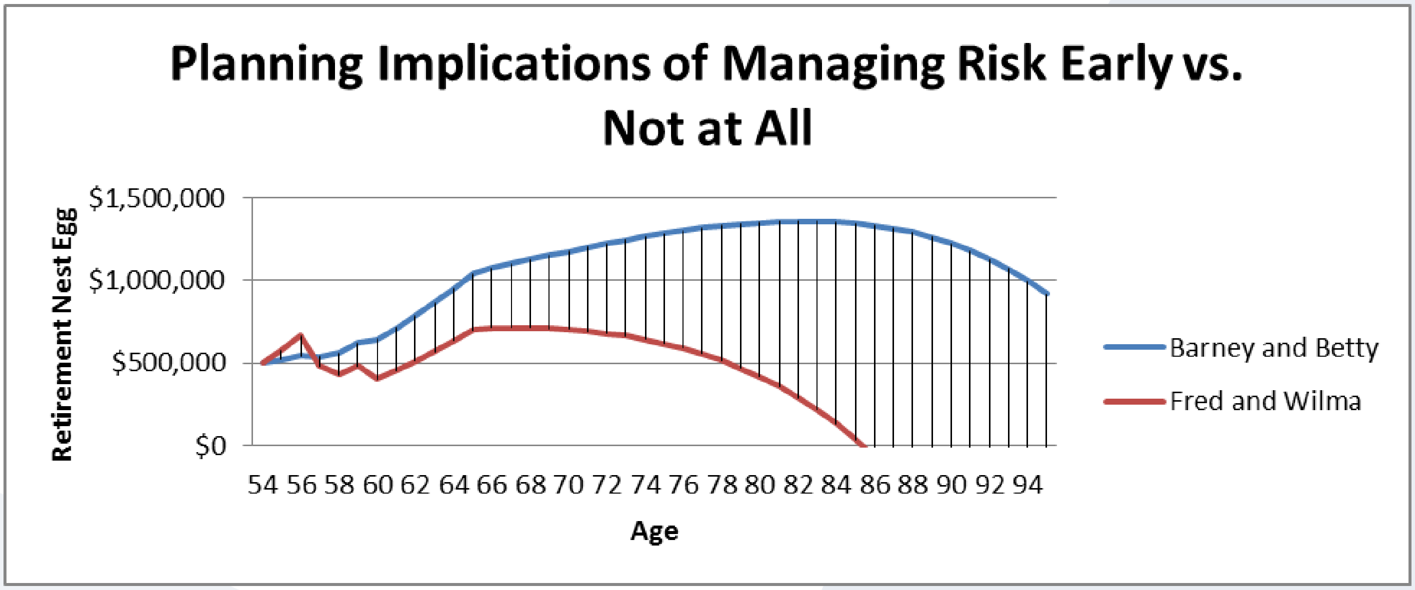
Our first couple, Fred and Wilma, just can't fight that feelin' any longer and decide to ratchet their portfolio risk up a notch or two in pursuit of those high stock market returns. We'll assume they were invested in a moderate risk portfolio over the last two years earning 11%. However after two years of watching the stock market rise, they decide to shift more of their underperforming bond and alternative investments into stocks to capture more gains, with the hope of meeting their retirement goal much sooner. (Because Fred and Wilma didn't do financial planning, they weren't aware that a 7% average return is all they needed to fulfill their retirement ambitions. They were already tracking well above where they needed to be).

Of course, all bull markets must end, just as they always have for as long as markets have existed, and this one decides to break down just after Fred and Wilma increase their stock exposure. Over the course of 4 years, the market declines by just under 50%, then resumes its upward path at an annualized 7% per year. This drop and subsequent recovery is consistent with the end of the last two secular bull markets in the 30's and 70's, if not more conservative. Under this scenario, Fred and Wilma go from being in terrific shape to running out of money at age 86. Although they were able to save $22,100 each year throughout the downturn, the steep losses on their nest egg were too much to recover from.

Barney and Betty

Our second couple, Barney and Betty, get more conservative two years prior to the market turning lower, as they feel uncomfortable with the downside risk to stocks going forward. They understand that timing the end of a bull market is nearly impossible to predict, so they take the approach of getting out early in order to minimize losses before the market corrects. Although it's not easy, they understand that missing out on gains over the short term is far less damaging to their long term plan than getting those gains for a short while only to participate in heavy losses when the market tide finally changes. As a result, they earned nothing over the first two years. Certainly not ideal, but given the conditions in the traditionally defensive investments they chose, that's just how it worked out.

Finally, as stocks turn lower, the risk management strategy they stuck to while the market was going up does a very nice job of preserving their nest egg as those unpopular investments come back into vogue. Of course there's no telling exactly how any type of investment would perform in this type of scenario, but since high quality bonds and alternative investment strategies have actually gone up during past stock market corrections, we're splitting the difference and illustrating what would happen if that risk management strategy only lost 5% throughout the downturn. Again, this is completely hypothetical, but very realistic with the right mix of investments. We then assume that this same portfolio goes on to earn 7% per year on average throughout Barney and Betty's retirement. (This too may be on the conservative side, as this is the same return as the diversified portfolio that Fred and Wilma are invested in. It's very likely that with risk being managed properly and consistently over their lifetimes, returns could be higher with this approach). At age 86, when Fred and Wilma ran out of money under the first scenario, Barney and Betty have $1.3 million in their nest egg, enough to keep them comfortable for the remainder of their lives.



<u>Bottom Line</u>

Although Barney and Betty may have felt like they were losing ground on their goals by focusing on preserving their nest egg a full two years before a significant downturn in the market, it more than pays off in the end. The relative discomfort they feel over that period of time pales in comparison to the discomfort Fred and Wilma face for the rest of their lives as a result of being hit hard when the bull market came to an end. By gaining a good understanding of the stock market relative to history, assessing the risks, and not falling into the emotional trap of chasing returns, Barney and Betty were able to stay on track toward their retirement goals. Unfortunately, this is not the case for Fred and Wilma.

<u>But What if the Correction Doesn't Come?</u>

Here's the good news - Most properly implemented risk management strategies can do well regardless of the market environment since markets will always fluctuate up and down over time. So even if we go another 10 years without a significant market correction, Barney and Betty still have a good chance of realizing their return goal while investing in alternative strategies. The key is not putting all of ones money in cash, CD's, or bonds in an attempt to manage the risk of a stock market loss. Properly managing risk involves utilizing a number of different asset classes AND investment strategies. Just like stocks can have lousy years, risk management investment options can as well, which most experienced over the last year. What's important to remember is that the magnitude of those bad years will likely be much less in these "safer" asset classes than it would be in stocks. History certainly supports that. So Barney and Betty could have their doubts about the "riskiness" of the market and still be served very well by a properly implemented risk management strategy over time. There's simply no need to stretch for investment returns at the wrong times.

Key Takeaways:

- It’s normal to feel the strongest pull to invest in the market toward the end of its rise. Peaks in previous bull markets always show the greatest volume of investor demand – precisely the wrong time to be investing more money in stocks.

- Missing out on gains toward the end of a bull market is far less damaging over the long term than getting those gains only to become part of the subsequent market collapse. What goes up always comes down – No exceptions.

- You may be well served reducing your allocation to stocks and getting more defensive given where we’re at in the market cycle along with a host of other indicators and research that suggests we’re due for a pullback.

- If you’ve been more conservative, don’t let the market convince you to change your investment plan. Remember why it’s your plan to begin with. There’s a good chance that the reasons you adopted it really haven’t changed. If anything, your plan to be more conservative probably makes even more sense now!

- In our case study, minimizing losses by avoiding overexposure to the stock market could give you a $1.3 million advantage in retirement! The long term benefits of minimizing losses apply to everyone, no matter how far from retirement they are.

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