
▶ The Impossible Choice 1-4

▶ Actively Managed Solutions Update 4

ISSUE 5 | VOLUME 3 | NOVEMBER 2014

Cadence clips

FOCUSED ON WHAT MATTERS MOST.

The Impossible Choice

Making money when the market's rising is fun. The idea that you can take money that you've worked hard for and put it into something that can do the work for you is alluring. Isn't this the definition of an investment? Something you can put your money into that makes money for you? Well, sort of, but it's an incomplete one at best and it tends to be where people get into trouble.

As human beings, we're inclined to feel comforted by markets that have risen for a long period of time – after all, they're working just fine. What could go wrong? We hear quite often from our clients things like, "Stocks are doing well, shouldn't I be more aggressive?" or "I'm willing to get more aggressive as long as we can get out when things start going down". These statements discount the second part of how an investment should be defined – the part that addresses risk of loss. When you make an investment, there is always a risk of loss regardless of how well that investment has performed in the past. In fact, we would argue that the more a particular investment has gone up, the greater it can fall. An investment in something requires consideration of both the potential gain and potential loss that could be incurred without being swayed by the most recent outcomes. Failure to adequately consider the likelihood and magnitude of possible losses can lead to real problems.

Investing in stocks is a decision that should be based on one's tolerance for loss as well as that person's assessment of the attractiveness of stocks as an investment at the time. Generally, the greater the tolerance or "intestinal fortitude" for quick and potentially sharp losses, the more of one's portfolio can be allocated to stocks. However, there are times when an aggressive investor should break the mold of investing in "aggressive" asset classes. If it's one's belief that stocks as an "Investment" don't offer sufficient potential gain relative to the potential losses, then that person may well decide to invest in something else even if it's considered a conservative investment. Just because stocks tend to fit the profile of an aggressive investor, it doesn't mean that they should be the investment of choice at all times. Being aggressive shouldn't be confused with being reckless.

Assume for a minute that real estate is considered a risky asset class. Being an aggressive investor, you decide that real estate is something you should own since you can stomach losses and can wait things out if real estate prices fall after you invest. So you buy that raised ranch next to the toxic waste dump for $1,000,000. Wait, hold on! That doesn't sound like a good deal at all. The reality is, even an aggressive investor who can handle big declines such as those we saw in the real estate crash in 2006 and 2007, wouldn't pay that much for the house in question. Price matters, whether it be in real estate or any other investment category.

The Lead-Up to the Impossible Choice

Jane, an aggressive investor, decides to invest in stocks with a good portion of her overall portfolio after determining that stocks are in fact an attractive long-term investment. Although she knows that stocks can go up and down, she's spent more time thinking about the attractive returns that stocks have gotten recently than about how much they could decline in value. When the market finally goes down by a meaningful amount, Jane will have a decision to make. Does she hang in there and ride things out, or does she sell her stocks? We like to call this the impossible choice, because there's no way for Jane to know if stock prices will continue going down after making the decision. Assuming that Jane did her homework and felt strongly that stocks were a good investment, her best choice is probably to ride things out over the longer term.

Where this decision becomes much more difficult is if a truly conservative investor changed his or her stripes just because stocks have been going up, without the faintest clue as to whether or not they're attractively priced. Let's assume Bill, a more conservative investor, has done just this – he's just joined the fun-loving aggressive club from the boring old conservative clan. He's in the market because he's excited about how the higher returns he's witnessed others getting will help him beef up his retirement plan and get him to retirement quicker. When Bill experiences his first 10% decline, he starts to panic. For the first time, he's thinking about how stocks could also hurt him and reduce the value of his 401k plan. With his 401k being money he can't afford to lose, Bill is faced with a difficult decision. Does he stay put or get out? If Bill swallows hard and stays put, the market could continue to fall, reducing the value of Bill's retirement plan even further. On the other hand, if Bill gets out of the market because he realizes he needs every penny to retire comfortably, the market could go up shortly afterwards. This would lock in his losses, after which he'd be faced with another tough decision – when to get back in.

Most investors like Bill will typically ride out market losses, hoping things will bounce back, until they reach a point where they start to lose hope, and genuinely fear for their financial well-being. What this can lead to is selling toward the bottom of a market decline and not building up the confidence to get back in until it moves much higher. Feeling anxious to make a decision on what to do as the market declines reflects the impossible choice and it's one that every investor that hasn't truly prepared themselves for large losses ahead of time will face. These choices can wipe out gains quickly and destroy long-term returns. They're one of the reasons that Dalbar reports that although the S&P 500 over the last 30 years has averaged 11.1%, the average stock investor has only averaged 3.7%. There's a big gap there and its main cause is not being prepared for market drops when they arrive.

Averting the Dilemma

The best way to avoid putting yourself in this unenviable position is to have a plan for it ahead of time. Expect it will happen and drill down on what you would do at various points of a market downturn. And write it down. This makes it harder for your brain in the heat of the moment to change its recollection of the exercise. Useful questions to ask are:

- Would I feel comfortable buying a 10% market dip or would I be more inclined to do nothing or even sell? The most recent correction last month would have been a good test.
- If I sold, would I buy back in at some point if the market moved higher? Would I buy back in if it moved lower?
- If I hung in there and that 10% correction turned into 20%, what would I do then?

These are just a few questions that could help get the process started. You should consider as many scenarios as possible to make sure you're prepared for everything your investments are capable of dishing out. And put losses in dollar terms to make them more realistic. On a $500,000 401k account, a 20% drop would equate to $100,000 disappearing from your monthly statement. That's typically enough of a loss to get people pretty confused as to what to do next. Let's play out this example a bit and assume first that our friend Bill chose to sell out. If the market went back up afterwards, Bill locked in $100,000 of losses. On the other hand, if the market dropped further, Bill would have felt vindicated for a bit, but still has to make a decision when to get back into stocks. Unfortunately for Bill, if he felt nervous about a market down 20%, he probably completely distrusts a market that's down 40% and doesn't get back into the mix until well into the next market recovery. Either way, the deck tends to be stacked against Bill and there's a good chance that $100,000 loss will be locked in no matter which direction the market moves after Bill sells.

If on the other hand, Bill decides to hang in there a bit, the stakes just get bigger. If the market bounces back, then Bill's escaped lasting damage. If on the other hand, the market declines further, Bill faces the same decision he did before only this time with less money in his 401k plan and more fear and panic behind the decision. At a 40% decline, that's $200,000 that Bill no longer has in his 401k plan to help him pay bills and travel the country when he retires. This decision and the emotion behind it couldn't be a bigger one. Some work out, but as this example and the aforementioned Dalbar study suggests, many don't.

In thinking about how you'd feel and act in these adverse scenarios, it may be a good idea to take a look at how you behaved in the past. A good acid test might be to think back to 2008. How did you feel as the market dropped over 50% from October 2007 through November 2008, and more important, what did you do? If you sold out of stocks when you didn't initially plan to (whether that decision paid off or not), then it's probably fair to say you weren't fully prepared for the drop that unfolded. In preparing for the next market decline, make sure you're being honest with yourself as to how you'd handle it. The allure of big market returns can easily cloud your judgment.

Devising a Plan

Assuming you're unwilling or unable to ride out big stock market losses (which is the case for most people), the only way to dodge or minimize the weight of the impossible choice is to either have a plan that outlines what you will do before or after stocks decline or to employ an actively managed strategy that does it for you.

Devising your own plan for how to handle market ups and downs could take many different forms. For an investor who doesn't find stocks particularly attractive at current prices, he or she may be willing to avoid them altogether until they become more appealing – a surefire way of avoiding the impossible choice. An investor who doesn't feel the same way or just doesn't know one way or the other whether stocks are attractively priced would be better served writing down exactly when they would feel it best to sell out as well as buy back in when markets get shaky. Although there's no telling how this would affect overall portfolio performance, there's a good chance it would be better than making impromptu emotional decisions at the time.

Another effective option would be to utilize a disciplined actively-managed strategy to help navigate through volatile markets. Assuming they're time tested and sound, actively managed strategies can help you with the following:

- Avoid too much exposure to markets that don't have an attractive risk/return ratio
- Sell at pre-determined levels based on factors that matter to the models, rather than emotional ones
- Buy at levels that represent more attractive valuations or that are technically important to the models being used

The nice thing about incorporating this type of approach into your game plan is that it takes the decision-making off your shoulders and makes adjustments for specific reasons based on strict criteria. Again, as long as the strategy is sound and well thought-out, confidence and peace of mind could be the emotions experienced during a stock sell-off rather than panic and anxiety.

Our Approach

If you're a loyal reader of our monthly newsletters, you're well aware that our current analysis of the stock market shows that the potential for making and keeping money isn't big enough to offset the potential for losing it. In general, the result of this is to recommend that our clients place less of their diversified portfolios in stocks than they ordinarily would based on their circumstances and tolerance for loss. When the market finally does experience the normal and healthy "other half" of the cycle by declining, we'll be in a much better position. Rather than wrestle with the impossible choice and make a gut call as to whether to ride out further losses or cut them, we'll be in the much more empowering position of thinking about when to buy more stock (at more attractive prices). This is a decision that's not only much easier to make, but much more lucrative as well.

Complementing the plan for our diversified portfolios are two actively-managed investment strategies that help us navigate the stock markets in a way that seeks to attain stock-like returns over time without all the risk that comes along with that over shorter timeframes. These strategies are very disciplined and driven by specific criteria that allow us to make much more informed decisions either before or while markets are dropping. We don't have to guess or make decisions from the gut when things get scary because we've thought things through in advance. The strategies were built based on the reality that markets can and will decline in value so it won't be a surprise when it happens.

No investment is guaranteed or obligated to provide you with positive returns. The very nature of an investment is that it will provide the chance to both make and lose money over a given period of time. When investing, pay equal attention to the money that could be lost and take the time to think about exactly how you'll react to the inevitable down moves in the market. Translate those moves into dollar amounts and be honest about how you'd be most likely to react. If you can answer these questions accurately ahead of time, and put a plan in place accordingly, then you've already gained a tremendous advantage in achieving the returns you need to reach your investment goals. Have a plan for the next market decline. Make empowered choices, not impossible ones.

Actively Managed Solutions Update

We're pleased with how the two strategies we manage to reduce overall portfolio risk have performed this year. As of October 31, our Market Trend strategy is up 11.4% and our Contrarian strategy 12.9%, while the S&P500 with dividends is up just over 11%. More important, the months where the S&P500 was down were much less volatile to the downside for both strategies, illustrating their diversification benefit to an overall portfolio.

In January, where the S&P500 was down ~3.5%, Market Trend was up 3.1% and Contrarian up 3.3%. In July, when the market was down ~1.5%, the strategies were down only .04% and .15% respectively. At the recent October 15 low in the market, on a year-to-date basis, the market was just above breakeven for the year, while Market Trend and Contrarian were at 8.0% and 10.1% respectively.

While past performance isn't necessarily a predictor of what future performance will be, we feel strongly that the characteristics displayed by both strategies this year illustrate the benefits that a disciplined, actively managed approach can have on overall portfolio performance. It's not always about how much you make, but how much of that you're able to hang on to that matters most.

CADENCE
WEALTH MANAGEMENT