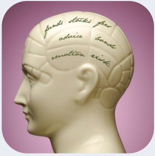

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Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

The Complacency Before The Panic

Most investors are caught in a trap right now and they don't even know it. According to a third party fiduciary company with which we have a relationship, a very high percentage of 55-65 year olds' 401(k) balances are currently at least 80% in equities. After the 2000-2003 and 2007-2009 stock market crashes, how does that even happen? Not only were those employees alive then, they were presumably saving into 401(k)s, watching their portfolio values shrink potentially 50%. We're not talking about the 1929 stock market crash here; there are TV shows on today that were on when those two things happened. Is it because they were still working and still saving that it didn't teach them a lesson? Is it because the markets did bounce back relatively quickly? Those could be possible factors, but one bit of investor psychology we believe plays into it is how long the boom periods last verses how quickly the bust periods do, and how human beings seem to be conditioned to be lulled by those up periods to the point they forget just how painful and inevitable those bust periods are.

To understand how human psychology can work against itself, consider the relatively uncomplicated relationship between spending and saving. The more you do of one, the less you can do of another, by definition. It seems simple when put that way, but consider some of the workshops we have held with people who are not good at saving systematically. We have administered questionnaires with the following two questions:

1. Could you save 10% more than you do?

2. Could you spend 10% less than you do?

Roughly 40% of our attendees admit they could save more than they do, while the remaining 60% apparently do not feel that they could. However, when it gets to question 2, nearly 80% say they could spend 10% less than they do? Wait, what's going on here? What do you think you're doing when you're spending 10% less? You're saving! It's the same question! Why don't the same

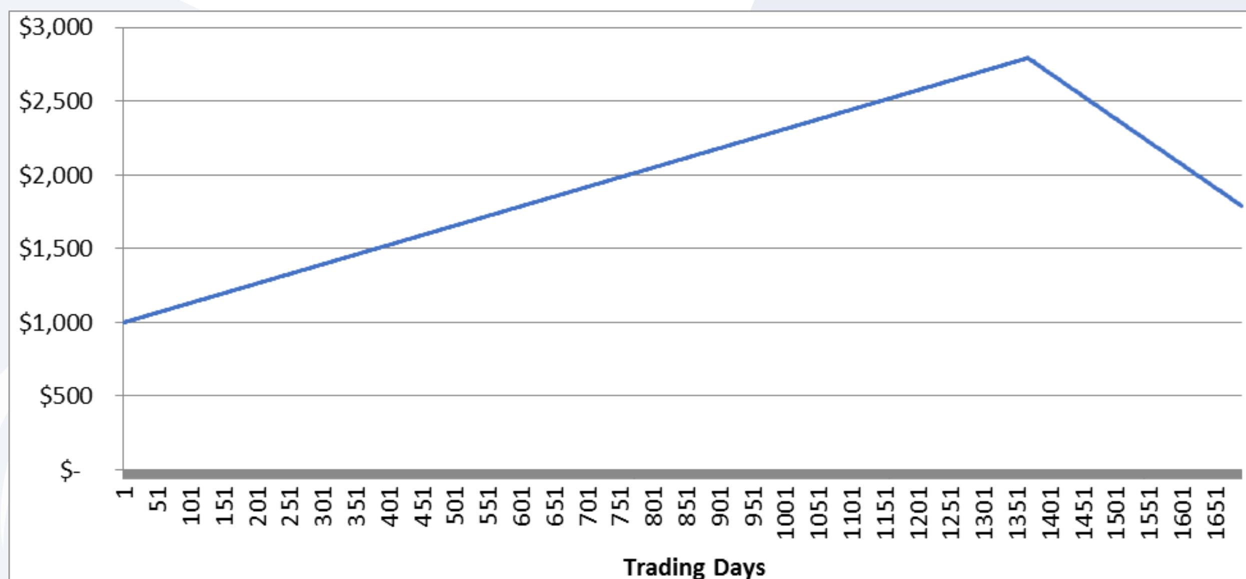
number of people say yes to both questions? We believe it's because saving seems harder than not spending, even though they're the same thing. It's how you frame the concept that influences the belief.

And that, in a nutshell, is what we are up against when we try and get our brains to make the proper financial decisions. Even something that uncomplicated confuses people sometimes. Consider something even more complicated, like our emotional relationship to investment gains and losses. We have read a variety of research studies that seem to prove people feel the pain of loss at least twice as strongly as they do the satisfaction of gains, and even that those painful feelings can increase exponentially the further below zero investment returns become. What these studies suggest is that people's feelings about investment gains are "asymmetric" in the sense that we feel losses more acutely than gains. That being the case, how do the typical moves of the markets work against this imbalanced investor psychology?

Since 1950, there have been nine times that the S&P500 has fallen by -20% or more. The average gain before those losses is 180%. In dollar terms, that means the average highest value of those increases on $1,000 would leave an investor with $2,800. The average time it took from the preceding S&P500 bottom to reach that 180% peak was 1,367 trading days, or 5.4 years.

Those metrics start to take on more meaning when you look at how long it took the S&P500 to fall and reach the lows after those peaks The average of those nine occurrences is around a -36% loss. The average amount of time it has taken the S&P500 to fall that much has been 323 trading days, or roughly 1 and 1/3 years.

When you plot the average magnitude and duration of the up moves followed by the same for the down moves, you are left with:

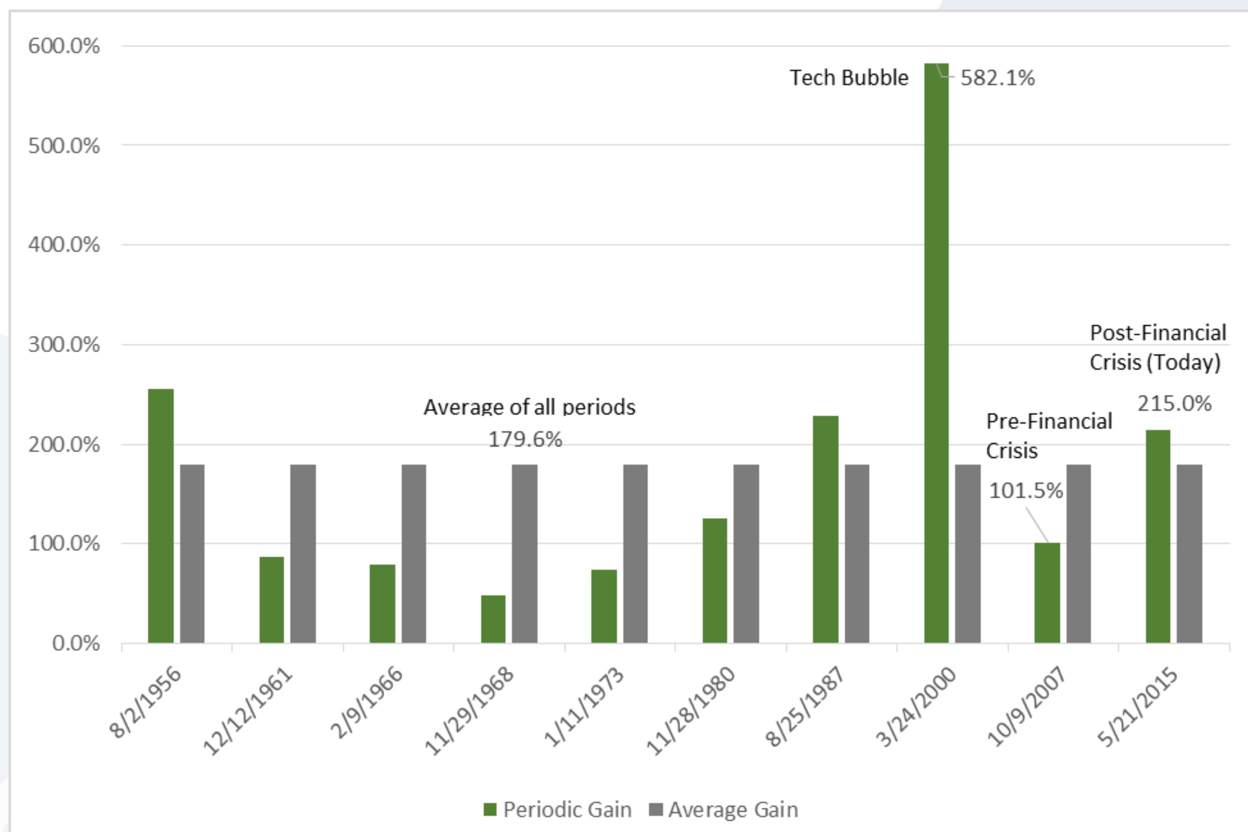


And here is where the timing of these up and down moves either plays into our asymmetric feelings about gains and losses, or is caused by it: the gains took more than four times as long to rise than the losses took to fall. This plays perfectly into our relatively benign feelings about gains, and our relatively malignant feelings about losses. As the market climbs, especially the longer it does, the more complacent we grow and the less aware we are of the

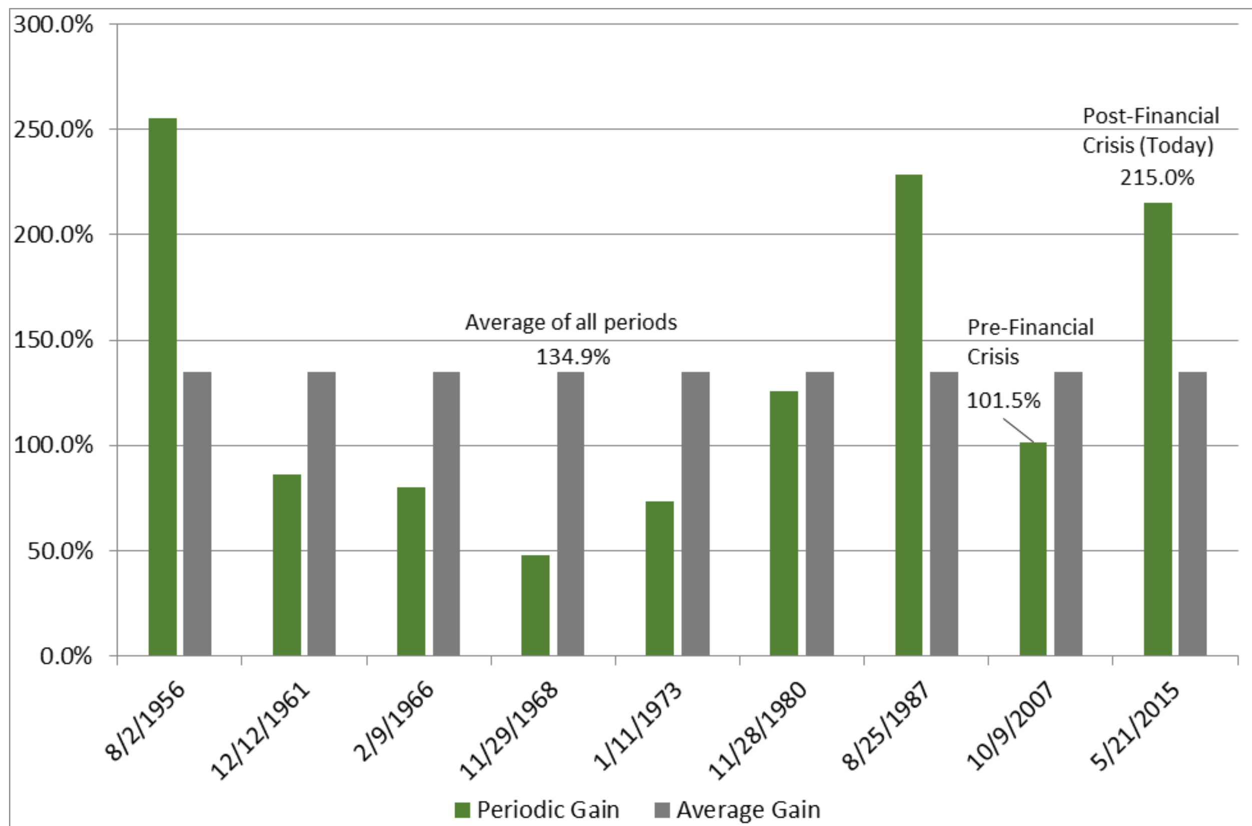
risks of investing. Being hypnotized by ever increasing values, we forget that our houses, our financial securities, even our tulip bulbs, for you 17th century Dutch horticulturalists, can lose value. However, when prices do fall, especially since they tend to decrease so much more quickly than they increased, our acute feelings of loss reversion kick in and can cause us to abandon our well thought out long-term investment strategies.

How does this relate to where we are today?

Between the bottom of the market during the financial crisis on March 9th, 2009, and the peak of the market this past May 21st, there have been 1,562 trading days, or roughly 6.2 years, which means this most recent run-up is already 14% longer than average. Not only has the run-up taken longer, it has also increased more than average: 215% verses an average of 180%. Even the post Tech Bubble, Pre-Financial Crisis run-up only rose a smidge over 100% and took fewer trading days than average to get there. Here is how the increases off the bottoms look like relative to the average of all of them:



Notice just how incredibly large the Tech Bubble growth was compared to all the other growth periods. It probably isn't a surprise that the Tech Bubble was also growing more than twice as long as average either. The problem with a data set that out of proportion is that it distorts how you look at the rest of the information. Today's 215% increase doesn't look so dangerous when compared to the tech bubble, yet in 65 years there are only two other periods with higher gains. If you take out the Tech Bubble data as an outlier (as exhibited in the following chart), then May's peak took 33% longer than average, and is significantly higher than average:



In other words, investors had quite a bit of time to grow complacent during this most recent run-up, which probably explains why 55-65 year olds' 401(k) investments have way too much in equities. So we are in a very dangerous position, where equity values have increased much higher than average off their previous lows and have also grown for a longer period than normal. Higher and longer is a very problematic combination considering most investor's penchants for being lulled into false senses of security. Likewise, considering the past three and a half months over-all negative moves, if the market is ultimately headed for at least a -20% loss, we could still be well over a year away from when it will bottom out.

Where do we go from here?

As we mentioned in last month's newsletter, there is no way to know when investment downturns will turn into calamitous -30% losses (or worse) verses troubling -15% losses. If you were to give in to that loss aversion instinct every time portfolio losses made you feel uncomfortable, you would almost undoubtedly sell out during a lot of downward market moves that would only reverse themselves a short time later while you waited to get back in until you were convinced the markets would stay up. Sometimes you would avoid big losses, but the likelihood you would get the money back in at a good time is low, according to research analyzing mutual fund flows. The best way to prevent asymmetric loss aversion from causing you to systematically lock in losses thereby reducing your long-term returns is to understand:

1. How much can your investment allocation lose?

2. Could you still reach your financial goals were they to lose that much?

3. If they could, take comfort; if they could not, take action.

"Taking action" could mean planning on building up your savings to a level where your goals could survive that investment loss, or it could mean changing your investments to avoid losses that would be that large.

Unfortunately, long run-ups play into our relatively complacent feelings about investment gains, and fast run-downs intersect tragically with our acute feelings about investment losses. Most investors are currently held captive by these forces right now, and recently have had to deal with the switch from complacency to concern and are one more series of three or four volatile months away from abandoning their "long-term" investment strategy. We probably can't avoid the acute pain of investment losses, but we can protect ourselves from ourselves by knowing ahead of time how much we could lose, if we can afford to lose that much, and how to remedy potential short-falls. It is far better to avoid the trap then to have to find a way out of it, like we fear millions of Americans will learn at some point in the near future.

Our Thoughts

With the S&P 500 12% lower than it was at its peak back in May, investors for the first time since last October have been presented with an interesting dilemma. Should they take advantage of this opportunity to buy the market on sale, with the assumption that it will resume its uptrend as it has rather consistently since 2009? Or, is there reason to believe those short-lived corrections – and subsequent sharp recoveries – are a thing of the past and that a better deal could be had down the road?

Let us first say that if an investor who's been holding off on purchasing stock decides to put money to work at a 12% discount today she really couldn't be criticized. The logic is sound and if implemented consistently – waiting for 10+% corrections before buying - the returns for that investor down the road will probably be better than had that discipline not been imparted. The question becomes where do we think the market's going and when? If you have no opinion one way or the other, then these are the kind of dips where it can make sense to increase your overall allocation to stocks.

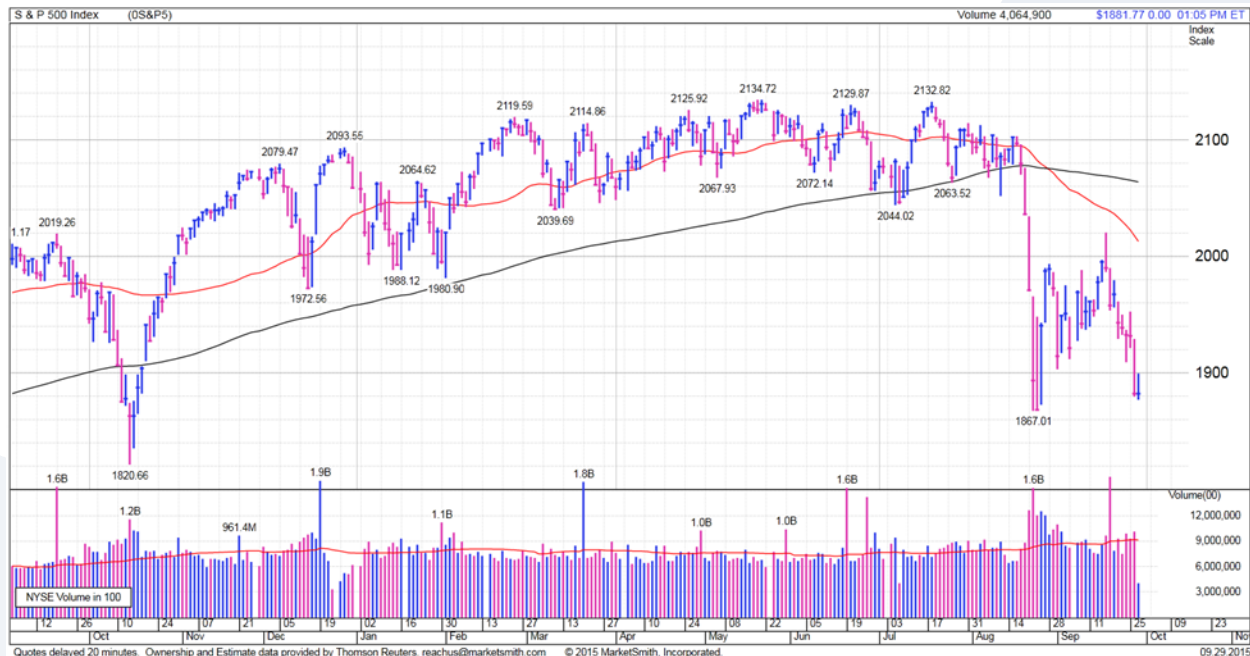
Like we mentioned in last month's letter however, we feel there's a good chance that the correction we're witnessing now marks a turning point between the bull market of the last 6 years and the upcoming bear market. Some have argued that we've already entered one based on the number of stocks in the market that are down over 20% and the limited number of stocks that are keeping the broad market indices from doing the same. Regardless of how we choose to define it, it's this very weakness across the majority of publically traded stocks that gets us feeling that this correction may have more staying power than the last few. In addition – and as we mentioned on the preceding pages – this bull market is running hotter and longer than average, which serves as a reminder that all trends eventually change.

We also continue to find it interesting that most market experts who share our skepticism about the market's ability to shoot back to new highs only see this market correction as one of limited depth. An outlandishly bearish opinion is one that calls for a 20% correction in stocks, where the majority of calls have either already been fulfilled or are very close to being reached. Although this strikes us as interesting, we're not surprised by it. It's human nature to be influenced by recent experience and to have difficulty comprehending or foreseeing an outcome that doesn't fall within the current "reality". It's the same reason very few people – especially market pundits – failed

to predict the full extent of the 2000 and 2007 bear markets. We shouldn't take comfort in predictions or proclamations that paint only a moderately gloomy or even optimistic picture. It's just par for the course at this stage in the game.

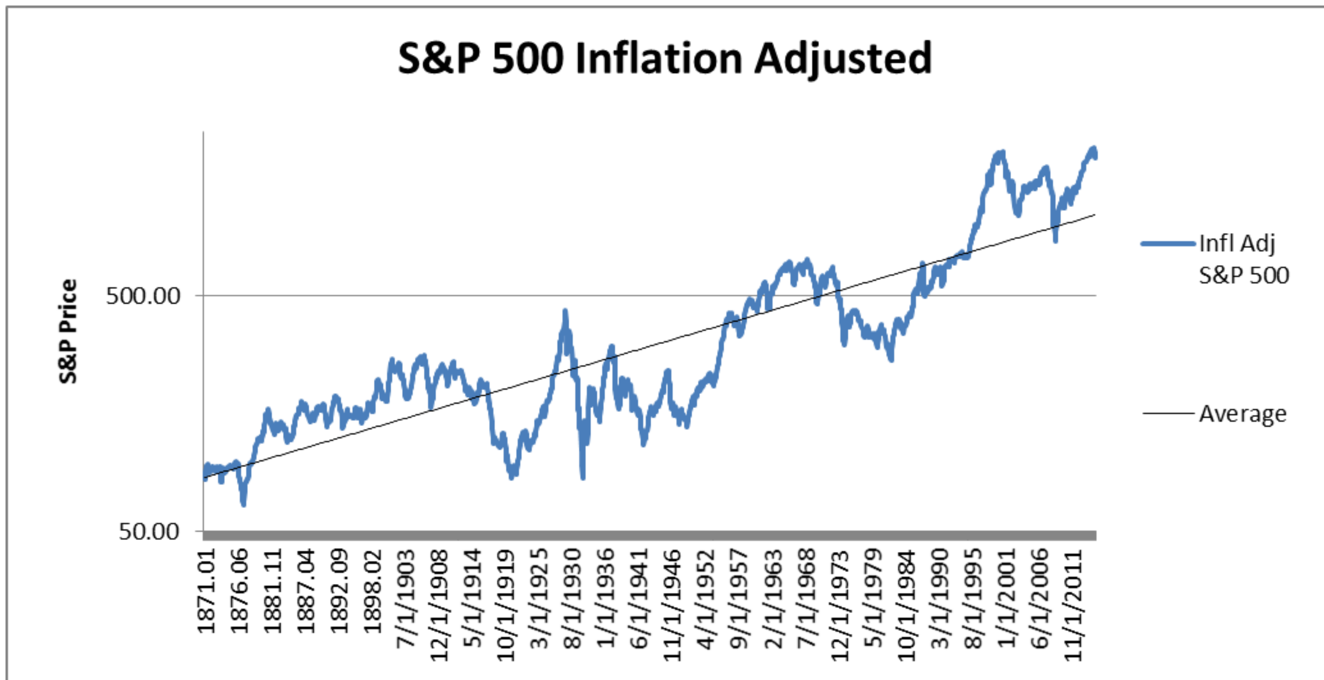
The Smaller Picture

If we look at a chart of the S&P 500 over the last year, the recent 12% correction looks like a tremendous buying opportunity. Relative to what the market's done over that period of time, this downturn looks plenty big enough to do some buying. Even over the last few years, it looks adequately unusual to the point where investing more money is enticing.



The Bigger Picture

However, since we know that recency bias makes it easy for us to forget about or discount the bigger picture and those other possible outcomes that we simply haven't experienced lately, we should always consider the bigger picture for perspective. When we look at the market over a 100+ year period of time, it's clear that we've done pretty well over the last 30 years or so. Based on the cyclicality of stocks, it wouldn't be at all unusual for the market to experience a decline of much more than 20% over the coming months and years. In fact, based on some well-known valuation measures that we've written about in the past that look at the price of stocks relative to their earnings and the economy, one could easily make the case for a decline of over 50%. The fact remains that stocks are at least as expensive now as they were at all other market peaks in history except for the 2000 tech bubble. That extreme valuation paired with a long-running bull market where the average stock is declining in price, leads to an environment where markets can fall much quicker and farther than one might think. History provides plenty of examples of this. As you can see from the following chart, the recent 12% drop pales in comparison to what we consider normal and healthy market movement.



If we are indeed in the early stages of the next bear market, we know they don't go down in a straight line. They ebb and flow and thoroughly frustrate investors along the way until nobody can easily envision the pain and suffering ever ending. That's when market experts who decide to stick their necks out, call for meager rallies of 5-15% - the same situation we're seeing now only in reverse. Much like pundits today are probably underestimating the magnitude of our next bear market decline, they'll also likely underestimate the ability for the market to go much, much higher at the next turning point. Our focus continues to be on weathering the impending down cycle so that we're positioned to take advantage of the markets when they look more attractive. As we've said before, at this point, it's more about principal preservation than big growth. At some point that will change. The key is to be able to capitalize on it when it does.

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

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