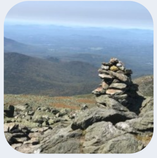

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Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

Certainty

By Casey Clarke

One of the things we're heavily deficient in these days is certainty. Whether one views current events as good, bad, or indifferent, most would agree that the ability to predict where we'll be in six to twelve months with any confidence is more difficult than it's been in quite some time. This is anxiety-provoking, and as homo-sapiens, we don't like to feel anxious or scared. Fear leads to poorly calculated decisions, and bad investment decisions, especially when made repeatedly, can set one back irreparably on their financial path. As ephemeral as it might be to obtain in reality, the perception of certainty is critical to the proper functioning of financial markets – the feeling that we know what tomorrow will bring. This of course doesn't mean that we actually know what tomorrow will bring, just that we feel we do. The fact is, there are very few things we can ever feel certain about at any point in time. Confident, sure, but certain, not so much. We crave it because it's simple and easy, often a shortcut to doing the hard work of truly figuring something out. It's also comfortable and resolute when the topic in question isn't easily solvable. As comforting as it might be to feel certain about something, it can also be a trap. It, like fear, also has the potential to set us back and to limit our potential. That thing that we individually and collectively seek can also hurt us. There is probably no better time to explore this than now.

Over-Confidence

We've probably all encountered people who've come across way more confident about something than they should be. Worse yet, it's especially frustrating when we encounter this total certainty when we know with equal certainty that they are dead wrong about whatever it is they're saying. The truth is, our brains aren't good at operating in the gray zone, especially when accompanied by fear. We can all think of moments where we thought for sure we said or did a certain thing only to find out that our memory was deceiving us. We may have felt frustrated in that moment at how we recollected something with such certainty that turned out to be inaccurate. This is a reminder of how treasonous over-confidence can be; how easily our brains can pin us into a corner from which we can't honorably escape. Like the saying goes, "It's not the things we don't know that get us into trouble, but rather the things we know for sure that simply aren't so." It takes maturity and humility to reserve total certainty for very rare moments. And no, this doesn't make one dumb, weak, or lacking in confidence. "I don't know" is empowering. What makes one exceptional is owning that uncertainty and deciding what to do next.

Letting Go

There are a host of potential reasons for over-confidence ranging from insecurity, the desire to be expert, to sound authoritative, or as a mechanism for dealing with fear. One could make the argument that in some cases, any of these reasons could justify that sense of certainty. We can probably all relate to the concept of "fake it till you make it" in some facet of our lives, or even convincing ourselves that the wounded deer we saw in the yard yesterday somehow miraculously healed overnight and is fine. When the consequences of over-confidence or certainty are minimal or benign, and pale in comparison to the benefits, then I suppose we can view the practice as productive and additive to one's well-being. Religion falls into this category. Having total belief and faith in what others might ascertain as being unknowable can add tremendous value to one's existence.

However, when it comes to other matters, where the consequences from being wrong are higher and the benefits stemming from certainty don't clearly outweigh them, we have a problem. "I'm absolutely sure this isn't a live wire, no need to test it first", or "this stock is going to double, I'm sure of it", or "this new drug is completely safe, smart people said so, so I'm sure of it." All of these statements are made for a host of complex reasons that we need not parse. What's important is understanding how dangerous they can be and being more aware, in the moment, of when we feel total certainty. The moment you tell someone you're 100% sure of something, you'd better be prepared to back it up, because if you're wrong, you'll have a hard time gaining that trust and respect back. Use it sparingly, in moments where the consequences of being wrong won't matter, if at all. Get into the habit of saying "I don't know", or "I'm not sure", or even "I'm fairly confident". Be willing to let go of the need to know things for sure. With investing, we will drive ourselves absolutely mad if we try to make complete sense of the puzzle that is the global financial system. We try, but we don't have to fool ourselves into thinking we have it mastered and know exactly what will happen next. That is a confidence trap.

Probability

Thinking in terms of probability is what the most successful investors in the world have always done. There are no certainties, only probabilities, which by definition means that great investors are totally comfortable being wrong a certain percentage of the time. So long as they're right more than they're wrong (assuming equivalent gains from winners as losses from losers), they can be successful. They don't need to be perfect, which is good news since it's not possible anyhow. When investors feel total confidence in an idea, it's just a matter of time before they make horrible decisions and risk losing it all. We'd be fooling ourselves to think this didn't lead to similar outcomes in other aspects of life. Confidence is a sliding scale that shouldn't be pinned at either extreme. Both ends are problematic. We need confidence to move forward but too much can get us into trouble. The goal should be to objectively recognize where we are on the scale as it relates to the matter in question, and seek to move as far over toward total confidence as one can reasonably expect to get. And importantly, where you end up won't be a permanent position. With new information and constantly changing variables, probabilities will change. One needs to remain open to constant reassessment and flexible in changing their mind. If there's one thing in life that we can count on, it's perpetual change.

Embracing Fear

Change is hard, and if given the choice, most of us would opt to avoid it. It's part of the human condition to strive to keep things familiar and comfortable. What most serious athletes would attest, however, is that the only way to continue to improve and grow is to seek discomfort and constantly push the limits of what you think you're capable of. There are no gains without discomfort, which is somewhat synonymous to saying, you must embrace fear and learn how to move beyond it. Everything worthy of achievement lies on the other side of something scary. It's interesting that we tend to spend most of our time letting fear push us around, influence our thinking and behavior, and most importantly, that we let others instill feelings of fear inside of us. If we're to succeed in investing or anything else, we need to accept that fear is 100% normal, embrace it, and adopt constructive thoughts and actions to move beyond it. It's not going to go away. The world is a scary place.

And, Back to Confidence

Something I've seen far too much of the last few years are people holding strong opinions on issues without a balanced perspective or full understanding of both sides of argument. This is almost always a case of an opinion that's been adopted rather than one organically developed. What tends to accompany this type of opinion is an unhealthy degree of certainty and the unsavory characteristics that come along with it – inflexibility of thought, lack of genuine curiosity to learn, and a reluctance to engage in open dialogue. In trying to assess the global economy and investment universe, we are constantly trying to play devil's advocate and think about the other side of our thesis in order to test the veracity of our thinking. We are never certain, and we are even less certain if we acquired a thought from a third party. Despite the fact that most feel comfortable trusting the opinions and assessments of experts, we do not. This isn't because experts don't know things and have value to offer, but because it ignores the potential pitfalls of conflicts of interest, perverse incentives, and systemic biases. Blindly trusting experts also discounts the effect of the intellectual trap, where "smart people" blindly trust other "smart people" in a dangerous game of telephone under the assumption that smart people can't possibly be wrong. We see these biases and traps play out all the time on Wall Street. In the end, it has nothing to do with education or expertise level and everything to do with other emotional and human factors. Our confidence in an idea or issue comes from our ability to think it through ourselves while assailing it from every direction possible. Will it be scary and uncomfortable if our conclusion puts us at odds with the masses? Yes. Are we completely sure that we're seeing things clearly and are correct on an issue? No, but it doesn't matter. Having a high probability of being right based on a strong, objective process allows us to have confidence; Not certainty, or false confidence, but confidence. We are not waiting for certainty to stare down and move past fear. With the odds in our favor, and the risks and rewards adequately assessed, we act, decisively.

Markets

Our assessment of markets is currently as follows:

- U.S. stocks continue to pose historically high levels of risk. In our estimation, it would not surprise us to see declines in the major indexes of -50% or more from current levels, and/or returns over the next 10-12 years flat to negative. This has less to do with the economy, current government policy, or any political drama of the day, and everything to do with valuations. Stock prices are simply way ahead of underlying fundamentals. A reversion to a 100+ year mean (more normal levels) would indicate much lower prices at some point.

- There's a reasonable chance this reversion in stock market valuations has already begun given underlying economic weakness and long-term market momentum levels that have already broken and reversed lower. Are we certain of this? No. Of course not. Nobody is.

- Gold has had a tremendous run higher, up 100% since Q4 2022. This adds confidence to our stock market assessment as it hints toward a shift in investor preference.

- Other precious metals investments such as silver and miners have lagged behind gold. If the transition from stocks to alternative investments gains steam, these investments could play catch-up.

- Treasury bonds appear attractive relative to stocks at yields over 4%. Although they haven't recovered from their historic price declines beginning in late 2020, they've been stable since Q4 2022 and are higher than they were in Q4 2023. In short, the decline appears to have stabilized, momentum increased, and could provide a safe haven for flows coming out of the stock market should the current trend accelerate.

- Passive flows that have fueled the historic stock market run the last few years will at some point reverse direction. This in theory would serve to accelerate and perpetuate a stock market decline once it gets bad enough to change complacent investor behavior. Think about how most are inclined to select among their 401(k) options. They look at recent return performance and select the top 4 or 5 choices. Imagine how that selection process would change if none of the top 4 or 5 choices were stock market investments. This is how flows stop. Portfolio rebalances into other options based on that same process is how flows would reverse.

- With all that in mind, our view is to gravitate toward investments that don't appear saddled with sticks of dynamite, diversify as best we can across those options, and be vigilant about managing and adapting as circumstances change. Are we certain about any of this? Nope. Great outcomes are rarely the result of absolute certainty. They stem from embracing uncertainty and risk, and gaining confidence to move past it through a persistent curiosity and commitment to understand, learn, and grow. Good odds, or high probabilities are enough. In fact, they are everything.

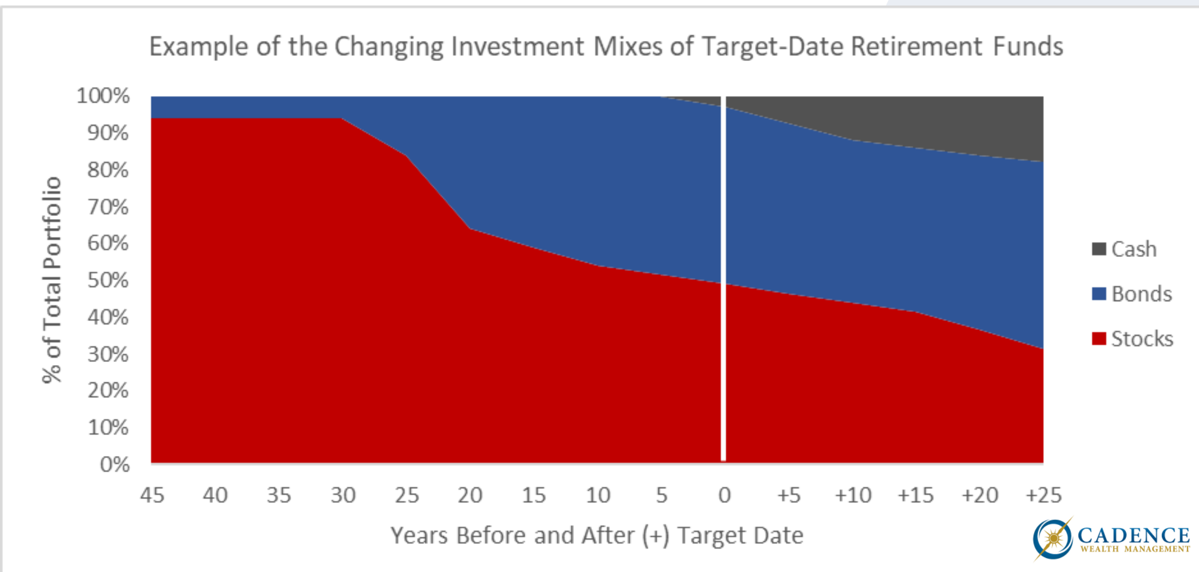
Beware the Target-Date Fund Cookie Cutter

By Steve DeBoth

It has been nearly six years since we published a Cadence Clips piece on target-date funds. Since then, they have continued being implemented to the point that I cannot remember the last time I saw a client's 401(k) investment choices where target-date funds were not offered. Much has happened in six years, and despite COVID, war in Europe, continued political acrimony at home and abroad to name a few, the price of the S&P 500 has doubled since June 2019 when we published that target-date fund piece entitled, "It Pays to Know What Is Under the Hood with Target-Date Funds". If other metrics had also doubled since then, perhaps that price growth would not be an issue, but whereas the total value of the S&P 500 was 50% more than the size of the US economy six years ago, it is now 100% more than the size of the US economy. By this, and many, many other measures, the S&P 500 remains historically expensive. Unfortunately, the recent stock market losses have done little to dent this, with the S&P 500 only -10% off its February 19, 2025 peak, and only -6% down this calendar year.

Target-Date Funds: A Review

As a refresher, a target-date fund, sometimes called a lifecycle fund, is designed as a one-stop investment shop with a diversified set of asset classes. With a target-date fund, investors pick the year they think they'll need to access the funds, say, 2030, and then the fund management company manages everything from there. The target dates chosen by the investors usually coincide with when they plan on retiring, but the target date can apply to any reason they feel they will need to access those funds by that date. As that target date gets closer, the funds reduce their exposure to traditionally more volatile asset classes, like stocks, and increase their exposure to traditionally more stable asset classes, like bonds. In this way, target-date funds are considered to be getting safer over time.



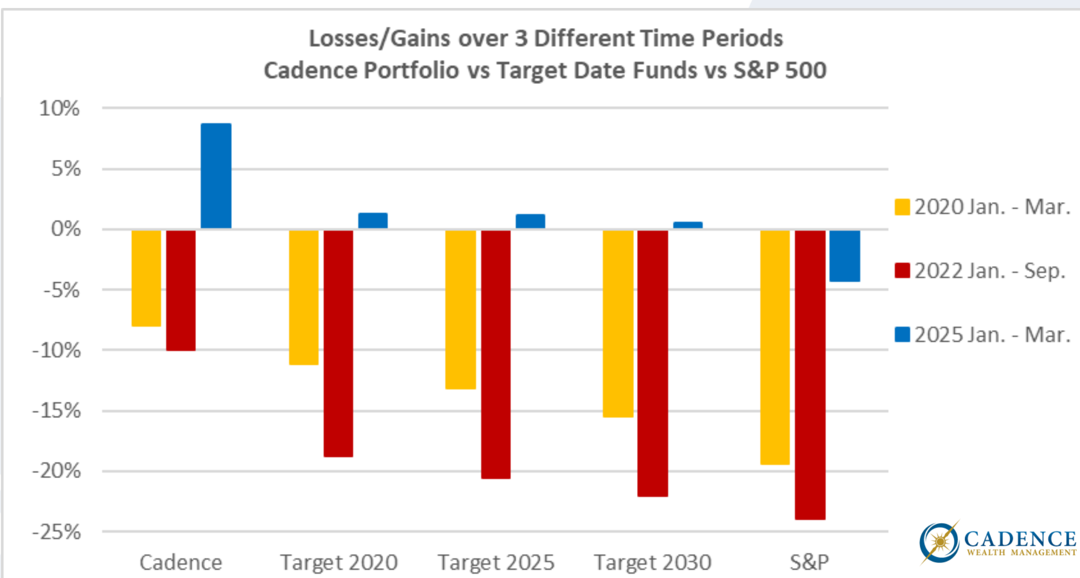
Having an investment mix get more conservative over time works in theory; as the goal gets closer there is less time to save and recover from losses, so having the asset mix get more conservative seems to make sense. However, it is short-sighted to base your investing completely on your potential target date. Even investors with decades left before retirement should take into account how overvalued the stock market is currently. Additionally, after a stock market crash, even people years into their retirement should consider getting more aggressive at a time they may be able to more safely increase their exposure to the stock market after it has gone on sale, especially if the sale is historic.

Which brings us to today. The potential for further stock market losses, and potentially historic ones, remains high as I alluded to in the first paragraph. It is logical to assume that the Fidelity Freedom 2020 Fund was geared to protect people retiring in 2020 from large losses, yet it was down -20% during the COVID decline in March of 2020 when the S&P 500 was down -34%, and down over -21% during the 2022 stock and bond market collapse when the S&P 500 was down -25%. There are many retirees who could survive a -20% decline in their asset values, especially if the financial markets rebounded relatively quickly, but how many of them out there could not, and how many out there would then make a panicky move at the wrong time as a result? Also, consider that the stock market was only down -25% in 2022, and the 2020 target-date fund was down a very close -21%. Could the investor survive being down -42% were the stock market to be down twice as much as it was in 2022?

I believe how target-date funds are named gives a false sense of security; people just assume that a fund with a target date of a couple years from now, or this year, or especially with a date a few years past, will not suffer much of a drop at all were the stock market to crash. That is just not the case.

What Should We Do Instead?

An investor willing to look outside of target-date funds has the ability to tailor their mix to not just their situation in life, but also the situations present in the investing and wider worlds. Consider how target-date funds handled the losses in 2020, 2022, and so far in 2025. I will compare the average performances of target-date funds from eight different fund companies to what the S&P 500 did over three different time periods, as well as a model Cadence client portfolio of 30% in one of our separately managed accounts, and 70% in one of our 20/80 core stock-bond portfolios.



Between January and March 2020, the S&P 500 was down nearly -20%; the target-date funds were down between -11% and -15%; and, the Cadence allocation was down -8%. Overall, the target date funds held up relatively well, but the Cadence portfolio's ability to own assets outside of traditional stocks and bonds allowed it to protect the investor's value even better.

2022 was a harder year for the target-date funds: They shared between 60% and 80% of the S&P 500's losses in 2020, but they shared between 80% and 90% of the S&P 500's losses from January through September 2022. The

Cadence allocation, on the other hand, shared in roughly 40% of the S&P 500's downward moves in both 2020 and 2022. Extrapolate that out, and if those ratios stayed the same were the S&P 500 to have lost -50% instead of -24%, that would translate to the target-date funds being down between -40% and -45%. The Cadence portfolio, with its ability to diversify beyond traditional stocks and bonds, would be down somewhere in the neighborhood of -20%. No one enjoys being down -20%, but at a time when the market is down -50%, and target-date funds are down between -40% and -45%, that -20% looks pretty good. At that point, a lot depends on the bounce back, and were you down only -20%, there's room to buy into the stock market once it's half off, and there's less your investments have to recover to get back to where you started. The target-date funds, on the other hand, with their rigid allocations wouldn't be buying more stocks; they'd actually be reducing their stock exposure.

The first three months of this year was an even more interesting story: The target-date funds held up pretty well, being up around 1% for all of them at a time the S&P 500 was down -4%. The Cadence allocation, on the other hand, was up 9% as of the end of March.

The message here is clear, I hope: Temper your expectations around just how much a target date fund will protect you during a stock market decline, especially during a crash. A target date 2025 fund sounds like it was created to protect asset values for someone retiring this year, but were it to lose -43% when the market is down -50%, I wager no one would be feeling all that protected. Don't let the names fool you: Target date funds were designed to give exposure to a mix of assets based on a date, and nothing else; not your risk tolerance, not your actual retirement date, and certainly not the historical value of the stock market.

That being said, an investment that has reduced its stock exposure over time to 40% from a starting position of 90% would probably protect an investor better for what may come next than had they maintained their initial 90% stock exposure. If you are using a target-date fund in your workplace retirement account, or anywhere else, the answer may not be to abandon it entirely. More retirement plans offer gold, or other commodity-based choices that could be used to further diversify those investments. Consult your Cadence advisor on if and how to utilize a target-date fund properly, and by all means consider whether those assets can be moved to an account that offers more than cookie cutter solutions.

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