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"Investor Complacency? Anything But . . ."

By Craig Pulliam, CFP® and Michael Comstock, CFP®

Not having seen a true market downturn for years, it might be fair to assume investors are becoming used to the calmer waters and even complacent about it. Indeed, many analysts, portfolio managers, and financial journalists wonder if investors have begun to expect the current tame conditions and market growth to last for the foreseeable future. So, how do *you* feel? Do you care as much now about managing with an eye focused on downside protection as you did a few years ago, when the risks seemed more palpable?

We think our clients are very concerned about the next market fall, and what will happen to their portfolios. It's not self-evident that investors will be complacent simply because there have been so few violent swings in the markets recently. That investors are not running into and out of stocks and bonds with each news headline does not mean they are sanguine or cocky. If anything, investors are "uncertain" about where their investments are headed, given the scars they still bear from 2008-2009, and the subsequent bull market run since March 2009. They just flat don't know . . . perhaps they're a little anxious . . . and each week we are asked "Isn't the market a little too high and overvalued?" Our clients are anything but complacent.

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But, it's interesting to note that –while clients may be uncertain about what will unfold- you're keeping cool heads. While there's been a willingness on the part of many to put a bit more cash to work in their portfolios, there has been no rush toward riskier assets. Nor have we seen excessive nervousness when the markets *have* dipped due to international turmoil in recent months. By most measures, clients appear to be "intelligently aware" at this moment, and they are more than happy to be in portfolios which, at times will lag the markets during the booms, but may save their bacon during the busts (no guarantees!).

And we continue to believe that portfolios like those, which manage risk through the downturns, can provide a better investing experience, and potentially better returns (historically).

Let's talk about why this is so, and why we continue to build these portfolios that have stood up well under great stress. You see, markets are inherently volatile. It's just a question of *how volatile* and jumpy they are. When there's high volatility, it gets tough for investors emotionally (watching their accounts gyrate daily), and it's during these times that investors (even professional money managers) tend to make their most egregious investing mistakes. When volatility is high, investors increase the rapidity and frequency with which they move their assets into and out of the stock and bond markets. We have seen the average investor holding period for investments fall from 7.1 years in 1940 to 2.8 years in 1980; 2.1 years in 1990 . . . and 0.6 years today, (LPL, AllianceBernstein, NYSE). Yet, this trend of increased trading and timing has done nothing to increase investor returns.

During extended periods of calm markets, this potential for portfolio destruction through bad timing and over-trading can be masked. But we believe that volatility is certain to rise to more average levels. In 2008 there were 28 market pullbacks (S&P 500*) of 5% or greater. In 2009, there were 11, and in 2011 there were 10. Since 2011 we've seen just 4 pullbacks of 5% or greater (Standard and Poor's, FactSet, JP Morgan) . . . and that is eerily tame. Even a return to an average of 4 or 5 such pullbacks annually might be more than some investors can stomach, causing them to shift their investments.

We've reminded you that relatively large market downturns are common (we haven't seen one since summer 2011, though). Such severe dips do not normally demand a strong reaction. 20%+ downturns happen about every 20 months; 10%+ dips once each year; and 5% drops on average every two to three months. So, be ready, we say. You know as well as we do that –if 100 years of investing history is any guide- we will have many more market tumbles in your lifetime. Fortunately, they've all been temporary so far.

Being the market historians that we are, we are pleased that our clients have been unwavering in their support of an investment philosophy that isn't built upon guessing the next moves of the Fed; or what will happen in Ukraine; or which party will win the next general election. Guessing wrong can cost you.

Sure, you may feel good about getting out of a bad market, but knowing when to get back in is something that eludes even the best money managers. According to financial columnist Mark Hulbert (Wall Street Journal, 8/8/2014) just 11 of 81 professional stock market timers actually made money during the bear market of 2000-2002 (wonderful for them). But those managers have averaged a *loss* from March 2000 through today (terrible). They guessed right on getting out, but didn't know when to get reinvested again. During the same 2000 –present period, had you been invested in a moderate mix (about 60% stocks) *and done nothing*, you would have averaged an annual return of 6% (using the DJ Moderate Portfolio as a proxy; Morningstar).

But if all market drops are temporary, why not just throw all your money in stocks and settle back for the ride? Here's why not: that Moderate Portfolio, which may lag the markets during the upswings, can possibly make you much more money over the long haul (no guarantees, mind you) than staying in 100% stocks would. Why did the Moderate Portfolio beat the S&P 500 from March 2000 to the present (6% annual return versus 4.33%; Morningstar)? It's because it didn't punish you as much when things were terrible. During the down years, the Moderate Portfolio beat the S&P 500 -9.33% annually to -18.54%. And during the up years, it only lagged the S&P 12.32% annually to 14.86% (Morningstar).

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Look, you can get 50 different opinions today, this minute, on TV and websites about what's going to happen to the markets next week or next month. We are on conference calls and webinars talking to really smart people about their "take" on things, but no one really knows . . . according to the Wall Street Journal (7/28/14, 2014) 18 respected market strategists who predicted the year-end S&P 500 returns annually since 2000, *missed the year-end return by a whopping 13.5% average annually*. Thank goodness you didn't invest with these folks! There's a risk of being too smart for your own good, and we cannot play with your money that way.

Which brings us full circle. We know what has worked. We try to avoid catastrophes with client money. And we deeply appreciate the fact that "No" our clients are not complacent now; you do ask questions; and you do evidence concern about what happens next. You're ready, you're alert, and you won't become distraught for no good reason. As we stated, you're intelligently aware. That's a very good thing right now.

**All indices are unmanaged and investors cannot actually invest directly into an index. Unlike investments, indices do not incur management fees, charges, or expenses. Past performance does not guarantee future results.*

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