The Financial Navigator – August Newsletter

Stock and bond market risk is a reoccurring theme in the financial press these days. The reason being is the US stock market has proceeded in an upward trajectory for three straight years without a correction of 10% or more, which is unusual. In addition, bond investors are waiting with bated breath for the Fed to begin to increase interest rates which would negatively impact bond prices. So below I have included a couple of short articles concerning stock market risk and stock picking, which may help you put the current market environment in perspective and prompt some thinking about your own portfolio risk.

You may know someone who has the same questions and concerns about the market and their portfolio. If you think it will help, feel free to forward this email and let me know if you have questions about a specific situation.

Sincerely,

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Behind the Risk Curtain

I am often asked by clients, "Just how much risk am I taking on with my stocks and how much could I lose?" Usually during this discussion the Great Recession and the associated drop in the US stock market of almost 46% from October 2007 to March 2009 comes to mind. Most people believe that this was a highly unusual event, not likely to be repeated. However, that was also said of the Great Depression, the 1987 market crash, the bear market of 2001, and many other 'one time' market events.

Based on history you have about a 0.5% chance that an all stock portfolio, as measured by the S&P 500, will lose more than 43% in any particular year. If you look at the S&P returns since 1913 only in one calendar year did the S&P lost more than 42.5%, that was in 1931 when it lost 44.2%. Digging a bit deeper into the numbers can tell a different story and can better prepare you for the seismic market events. For example, the 44.2% drop in the 1931 noted above was preceded by two more years of losses: 9.5% in 1929 and 22.7% in 1930. The 1931 drop was followed by a 6% loss in 1932.

Other notable "one-time" stock market events as measured by the S&P500 worth mentioning:

- 1945 recession: S&P lost 19%.
- Bear market of 1973-74: S&P lost 38%.
- Black Monday October 19, 1987: S&P lost 20%.
- Asian economic crisis October 1997: S&P lost 7%.
- Dotcom crash of January 2000-October 2002: S&P lost 35%.
- Since 2008 there have been 11 days where the S&P lost 5% or more.

According to some research the probability of the 7% drop in October '97' was one in 50 billion. The probability of the July 2002 15% lose was one in 4 trillion and the probability of the October 1987 crash was one in 1050, so small a probability that it can hardly be measured.

So it appears that these highly improbable, unpleasant market events are happening with some regularity, and there is every reason to believe we will continue to experience both short and long-term significant market downturns. The purpose of this article is not to scare you, but to point out the good news is that you know these events will happen again and can prepare yourself for them.

For example, a couple of approaches you might keep in mind are:

- Keeping enough liquidity in your portfolio to meet your cash requirements over the next couple of years is a great way to protect yourself from having to sell an investment that is in a loss position to meet living expenses.
- Cash that will be needed for such things as a house down-payment or a car purchase in 3-5 years should not be invested in the stock market.
- Diversifying one's portfolio by adding asset classes that don't move in lock step with the S&P 500 can help to reduce the likelihood of the significant decreases in market value; emerging market stocks, bonds, and real estate investment trusts are examples.

However, remember, over the long-term, the S&P 500 has returned on average about 10% per year and, regardless of the market downturn, it has always recovered and rewarded investors for their faith and patience.

Not Rocket Science

Jim Parker, Vice President-Dimensional Fund Advisors.

When the media raises the subject of beating the market through astute stock picking, the name Warren Buffett is usually cited. But what does this legendary investor actually say about the smart way to invest? Buffett is considered to have such a track record of picking stock winners and avoiding losers that his annual letter to shareholders in his

Berkshire Hathaway conglomerate is treated as a major event by the financial media.[1] What does he think about the Federal Reserve taper? What could be the implications for emerging markets of a Russian military advance into Ukraine? What does an economic slowdown in China mean for developed markets?

Buffett has a neat way of parrying these questions from journalists and analysts. Instead of offering instant opinions about the crisis of the day, he recounts in his most recent letter annual a folksy story about a farm he has owned for nearly 30 years.[2] Has he laid awake at night worrying about fluctuations in the farm's market price? No, says Buffett, he has focused on its long-term value. And he counsels investors to take the same sanguine, relaxed approach to liquid investments such as shares as they do to the value of their family home.

"Those people who can sit quietly for decades when they own a farm or apartment house too often become frenetic when they are exposed to a stream of stock quotations," Buffett said. "For these investors, liquidity is transformed from the unqualified benefit it should be to a curse."

While many individuals seek to ape Buffett in analyzing individual companies in minute detail in the hope of finding a bargain, he advocates that the right approach for most people is to let the market do all the work and worrying for them.

"The goal of the non-professional should not be to pick winners," Buffett wrote in his annual letter. "The 'know-nothing' investor who both diversifies and keeps his costs minimal is virtually certain to get satisfactory results."

As to all the predictions out there about interest rates, emerging markets, or geopolitics, there will always be a range of opinions, he says. But we are under no obligation to listen to the media commentators, however distracting they may be.

"Owners of stocks… too often let the capricious and irrational behavior of their fellow owners cause them to behave irrationally," Buffett says. "Because there is so much chatter about markets, the economy, interest rates, price behavior of stocks, etc., some investors believe it is important to listen to pundits—and, worse yet, important to consider acting upon their comments."

The Buffett prescription isn't rocket science, as one might expect from an unassuming, plainspoken octogenarian from Nebraska. He rightly points out that an advanced intellect and success in long-term investment don't necessarily go together.

"You don't need to be a rocket scientist," he has said. "Investing is not a game where the guy with the 160 IQ beats the guy with 130 IQ."[3]

References

1. "Buffet Warns of Liquidity Curse," Bloomberg, Feb 25, 2014.
2. Berkshire Hathaway Inc. shareholder letter, 2013, www.berkshirehathaway.com/letters/2013ltr.pdf.
3. "The wit and wisdom of Warren Buffett," Fortune, November 19, 2012, management.fortune.cnn.com/2012/11/19/warren-buffett-wit-wisdom/..