

## **The Financial Navigator – June Newsletter**

Greetings, I hope your summer is off to a great start. With the stock market about five years into a bull market some clients are asking ‘is now the time to put new money into the markets?’ Recent uncertainty brought on by events overseas combined with the current bull market that is perhaps getting a little past its prime has served to heighten this concern, especially among members of the financial press. The article below may put some of this uncertainty into context and hopefully prevent some of the emotion driven portfolio changes that many investors embark upon during times of uncertainty.

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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### ***The Certainty Principle***

Jim Parker, Vice President-Dimensional Fund Advisors.

A frequent complaint from would-be investors is that “uncertainty” is what keeps them out of the financial markets. “I’ll stay in cash until the direction becomes clearer,” they will say. So when has there ever been total clarity? Alternatively, people who are already in the market after a strong rally, as we have seen in recent years, nervously eye media commentary about possible pullbacks and say, “Maybe now is a good time to move to the sidelines.”

While these kneejerk, emotion-driven swings in asset allocation based on market and media commentary are understandable, they are also unnecessary. Strategic rebalancing provides a solution, which we will explain in a moment. But first, think back to March 2009. With equity markets deep into an 18-month bear phase, the Associated Press provided its readers with five signs the stock market had bottomed out and followed that up with five signs that it hadn’t.<sup>1</sup> The case for a turn was convincing. Volumes were up, the slide in the US economy appeared to be slowing, banks were returning to profitability, commodity prices had bounced, and many retail investors had capitulated and gone to cash. But there also was a case for more pain. Toxic assets still weighed on banks’ balance sheets, economic signals were patchy, short-covering was driving rallies, the Madoff scandal had knocked confidence, and fear was still widespread.

Of course, with the benefit of hindsight, that month did mark the bottom of the bear market. In the intervening period of just over five years, major equity indices have rebounded to all-time or multi-year highs. **Exhibit 1** shows the cumulative performance of major indices in the 18

months or so of the bear market from November 2007 and then the cumulative performance in the subsequent recovery period.

**EXHIBIT 1 – MARKET PERFORMANCE: FINANCIAL CRISIS AND POST-CRISIS (RETURNS IN US DOLLARS)**

	11/2007-02/2009 Cumulative	03/2007-05/2014 Cumulative	11/2007-05/2014 Cumulative	11/2007-05/2014 Annualized
MSCI World Value	-54.38%	157.24%	17.34%	2.49%
Russell 2000 Index	-48.34%	213.33%	61.87%	7.69%
MSCI World Small Cap	-52.80%	217.93%	50.07%	6.44%
MSCI World Stock	-52.03%	163.11%	26.22%	3.65%

You can see in the exhibit there have been substantial gains across the board since the market bottom. And while annualized performance over the six-and-a-half years from November 2007 is not impressive, there has been a lot less pain for those who did not bail out in March 2009. So those who got out of the market at the peak of the crisis and waited for “certainty” may have realized substantial losses. But keep in mind that these past five years of recovery in equity markets have also been marked by periods of major uncertainty.

In 2011, Europe was gripped by a sovereign debt crisis. Across the Atlantic, Washington has been hit by periodic brinksmanship over the US debt ceiling. In Asia, China has grappled with the transition from export-led to domestic-driven growth. Around any of these events, there was a broad range of views about likely outcomes and how these possible scenarios might impact financial markets. The big question for the rest of us is what to do with all this commentary.

The fact is, even the professionals struggle to consistently add value using analysis of macroeconomic events, as we see repeatedly in surveys of fund-versus-index returns. And history suggests that those looking for “certainty” around such events before investing could be setting themselves up for a long wait. There is always something to fret about. Recently, the focus has been on low volatility, particularly when compared to 2008–09. Sage articles muse over whether risk is being appropriately priced and whether volatility is being unnaturally suppressed by central banks’ explicit forward guidance about policy.<sup>2</sup> Just as in March 2009, one does not have to look far to find well-reasoned discussion in support of why the market has topped out, alongside equally compelling reasons of why the rally might continue for some time.

Just as in March 2009, one does not have to look far to find well-reasoned discussion in support of why the market has topped out, alongside equally compelling reasons of why the rally might continue for some time. What is the average investor supposed to make of all this conjecture? One way is to debate the market implications of news and to try to anticipate what might happen next. But whom do you believe? We’ve seen there are always cogent-sounding arguments for multiple scenarios.

An alternative approach is much simpler. It begins by accepting the market price as a fair reflection of the collective opinions of millions of market participants. So rather than betting against the market, you work with the market. That means building a diversified portfolio around the known dimensions of expected returns according to your own needs and risk appetite, not according to the opinions of media and market pundits about what will happen next month or next week. It also means staying disciplined within that chosen asset allocation and regularly rebalancing your portfolio. Under this approach, shares are typically sold after a solid run-up in the market. The trigger for rebalancing is not media speculation but the need to retain your desired asset allocation. Say you have chosen an allocation of 60% of your portfolio in equities and 40% in fixed income. A year goes by and your equity allocation has rallied strongly so that the balance between the two has shifted to 70%/30%. In this case, it makes absolute sense to take some money out of shares and move it to bonds or cash.

It works the other way, too, so that if shares have fallen in relation to bonds, you can take some money out of fixed income cash and buy shares. Essentially, this means buying low and selling high. But you are doing so based on your own needs, rather than on what the armies of pundits say will happen in the market next. Of course, this doesn't mean you can't take an interest in global events. But it does spare you from basing your long-term investment strategy on the illusion that somewhere, at some time, "certainty" will return.

#### **References**

1. "Five Signs the Stock Market Has Bottomed Out and Five Signs It Hasn't," Associated Press, March 15, 2009.
2. "When Moderation is No Virtue," Economist, May 22, 2009.