MARKET UPDATE AUGUST 2015

THE TRANQUILITY WAS NICE WHILE IT LASTED . . . .

Now that the stock market has taken its inevitable step back after an unusually long period without normal declines, I thought it would be worthwhile to address some common investor questions. Although these questions and concepts might seem elementary to some, it makes sense for investors to revisit key facts and concepts just like how athletes and musicians continually practice fundamental drills.

ISN'T THE MARKET DUE FOR A CRASH SINCE IT'S BEEN AT ALL-TIME HIGHS AND THINGS ARE SO UNCERTAIN WITH THE WORLD AND ECONOMY?

No. The market is always hitting new highs when it is in a prolonged upward trend. Furthermore, everything is always uncertain with the world and economy. The passage of time and nostalgia always make it seem like prior periods of time had more certainty and that dramatic events were of less importance. For example, try to really remember the details and anxiety you felt over the following market-moving events: The Russian annexation of Crimea in 2014, the fiscal cliff scare in the winter of 2012, Greece worries in the spring of 2012, the debt ceiling and U.S. credit downgrade in late summer 2011, Greece worries in the spring of 2010. And looking back a few more years: Argentina defaulting on its debt in 2001, Russia defaulting on its debt in 1998, the Long-Term Capital Management hedge fund meltdown in 1998, the Asian economic contagion in 1997, the bond market crash in 1994.

Bottom line: Anytime you read a statement from some so-called market expert saying that it's a difficult time to invest because of all the uncertainty, realize that they either don't know what they're doing or they're trying to get people to believe that they really can predict the future . . . just not necessarily this time.

WHY DOES IT SEEM LIKE OVERALL RETURNS HAVE BEEN FLAT FOR A LONG TIME, BUT THE MARKET HAS BEEN MAKING HUGE GAINS?

Frequently when talking about investing, I blurt out "The majority of the time it's frustrating to be an investor." When I do this, I can usually see the disappointment on people's faces. I guess they want me to say that I'll make it a blast, but here are the facts: The prices of any asset are either doing one of three things: moving up, moving down, or flip-flopping in a sideways movement. Two of the three aren't fun. Fortunately, throughout time, the one enjoyable phase has more than made up for the other two.

However, the world markets have been in a phase the past few years that we haven't experienced since the late 1990s. It might be surprising to hear, but that period of time was one of frustration for many investors. Back

then, the stocks of large U.S. growth-oriented companies were on fire. Pretty much everything else was left in the dust in comparison. The result was that investors that had high-quality, diversified portfolios with exposure to all the other investment categories felt like they were missing out on the "big, easy, seemingly low-risk money" being made by apparently everybody but them. I remember a financial magazine during that era that had a cover story making the case for why investors didn't need diversified portfolios and should just invest everything in an S&P 500 index fund. We know how that period of time ended.

Well, the past few years have been similar. Large U.S. stocks have done substantially better than other investment categories. And since the financial media focuses on this one category when reporting the financial news (referencing the Dow Jones Industrial Average and the Standard & Poor's 500 indices), it is common for investors to extrapolate those returns to what they think is occurring across the board.

Just as humans tend to be influenced by "keeping up with the Joneses", many times they feel like their peers are doing better with their investments. Chances are, they're not. If they're really bragging, ask to see their statements. It's likely that the real math and what they're saying are miles apart. That might sound harsh, but I'm speaking from years of experience. This is the way it works.

This trait of "wanting to believe" knows no socioeconomic or investing sophistication limits. Here is a similar high-profile example:

In the summer of 1999 Warren Buffett gave a speech at an annual business conference in Sun Valley, Idaho that is attended by the upper echelon of business tycoons. At the time, the stock market was going through the roof, and the valuations of technology stocks were absurd. He broke from his policy of not making market predictions, and laid out the facts that pointed to why he believed the market would have below average returns for almost the next two decades. It was reported that after the presentation, he felt pretty good about how he perceived that he had persuaded the attendees to believe his case. Apparently though, the extremely successful attendees mingled afterward and talked about how he had lost his touch, was too old to relate, and were overall disgusted that he rained on their parade. After all, he had his heyday to make a fortune in the 1950s and 60s, and now it was their time.

What investment category can provide stability and access to your money with good long-term growth?

This combination doesn't exist. Bonds tend to be more stable than stocks, but the returns are always a function of inflation rates. After counting inflation, shorter-term bonds always tend to have returns near zero while longer term bond returns are in the low single digits. After factoring in taxes, short-term bonds typically have negative "real returns" while longer term bonds might squeak by with 1 – 2%. (This was the still the case in the early 1980s when interest rates –and inflation– were in the double digits.)

Owning a private business or investment real estate allows investors to pretend that the prices don't fluctuate because they don't receive a monthly statement with an updated appraisal or the latest offer, but in reality, the prices are fluctuating all the time. The price of being able to pretend that it's at a stable level is that it takes a lot of work and expense to sell it.

There currently is a type of insurance-based investment that is getting lots of advertising and is being talked about constantly on radio shows. The pitch is that you can get stock market returns and never experience declines. Sounds good! The reality is that the long-term returns are likely to approximate those of short-to-intermediate term bonds. If that's someone's goal, then it might be worthwhile (while making sure the rest of the terms aren't overly restrictive). Unfortunately though, these investments tend to be marketed as a way to get returns similar to the stock market without ever experiencing any losses. A guy named Madoff had a deal like that too.

Why does it seem like the stock market drops faster than it increases?

Because it does. Always has, always will. This is a result of supply and demand, and human emotion. When people become convinced that they want to buy something, that behavior occurs at a more spread out and leisurely pace than when people get scared and want to bail. Think of it like the steady, orderly stream of people entering an arena for an event compared to how they would try to leave if there was a fire.

How can I reduce the stress that stock market declines cause?

One of the best ways to think about the market came from an analogy used by Buffett's graduate school professor and mentor, Benjamin Graham. He suggested pretending like the stock market was an individual named Mr. Market that you co-owned a business with. Each day Mr. Market would blurt out a price at which either you could sell your half of the company to him or at which you could buy his half. Alternatively, you could choose to do nothing. Some days Mr. Market was in a good mood and would throw out a very high price, but other days he was depressed and would state a ridiculously low price. If the price was so high that it didn't make sense, you could take advantage of it and sell your half of the business. Likewise, if it was absurdly low, you could buy him out. The key was that you weren't forced to do anything.

No matter how rich or how sophisticated an investor, I feel that in times of market turmoil, it makes sense to revisit this analogy.

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