Lessons to Consider When the World Goes a Little Mad

Nobel Prize winner in economics Daniel Kahneman, author of the book "Thinking Fast and Slow," and colleague Amos Tversky have found that we tend to feel the pain of a loss twice as much as we feel the joy of an equal-sized gain. Losing one dollar hurts twice as much as winning one dollar feels good. For some, that sentiment is what makes stock market movements difficult to live through without panicking. On balance, investors are highly risk averse. And Kahneman and Tversky's collaborator (and recent economics Nobel winner) Richard Thaler found that the 2:1 ratio increases with the size of the investment!

Research has found that losses even lead to heightened autonomic responses, compared with equivalent gains. Professors Guy Hochman and Eldad Yechiam studied the effect of losses on investors and noted that losses spurred higher physical responses, such as pupil dilation and increased heart rate. This was true even for people who weren't naturally averse to losses.

So, if your investments are causing you to feel a bit stressed, do not feel bad about your anxiety. Your feelings are normal. However, the first step to addressing a problem is to predict its arrival and admit its existence. Even if you have a well-thought-out plan that anticipates such declines, as the saying goes, all plans are great until the first shot is fired. You might recall renowned "philosopher" Mike Tyson's famous quip, **"Everyone's got a plan until they get punched in the mouth."**

The good news is that you already understand that bear markets are a feature of the stock market. Without them, there would be no risk and, therefore, no equity risk premium (that is geek-speak for higher long-term returns from stocks than from cash or bonds). As investors, we would not like that one bit. If we were to look back at every other market decline, we would see there were plenty of noisy investors who thought the only light at the end of the tunnel was the proverbial headlights of a truck coming the other way. They were wrong. In each instance, it turned out that wasn't the case. And it's likely that isn't the case now, either. In other words, every *past* decline looks like an opportunity; every current decline feels like risk.

When the stock market is meeting our best expectations, accepting the market's inevitable up and down cycles and the benefits of a disciplined approach sounds reasonable, even easy. Yet when the market goes down, it often feels different, maybe difficult. That is explained by the tug-of-war between our emotions and our reasoning. Which side wins? French philosopher Blaise Pascal declared, "All of our reasoning ends in surrender to feeling." Our job as your advisor is to prove Pascal has misjudged the intelligence of Rockwood's clients!

It's why we write down your strategy and the logic that supports it in your investment policy statement (IPS), tied to your specific goals. That way, when emotions threaten to overrule reason, we can help reason prevail. For instance, your IPS includes data about past downturns, because downturns are expected to occur periodically. Reason can remind us that this current market correction is expected, and your financial plan is designed with this in mind. You are like a reasonable boxer who already knows in advance that you will periodically get punched in the mouth.

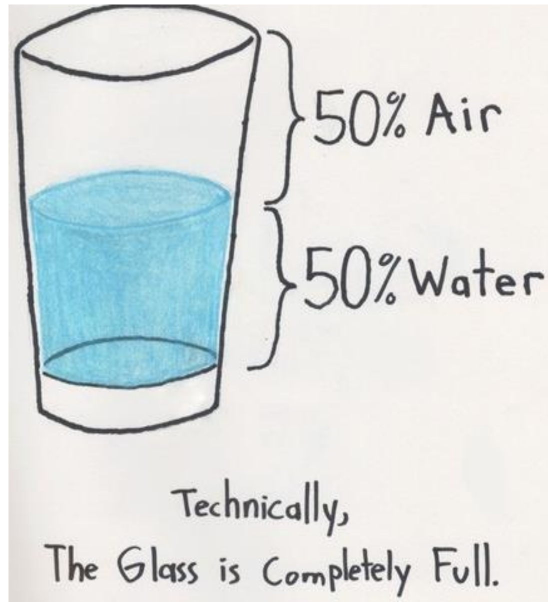
There is always a financial boogeyman to worry about…and there always will be. It's why during bull markets, stocks are said to climb a wall of worry. Also important to remember is that while you might be worried about issues such as still-high US equity valuations (the Shiller CAPE 10 remains about 26, though it is well down from its January 2018 level of 33.3), a slight inversion in the yield curve, the potential of a major trade war, and the shutdown of at least part of our government, you can be certain that the sophisticated institutional investors who now account for 90% or more of trading volume, and who are thus setting stock prices, are also well aware of those issues.

Therefore, risks are already incorporated into today's prices. That means that unless the outcomes are worse than currently expected, markets may not fall further. **Remember, it doesn't matter whether news is good or bad, only whether it is better or worse than already expected by all market participants.**

Somewhat paradoxically given recent stock prices, the data points below support the notion that the news on the economic front is mostly positive.

- Economic growth is consistent. The Federal Reserve Bank of Philadelphia's Fourth Quarter 2018 Survey projects real GDP growth of 2.7% for 2019, down just slightly from the forecast of 2.9% for 2018.
- Unemployment is at 3.7%, the lowest rate in 50 years.
- Inflation is moderate. The Philadelphia Fed's latest 2019 forecast is for an increase of 2.3% in the Consumer Price Index (CPI), down slightly from its forecast of 2.4% for 2018.
- Consumer sentiment (a leading indicator) is strong. The final December University of Michigan Consumer Sentiment Survey came in at 98.3, remaining near the highest levels we have seen over the past 18 years (despite the recent weakness in stocks).

What's more, fiscal policy is currently very loose and monetary policy is far from tight. While no one knows for sure, there isn't a whole lot of evidence that a nasty recession is right around the corner. The most successful investors have long asserted that investing is simple, but far from easy.



The reason investing is not easy is that it is difficult for most individuals to control their emotions – emotions of greed and envy in bull markets and fear and panic in bear markets. In fact, bear markets are the mechanism that serves to transfer assets from those with weaker stomachs and without investment plans to those who are well-advised and have stronger stomachs and well-thought-out plans.

You are firmly a member of the latter group, as you have an empirically derived plan supported by a globally diverse, balanced, risk-aware portfolio. In other words, you've planned well, and your mouthguard has been in the whole time…

Coal in the Proverbial Stocking 2.0

We recognize that we sent this particular article via email in late December. However, its content is so important that we felt obligated to include it in print in our quarterly perspective to make sure it reached you all.

The stock market is definitely going to get coal in its proverbial stocking this year. It has been misbehaving of late, and nearly everyone is displeased.

If you are one of our clients who worries from time to time, that is okay – it's perfectly natural. We thought we'd share a bit of perspective to provide some comforting clarity and insight. However, if you and everyone you know possesses ironclad behavioral finance mastery…well then, read no further.

The catalyst for our writings here is that global stock markets are lower than they were at the start of 2018. In just a few weeks of trading, the global equity market is down about 10% for the year, which puts us in correction territory (finance geek-speak for a 10% decline), and predictably, some prognosticators extrapolate recent trends and then predict a bear market (a 20% decline) to follow.

Whether or not that actually happens, the unassailable truth is that stock market downturns are a normal part of life. They often cause us to suffer while they are happening, and they always feel like they last longer than they really do. Each time declines arrive, they seem to uniquely affect different people, often in different ways. If this time around it's bothering you, we invite you to turn off the news and avoid the websites you normally surf. Trust us when we tell you that their intent is to make you feel worse (they earn more money that way). Don't participate in that cycle of anxiety, and instead please call us if you would like to talk about it.

During every run-of-the-mill market correction, you can count on the doomsayers and pundits to spew hyperbole endlessly about forthcoming financial calamity. They can make it seem like it's the end of the world. Except of course…that it is not. Life will go on, and markets will recover – because downturns such as this one are a perfectly normal part of a market economy.

When you perceive you're in the middle of so much uncertainty, when people are heedlessly reacting to sound bites, it's hard to step back and realize that there is no need to fear. Rising above the fray, you might take a moment to think about some of these panic triggers. Are tariffs and trade disputes really going to linger forever? Are interest rates going to forever rise unabated? Will a polarizing political climate persist interminably? Hmmm…the answers are no, no, and no. Furthermore, none of these topics of the moment is relevant to the long-term health of your portfolio nor the long-term value of the investments you own.

You might already know our advice, which is to assert that if you've planned with us and you are retired, you have more than enough bonds and cash to last until the market improves (just like you did in 2008-2009). So we won't be selling any stocks at depressed prices for the purposes of producing cash flow.

If you are still working or you have a little extra cash, take advantage of buying shares more cheaply. Keep following the plan and doing the things you know you should be doing. We won't let you get distracted by the headlines.

Speaking of headlines, these patches of market volatility, particularly when paired with the arrival of the new year, almost always elicit a flood of baseless predictions from the financial media. In an effort to preempt that impending deluge of nonsense, we thought we might refresh and peddle our own predictions:

How about some predictions that actually might come true this year?

- Markets will go up some of the time and down some of the time.
- There will be unexpected news. Some of this will move prices.
- Thousands of tons of newsprint will be devoted to speculating on tariffs and trade.
- Thousands of tons more will be devoted to the likely path of interest rates.
- TV pundits will frequently and loudly debate short-term market direction.
- A colleague or friend you unconditionally respect will be selling all of their stocks because they are convinced a crash is coming.
- A colleague or friend you unconditionally respect will be buying all the stock they can find because they see obvious opportunity in temporarily depressed prices.
- Some economies will strengthen. Others will weaken. These change year to year.
- Some companies will prosper. Others will falter. These change year to year.
- Parts of your portfolio will do better than other parts. We can't predict which.
- A new book will come out by some smart author saying the rules no longer work and everything has changed.
- Another new book will come out by some smart author saying nothing has really changed and the old rules still apply.

We've written before that the future is always uncertain. There are always unexpected events. Some will turn out worse than we expect; others will turn out better. The only sustainable approach to that uncertainty is to focus on what we can control – such as asset allocation, rebalancing, tax-loss harvesting, and a redoubled commitment to perfect behavioral finance.

Evidence shows that in the past seven decades, the US markets have experienced a decline of 10% (the territory we're in already) in about one-third of all calendar years – which is another way of corroborating that this recent drawdown is entirely normal. In one in every five years, we have experienced drawdowns of between 10% and 15%, and in about one in every six years, the market declines farther than 20%.

Like clockwork, stocks periodically become very attractive in price because investors with no plan simply panic and sell them at just about any price they can get in their rush to the exits. It sure feels like we are experiencing one of those periods now.

Whether this coming year will be one of those 10% down years, a 20% down year, or an up year, only time will tell. But it's worth noting that in the past, every one of those drawdowns eventually ended with an even greater upturn and markets reaching new record highs.

If you've internalized our message and you are still feeling anxious or nervous, or you just want to talk it through – please give us a call. If we happen to be out of the office, you already know we will get back to you as soon as humanly possible. We're here for you…

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