Stay Focused, Markets are Moving

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Most people would like to see a gain of 21.6 percent on their annual statement. That was the annual return for the Standard & Poor (S&P) 500 Index during 2017. In general, U.S. stock indexes did quite well last year – and the year before, too. For instance, the S&P 500 Index was up 11.8 percent in 2016.[1]

While no one can invest directly in an index (many mutual fund companies offer index based fund options) recent returns make it easy to understand why U.S. stock markets have been popular with investors. *Morningstar* reported record amounts of money flowed into various types U.S. stock investments during 2017.[2] Was this a result of the proverbial "herd mentality"? Whenever large numbers of investors are doing the same thing, we believe a prudent course of action is to step back, take a breath, and evaluate the situation. Here are two questions that investors should consider:

1. Is the price or return above average or below average?
Usually, being above average is considered a positive state of affairs. That's not the case with investing. Mean Reversion Theory (MRT) suggests prices and returns eventually move back toward the average. In other words, when annual returns are above long-term averages, they're likely to move lower. The reverse is true, too. When returns are below long-term averages, they may move higher.[3]

Consider the S&P 500 Index. It returned 21.6 percent last year. The historic average annual total return for the Index over the last 89 years, from 1928 through 2017, was 11.7 percent. During the last 40 years, the average total return was 11.4 percent.[4] Therefore, 2017 returns were well above average.

That doesn't mean 2018 returns will be below average. It simply suggests investors may be buying high. In addition to prices and returns, MRT can also apply to interest rates and price-to-earnings ratios.[3]

Mean Reversion Theory is the bucket of cold water that can help restore sanity when investments trade well above (or well below) historic averages.

2. Are animal spirits informing investors' opinions?
Animal spirits is a term used by economists to describe investor behavior. The blog *Organization and Markets* explained, "The new behavioral economics literature uses the term to refer to a range of behavior which falls outside what is normally understood as rational."[5]

In *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters*, co-authors George Akerlof and Robert Shiller said animal spirits are often inspired by 'new era' stories that "purport to describe historic changes that will propel the economy into a brand-new era."[6]

You don't have to think very hard to remember one of the greatest new era stories ever. The story was about the future of the Internet, and it led to the dot.com bubble. The storytellers weren't wrong. Indeed, the Internet *was* an important technology paradigm that created a new era. However, investors became prematurely enamored which led to a stock market bubble that delivered devastating results. [6, 7]

Back to Basics
Today is no different, investors can easily identify "new era" stories. Spend a few minutes reading the research of investment analysts or brokerage firm and you'll find captivating tales about the potential of self-driving cars, facial recognition

software, space exploration, and life-extending medical innovations.[8] At any given time, a cornucopia of investment opportunities exist with the assumption of attractive returns. This abundance potential can be overwhelming, making it easy lose sight of basic investment principles.

When you find yourself inspired by the potential of new era stories, and you consider moving more of your savings (perhaps, all of it) out of investments that have been chosen specifically to help meet your financial goals, it's time to remember the foundational principles of investing and your personal index number:

1. **Defining measurable and attainable financial goals.**[9] Typically, your goals should describe what your money needs to do for you. Every goal should be measurable so you know if you are saving enough. Additionally, every goal should have a time frame. For example, a goal might be:
   - A retirement income of $5,000 each month for the rest of your life
   - $100,000 in savings to put toward your child's college tuition in 14 years
   - Leaving a million dollars to each of your children or grandchildren
   - Providing lifetime income for a child with special needs
   - Being able to afford healthcare in retirement
2. **Developing allocation strategies to reach your goals.**[10] Choosing an asset allocation strategy and diversifying investments based on your Personal Index Number may help manage risk more effectively. Typically, asset allocation strategies blend stocks, bonds, cash, and other investments to balance risk and potential reward.
3. **Maintaining a long-term perspective.**[11] Animal spirits often inspire impulsive investment decisions – the kind that can undermine the success of any well laid financial plan. When market gyrations tempt you to make significant changes to your portfolio, even though your financial goals remain the same, contact your financial advisor and have a conversation.

The basic principles of investing remain fairly constant. Human emotion, however, is quite variable. When emotion tries to jump into the front seat and drive your investment choices, pump the brakes and reconsider. If you still have questions about a plan that best suits to your needs, give us a call.

Looking across the medium-term investment landscape, rates are likely on the rise. The Federal Reserve meets in late March and is expected to raise the federal funds rate a quarter point to 1.50-1.75%, making this the sixth move higher since the cycle began in 2015. The Fed is anticipating three hikes in 2018, two in 2019 and two in 2020, which would raise the fed funds rate to slightly above 3.0%. Looking at current fundamentals, the economy is strong enough to handle rate hikes and the Fed's balance sheet should continue shrinking as it unwinds its quantitative easing programs. This leaves the central bank in position to address the next financial crises.

Modestly higher rates in the quarters ahead should congruent with a stable and growing economy. Still, we cannot rule out the potential for exogenous events that could send rates sharply higher. For example, rapid inflation, full employment and the ballooning U.S. budget deficit could require the Treasury to flood markets with supply at a time when global investors are losing confidence in the United States. This confluence is unlikely, but it reminds us that bonds are fully valued compared to stocks. Our fixed-income securities account for a relatively low allocation in our diversified strategies.

Sources:
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