FA Financial Alternatives
integrated wealth management

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Year to Date 2017

All asset classes except for commodities continued to have positive returns in the first half of the year; and stock market volatility remained low, despite events including the Syrian refugee crisis, Brexit, the US election and its political aftermath, and the North Korean nuclear threat.

Exhibit 1 shows the rolling 20-day volatility of daily returns of the Russell 3000 index (a measure of the total US Stock Market) since 1995. You can see that it has fallen well below the average for the entire period – an indication that US equity market volatility has been low.

There have been many stories in the press speculating about why volatility has been low, how this is related to the real economy and global events, and what it might mean for future returns. However, the stories are just that—stories. But it might not matter much anyway, as research shows that recent volatility does not predict whether future returns will be high or low.

Instead of dwelling on the unknowable, we can focus on what we do know. Over time, stock markets have been volatile with their ups and downs. You should not be caught off guard by the next market downturn, whenever that might occur. The level of volatility will not tell us when, why, or by how much the market may drop because volatility often spikes during a market decline.

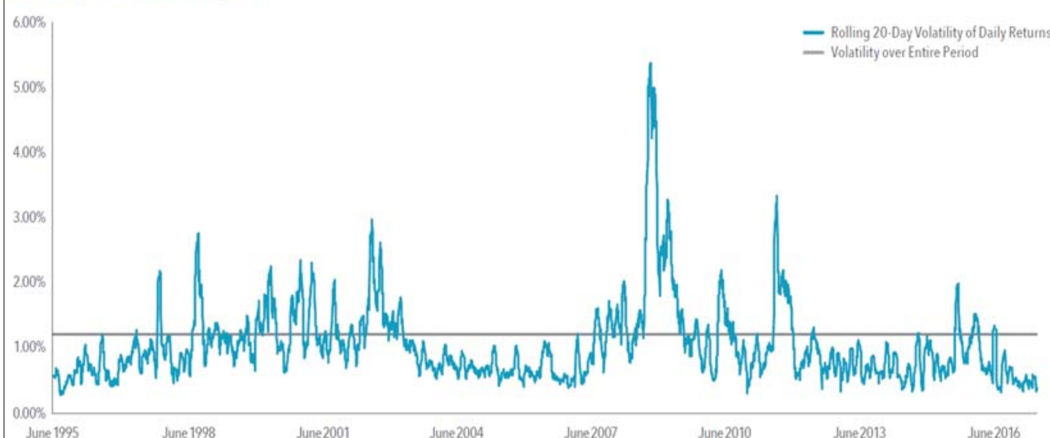
Executive Summary

- Investors continued to earn positive returns in the first half of the year.
- Nobody knows when the next bear market will occur, but we know that stock markets have had their ups and downs and they always will.
- Bear markets, which are corrections of 20% or more, cannot be distinguished beforehand from normal 5%-10% corrections which occur on a regular basis.
- Trying to sell before a bear market usually causes investors to miss the next market up turn because most market drops turn out to be just normal 5%-10% corrections.
- Accept that bear markets occur on a regular basis and avoid panic selling your stock positions during the downturn.
- Maintain ample conservative investments in your overall portfolio.
- Try to ignore the day to day financial news which is often sensationalized to keep your attention.

When Will the Next Bear Market Occur?

A bear market typically refers to a stock market decline of 20% or more lasting at least two months. On average, a decline like this occurred about once every seven or eight years since 1973. No one knows when the next bear market will occur, and unfortunately these cannot be distinguished beforehand from normal 5%-10% corrections which occur on a much more regular basis. Trying to time the market and sell before a bear market usually causes investors to miss the next market up turn because most market drops turn out to be just normal 5%-10% corrections. Trying to time these market swings is a losing strategy. Many claim to be able to successfully time the market but we have not found anyone who can do so with any degree of accuracy and consistency.

Exhibit 1: Rolling 20-Day Volatility of Daily Returns—Russell 3000 Index
June 29, 1995–June 23, 2017



In USD. Volatility is measured as standard deviation. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. Past performance is not a guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

What Can You Do to Prepare for the Next Bear Market?

Peter Lynch, the famous mutual fund manager from the 1980's and 90's, said, "far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves." We agree. Still, the following three points will help you prepare:

Exhibit 2: Hypothetical Growth of $1 Invested at the Market High
Past Six Market Declines of at Least 20% (1973–Present)

			100% Equity			60% Equity/40% Fixed Income		
High	Low	Market Total Return	At Low	5 Years After High	10 Years After High	At Low	5 Years After High	10 Years After High
Jan. 1973	Sep. 1974	−37.26%	$0.64	$1.45	$3.51	$0.79	$1.45	$3.07
Aug. 1987	Nov. 1987	−23.41%	$0.77	$1.52	$3.76	$0.87	$1.54	$2.99
Apr. 1998	Aug. 1998	−21.13%	$0.79	$1.10	$2.63	$0.88	$1.21	$2.20
May 2002	Sep. 2002	−20.86%	$0.79	$2.41	$2.36	$0.88	$1.82	$2.00
Oct. 2007	Feb. 2009	−58.37%	$0.42	$1.00	—	$0.62	$1.10	—
Apr. 2011	Sep. 2011	−22.10%	$0.78	$1.37	—	$0.87	$1.25	—

In USD. Source: Dimensional Fund Advisors. Market Total Return reflects the return of the 100% equity strategy for the indicated period from high to low. Returns are based on Dimensional balanced strategies. The strategies are hypothetical, for illustrative purposes only, and are not to be construed as investment advice. They do not represent actual portfolios or investments. Assumes $1 invested at the high point. The 100% equity strategy is 70% US stocks and 30% non-US stocks. The equities are composed of 20% S&P 500 Index, 20% Dimensional US Large Cap Value Index, 10% Dimensional US Small Cap Index, 10% Dimensional US Small Cap Value Index, 10% Dow Jones US Select REIT Index, 10% Dimensional International Marketwide Value Index, 5% Dimensional International Small Cap Index, 5% Dimensional International Small Cap Value Index, 3% Dimensional Emerging Markets Index, 3% Dimensional Emerging Markets Value Index, and 4% Dimensional Emerging Markets Small Cap Index. Returns for the 60% equity/40% fixed income strategy are based on a 60% allocation to the 100% equity strategy and 40% allocation to fixed income, which is represented by an equally weighted blend of the BofA Merrill Lynch One-Year US Treasury Note Index, Citi World Government Bond Index 1–3 Years (Hedged), Bloomberg Barclays US Treasury Bond Index 1–5 Years, and Citi World Government Bond Index 1–5 Years (Hedged). The S&P data provided by Standard & Poor's Index Services Group. Dow Jones data provided by Dow Jones Indices. The BofA Merrill Lynch Indices are used with permission; © 2017 Merrill Lynch, Pierce, Fenner & Smith Inc.; all rights reserved. Citi fixed income indices © 2017 by Citigroup. Bloomberg Barclays data provided by Bloomberg. The balanced strategies are not recommendations for an actual allocation. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results. Diversification neither ensures a profit nor guarantees against loss in a declining market.

1. **Accept that bear markets occur on a regular basis**, and decide beforehand that you will not sell your stock positions during one due to fear and panic. Moreover, decide beforehand that you will rebalance your portfolio and add to your stock allocations during the next bear market.

2. **Maintain adequate emergency reserves and conservative investments**, which do not fluctuate as much as stocks, as a part of your overall portfolio. This will provide the emotional reassurance you may need when stock prices are falling. With sufficient reserves and conservative investments, you can withdraw needed funds from these investments – so you are not forced to sell your stocks in a bear market.

3. **Try to ignore the day to day financial news**. Do yourself a favor and tune out this day to day financial news. It is not helpful. The message from daily financial news is that you should either buy or sell and if you don't, you will miss the boat. This message captivates listeners, heightens emotions and convinces people that they need to do something to avoid the danger of losing money. But if you already have a good plan, the best thing you can do in most cases is nothing or simply rebalance your already well diversified portfolio. News, in general, is mostly negative and focuses on the problems of the world to grab your attention. But what the news often misses is the significant long term positive progress that continues to be made and that we all benefit from.

Global Stock Markets are Resilient

Fortunately, history has shown that global stock markets are resilient. Exhibit 2 shows how a hypothetical 100% equity strategy and a hypothetical 60% equity/40% fixed income strategy would have fared in the past six global stock market downturns of at least 20%. The last occurrence was in 2011. The addition of bonds would have helped to mitigate the decline in the 60/40 strategy relative to 100% equity strategy. Additionally, investors might take comfort in knowing that for most of the historical downturns, $1 invested in either strategy at the market high point (before the decline) would have resulted in positive growth within five or 10 years.

Summary

Investments continued to experience positive returns in the first half of the year and stock market volatility remained low. On average, bear markets occur every seven to eight years and are a normal part of stock market investing that should not be feared.

The best preparation for bear markets is to simply accept them and to decide ahead of time not to panic and sell stocks during the downturn, and instead to rebalance your portfolio and buy stocks during the next stock market drop.

Holding enough of your portfolio in more conservative investments and ignoring the popular day to day financial news will also help you deal calmly and coolly with the next bear market.

Please call us if you'd like to discuss your investments or any other aspect of your financial life in greater detail. We hope you are enjoying your summer.

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