Remaining At Rest In A Room

SYNOPSIS

- Last year was difficult for well-diversified investors because the annual return of nearly every major asset class failed to beat inflation.
- Modifications to asset allocation should only be done to profit from changes in financial markets over time.
- As anxious as conservative investors may feel to adjust their allocations, resist the urge simply because a New Year is upon us.

OUCH

The idea behind proper diversification is that when one market struggles, the other(s) step in and offer support. Several conservative investors who closely watched their portfolios in 2015 are now questioning this strategy for very good reason.

ASSET	2015 PERFORMANCE	INDEX
Aggregate Bonds	0.55%	Barclays Aggregate Bond
Long-Term U.S. Government Bonds	-0.53%	Barclays Long-Term Treasury
U.S. Large-Cap Stocks	-0.78%	S&P 500
Cash	0.11%	3M Treasury Bills
Commodities	-22.83	CRB Index
Emerging Markets Stocks	-16.95%	MSCI Emerging Markets
European Stocks (Local Currency)	7.00%	Stoxx 600

This table shows that there was nowhere to run last year, and any return that came close to what would be deemed "attractive" would have required deviating from diversified asset allocation and tactically making bigger bets on fewer ideas.

For example, had an investor taken all of her assets and placed them into Facebook, Amazon, Netflix, and Google, she would have most likely doubled her money or better (depending on the actual percentages allocated to each stock). These four stocks, dubbed "FANG" stocks by financial news media, surged last year.

A New Year does not always warrant a new strategy. Stay the course and be patient.

***NOTE**: Although European stocks appear to show a nice gain, due to the roughly 9% depreciation of the Euro relative to the U.S. dollar throughout the year, U.S. investors actually lost 2% (7% - 9%) when the effects of currency are incorporated into the analysis.*

Diversified portfolios typically do much better. Practically every year since 1995 has seen at least one asset class deliver a return that exceeded 10 percent, and last year was the worst in almost 80 years for asset allocation strategies. The fact that 2015 deviated so far from its track record has led many to believe that diversification no longer works.

It's human nature to succumb to the hindsight-fueled "would have, should have" mentality, as many of us look back to see what could have been had we only picked the winners. For example, had we known a year ago that FANG stocks would surge and subsequently moved all our assets into these holdings, we'd be grinning from ear to ear at the moment. Or would we?

Owning just four stocks in the same sector in a single geographic region breaks the single most important

mandate of conservative investment strategies, and that is to manage risk.

Furthermore, not a single FANG stock pays a dividend, and most carry valuations that risk cutting a stock in half over even a hint of a bad headline. Don't believe me? Take a look what happened to biotech stocks back in September after Hillary Clinton posted a fragmented sentence on Twitter, discussing her desire to regulate drug pricing. The sector lost billions in value in a matter of days.

To be clear, I have nothing at all against the FANG stocks, and lack of a dividend and a high valuation are not necessarily bad characteristics. The issue is that a high concentration to these is a bad fit for a conservative investor who (1) wants volatility mitigated, and (2) needs income from investments.

After considering the amount of risk a conservative investor must accept to ignore diversification and own only these four stocks, this decision may not sound so wise after all.

Simply put, diversification did exactly what it is supposed to do last year, and any conservative investor whose total return came even close to double digits should ask why they have so much risk in their portfolio.

NOW WHAT?

Blaise Pascal, the legendary mathematician and philosopher, famously said:

"All of human unhappiness comes from a single thing - Not knowing how to remain at rest in a room."

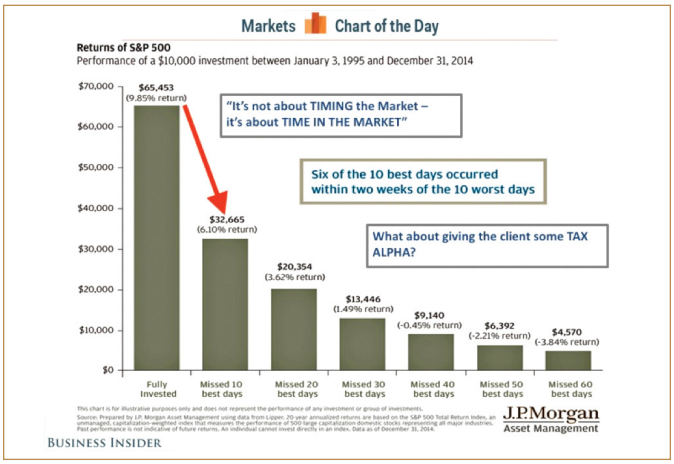
The truth behind these words can be applied to nearly every facet in life, but arguably no more than in the way we view our investments. The volatility that has rocked markets for several years now, combined with the Fed's policy of keeping interest rates artificially low, has prompted many conservative investors to feel as if their current strategy is failing them.

Many want a change, and now that the New Year has arrived, it seems like the right time to do one of the following:

1. Go to cash and wait out this storm. It's not worth stomaching the volatility and paying fees to get these returns.
2. Add more risk into a conservative portfolio in order to achieve returns that were so easy to obtain just a few years ago. There are bills that need to get paid.

While I understand the desire to make a change, the beginning of the New Year is as arbitrary and irrelevant as any other time period. Altering an asset allocation should only be considered as financial markets evolve over time, and these moves have absolutely nothing to do with the current positioning of the Earth as it orbits around a big ball of gas.

In fact, let's dig deeper into the two scenarios above to show why it's often best to do nothing at all. To those who can't handle seeing their nest eggs up one day and down the next, the chart below shows why trying to time markets in such a manner is akin to gambling.



A $10,000 investment in the S&P 500 back in January 1995, has delivered $65,453 (far left green bar) as of the end of 2014. Had an investor

missed the ten best days in the market, his return would get cut over half to $32,665 (second green bar from the left).

What makes timing markets even more brutal is that six of the ten best days occurred within two weeks of the ten worst days. Meaning, the best and worst days transpired during periods of volatility, and proper timing would require an investor to know the exact days to buy and sell.

Simply put, it's not about timing markets but rather time in the market. Cash will do nothing but lose money safely, so it's best to stay the course for now.

In regards to those conservative investors who prefer to alter their risk profile in search of higher returns, I urge you to sit still in this room as well. Although I remain quite bullish, I also expect the volatility plaguing markets to persist for two reasons:

1. **Nothing's Changed:** Many of the sources of volatility from 2015 remain. The Middle East seems more unstable, Greece is still a fiscal disaster, Puerto Rico may still default, Russia is still not playing nice, China continues to transition their economy, etc.
2. **Fed Policy:** The Fed has already forced investors far enough up the risk curve and into a larger allocation to stocks than most can tolerate. This cohort is exacerbating volatility spikes because they own investments that they don't trust and sell into panic.

As in years past, this volatility is not expected to materially impact the future path of our $18 trillion economy. However, that does not change the fact that conservative investors must sleep at night. Investors who alter their risk profile put themselves at real risk because the odds of an emotionally charged decision, such as panic selling, are amplified.

The bottom line is that a New Year does not always warrant a new strategy. Stay the course and be patient. Although the risk of a recession remains quite low, the volatility that has rocked financial markets over the past year could very well remain intact for some time.

Sincerely,

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