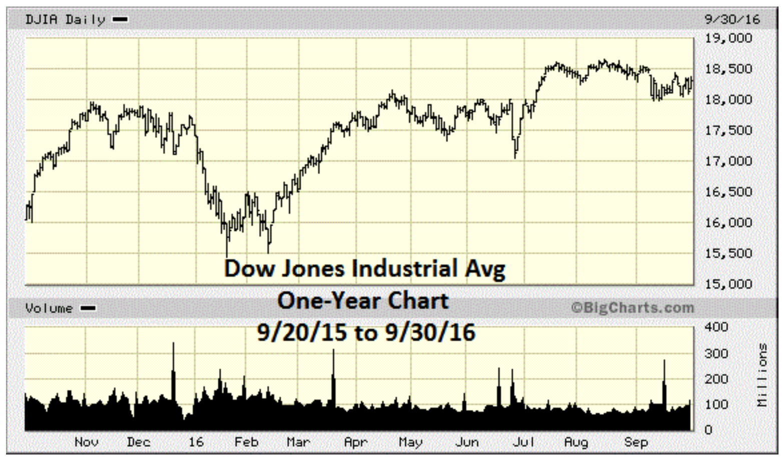
American Heritage Financial

October Update **October 4, 2016**

Pain and Pessimism

There has been no shortage of reasons to fear the stock market in 2016. Crazy events like BREXIT (Britain voting to leave the European Union), the ongoing crises—or near crises—in economies around the globe, escalating terror, intractable immigration problems and, of course, there is that little event U.S. voters will deal with in early November! Any thoughtful investor has to feel the pressure of the perpetual uncertainty and many, understandably, react with an attitude of ***pessimism***.



Pessimism can be healthy but it also can detract from executing a successful investment plan. For example, there currently are plenty of scary charts and soft fundamentals (earnings, etc.) that infer above average risk in the stock market. But charts and earnings estimates rarely, if ever, are much value in pinpointing a market top. Indeed, a characteristic of this long-running bull market is that bold bearish calls have been continually discredited. If one is going to take a pessimistic approach about future stock market returns, the current environment requires one to *think outside the box when it comes to seeking out safe investments.*

Recall back in early January when a few analysts (RBS, for one, specifically) made highly publicized calls to *"sell everything except high quality bonds."* Sure, the market did experience a dramatic plunge and by mid-February stocks were near multiyear lows and investors felt the pain of the third correction in less than two years. But, now, nine months later, it is apparent that heeding calls to sell would have been costly as markets soon rebounded and then rallied to record highs by mid-August. (Through the third quarter, ending September 30, the S&P 500 is up 6.1% year-to-date for 2016.)

A senior investment strategist at Russell Investments, Wouter Sturkenboom, said the current environment has been among the most trying he can recall for market bears and he added, "Normally, if you feel bearish about the stock market you would be looking for safe bets but right now, all the traditional safe bets are no longer safe." He specifically referred to bonds, which tend to rally when things get gloomy, stating they are not now a dependable alternative. "Bonds are overvalued, which makes exposure to duration risky if inflation rises even by a bit," he said. (Duration is a measure of the sensitivity of a bond's price to a change in interest rates. Bonds with higher duration carry more risk.)

There is little debate that the stock market is not cheap based on historical valuation metrics. According to JP Morgan, the S&P 500 is currently trading at just under 17 times earnings estimates for the next twelve months, about one point higher than "average." That price-to-earnings ratio has not had much help this year from soft earnings and sales. At the least, these fundamentals suggest that future returns may be low over the next year or a number of years. This leads to one of the first steps investors must take: Accept that future returns may be lower than historical averages.

Accepting that returns may be lower is not great news. It requires investors who are trying to achieve future goals to save more—not appealing for most people and maybe impossible for those stretching to make ends meet or on a fixed income. It is, however, preferable to a solution that some investors lean toward: ***timing the market***. The idea that you can boost low returns by moving in and out of the market is a faulty strategy for normal investors. Even if you knew with precision how much earnings will be next year, you won't know what multiple investors are going to be willing to pay. Or, if you managed to time your exit from the market perfectly, study after study shows investors fail to reinvest at the right time.

Still, there are strategies to invest and build long-term wealth even with a sense of pessimism. One is to add assets with lower valuations while trimming exposure to expensive assets. Our market has examples of this currently in the undervalued energy and materials sectors which are in contrast to expensive large-cap U.S. equities, especially high yielding stocks. It takes thinking outside of the box and a willingness to buy investments which are out of favor to succeed in this environment.

Raising “some” cash is not necessarily a bad strategy for the pessimistic investor. One problem is determining what the right amount might be. Normally 20%-25% of one’s portfolio would be an aggressive move to cash. Cash could provide an opportunity to swoop in and sweep up bargains when the market tanks but it requires patience as big drawdowns are rare events. Even more, when those big declines occur, pessimistic investors often become even more nervous. The past three years, for example, have had numerous short-lived selloffs where only a very nimble investor could move back into the market before prices rebounded.

It all comes back to developing a **long-term investment plan and sticking to it**. Buying great companies for the long-term in a diversified portfolio is a valid strategy. Making some tactical allocations in or out of cheap or expensive areas is also a valid supplement to any strategy. Wholesale market timing is a bad idea for all but a select few professionals. Building wealth through investing in the stock market does occasionally require a measure of pain because we all feel the emotional pressures of volatile markets and our uncertain world. Still, more money has been lost by trying to avoid drawdowns than by staying invested in a well-developed and thoughtful investment plan. We ae here to help you deal with any sense of pain or pessimism you may feel about your investment plan. Please give you advisor a call if you have any concerns.

Best regards,

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Questions or comments?
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