Staying the Course in the Face of Uncertainty

By the Investment Management Research Group of 1st Global
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When fear and uncertainty find their way into headlines, investors should ignore the herd and "stay the course."

While there is no magic formula for handicapping a stock market correction, it is not uncommon for resoundingly jubilant investor sentiment to precede a sudden spate of selling. Building on a record run not seen since the Eisenhower Administration, January's 5.73 percent gain in the S&P 500 Index marked 13 consecutive months of positive returns for U.S. stock markets. Equity markets began pulling back from this uninterrupted climb on Feb. 2. Ironically, this reversal of fortune came on the heels of good news, *really* good news – too good, it would seem.

The Bureau of Labor Statistics' *Employment Situation Report* (the Labor Report) indicated a better than expected increase in nonfarm payrolls (200,000) coupled with the largest year-over-year increase in private-sector wages since June 2009 (up 2.90 percent). Fearing the return of long-dormant inflation that would lead to higher interest rates, the stock market has sold off sharply in response.

Demand-pull inflation, defined as *too much money chasing too few goods*, can push prices higher as aggregate demand fueled by increased wages outpaces supply. Left unchecked, this can lead to an erosion in the purchasing power of each unit of money. Economists and monetary authorities favor a low and steady inflation rate as an indicator of healthy, stable economic growth. The most recent report indicates core inflation is at 1.80 percent, which is just shy of the U.S. Federal Reserve's (the Fed) target rate of 2 percent. Should the next reading indicate a gap above the Fed's target, monetary tightening is a likely response. While the fear is currently unsubstantiated, it has markets spooked. Billionaire hedge fund manager Dan Loeb observed that "low inflation has been a critical support for the market because it has allowed the Fed to be unhurried in its rate normalization".

Removing the Punchbowl

To cool an overheating economy, the Fed has historically raised short-term interest rates. This can cut into a company's earnings by increasing its cost of capital, but can also make "risk free" assets, such as U.S. Treasuries, more attractive than their equity counterparts. Anticipation of

more aggressive interest-rate hikes are behind *some* of the selling you have seen in recent days.

Wall Street participants watch the Labor Report closely because it often reflects the current state of the U.S. economy. However, as an economic indicator, it is not without faults. The most significant being its volatility with large upward or downward monthly revisions. Only time will tell if this inflationary pressure is transitory or persistent.

Whether this sell-off was a correction in search of a catalyst or an organic response to fears of higher inflation, market corrections are one of the normal and expected remedies to adjust for overinflating asset prices.

Returning after a lengthy absence, market volatility, especially when abrupt, can not only torpedo investor confidence but also possibly evoke memories of the fear and uncertainty surrounding the 2008 Global Financial Crisis. However, it is important that investors do not conflate normal market volatility with a structural deficiency in the U.S. economy or stock market.

Benjamin Graham, the father of value investing, is the believed author of this observation: "In the short-term, the market is a voting machine, but in the long-term it is a weighing machine".

This is to say that in the short-term, momentum or the relative popularity of a stock, sector, industry, etc., can push asset prices higher in the absence of supporting fundamentals. Just a few months ago we witnessed Graham's "voting machine" in action with Bitcoin prices rising stratospherically. However, when viewed over a longer period of time, the market favors those assets with persistently strong fundamentals. This is a critical lens through which to view the recent fluctuations in the market.

They Must Know Something I Don't

Another factor at work in this market pull-back is human emotions – which are often divorced from facts. The *fear of missing out* (FOMO) is so ingrained in human behavior that it often leads to the herd effect — a phenomenon in which individuals base their actions on the actions of others, most often in the absence of evidence and in contravention of their own beliefs and knowledge. When applied to behavioral finance and market dynamics, this effect often causes either large unsubstantiated rallies or sudden selloffs based on seemingly little justification.

In a correction, sellers will often pile on, believing those other sellers *know something they don't*. As the number of sellers increases, so does the correction, creating what renowned sociologist Robert Merton called a "self-fulfilling prophecy." Merton observed that when a person is gripped

by a belief or fear, often *unjustified*, he or she will behave in a way that conjures that very outcome leading to a "reign of error."

Sadly, investors are not helped by the surplus of stock market punditry where fear-mongering is used to lure viewers and increase advertising revenue. A quick scan of headlines and "alerts" shows that nearly every report hypes the Dow Jones Industrial Average's 1,175.21-point drop on Feb 5 as the largest in its history. This ignores the critical and important fact this drop doesn't even rank in the top 20 percentage losses for the index. This seems the reporting equivalent of yelling "fire" in a crowded theatre. Instead, the largest percentage loss belongs to Black Monday (Oct. 19, 1987) when the Dow ended the trading day at 1,738.74 — down 508 points from the previous close representing a 22.61 percent daily loss. Compare that to today's Dow above 24,000 and perhaps you'll see that context is everything. That said, viewership would likely suffer if TV personalities observed that the market has not had a meaningful correction in almost two years and a pull-back was long overdue.

However unnerving self-fulfilling prophecies might be for investors, they should be expected. In any swiftly occurring capital market selloff, investor fears are a common, very human, response. These fears are derived from a belief that perhaps an economic contraction is imminent. They fear that some serious, irreversible, world-shattering unknown consequence will result if the selling continues. Like any wise sage, we always remind investors to remember their history as a guide as they drift into uncertain periods. Eventually, the selling stops and buying resumes.

Fight Fears with Restraint and Thoughtfulness

Keep in mind that it was *good* news, not calamity, which initiated a temporary head for the exits. Perhaps one of the best pieces of reporting in response to recent market gyrations is from CNBC contributor Matthew Belvedere who wrote that, "Buying stocks at the three worst times in the past 30 years still proved the best place to invest." Belvedere suggests that "[a] pullback is a chance to buy stocks off the sale rack."

In *More Than You Know*, behavioral finance pundit and prolific author Michael Mauboussin points out that the stock market has no defined outcome and no defined time horizon. This means that it's actually the *prices* in the financial market that both inform its participants about the future and influence decisions.

When investors imitate one another, or rely on the same information cascades, market efficiency is lost. The actions of some market players induce others to take the same course of action (buy or sell) based on the same signals from the environment without consideration that others are doing the same. Most importantly, they may be ignoring clear signals that it's in their best interests to refrain from taking the same action as a large group of others.

In some sense, information cascades are related to herd behavior, exacerbated during periods of extreme sentiment. "That unintended system-level consequences arise from even the best-intentioned individual-level actions has long been recognized," Mauboussin wrote in his second book, *Think Twice*. "But the decision-making challenge remains for a couple of reasons. First, our modern world has more interconnected systems than before. So we encounter these systems with greater frequency and, most likely, with greater consequence. Second, we still attempt to cure problems in complex systems with a naïve understanding of cause and effect."

Feedback loops involving investor confidence occur in the context of a complex social and psychological environment. Noted economist Robert Shiller stated in his famous book *Irrational Exuberance* that feedback loops are a vicious circle. "Underlying this feedback is a widespread public misperception about the importance of speculative thinking in our economy. People are accustomed to thinking that there is a basic state of health of the economy, and that when the stock market goes up, or when GDP goes up, or when corporate profits go up, it means that the economy is healthier," Shiller wrote. "It seems as if people often think that the economy is struck by some exogenous maladies, and that the stock market is just a reflection of those shocks. But people do not seem to perceive how often it is their own psychology, as part of a complex pattern of feedback that is driving the economy."

While asset price bubbles represent one set of challenges, it's during times of negative feedback cycles that restraint and thoughtfulness must prevail. Merton concluded that the only way to break the cycle is to redefine the propositions on which the false assumptions were originally based.

Six Things Investors Should Remember

It appears that a meaningful amount of action in the last few days reflects a rapid rise in investor uncertainty. Uncertainty means that investors will demand a higher risk premium — and, thus, lower asset prices — even in a world where economic fundamentals are strong. Hundreds of years of market history tell us that the current rash of uncertainty will be dispelled. However, the time it will take to do so is unknown. In the meantime, investors should expect that markets will potentially experience bouts of volatility over the next few months, and the ultimate timeframe for markets to find new levels to attract buyers cannot be foretold.

Six Things Investors Should Remember

1. **Breathe, Don't Panic**
2. **Separate Fact from Opinion**
3. **Remember Your Long-term "Why"**
4. **Discuss Your Fears and Concerns**
5. **Know Your Needs**
6. **Stay Diversified***

When fear and uncertainty find their way into headlines, investors should remember these six things:

1) **Breathe, Don't Panic —** Making rash decisions during times of emotional stress often have negative consequences in the future and can potentially threaten long-term financial goals.

2) **Separate Fact from Opinion —** With thousands of "expert" voices in earshot, it's important to focus on the facts when reviewing stories on the market and the economy in the press.

3) **Remember Your Long-term "Why" —** Why are you investing for the long-term? Commonly, the reason is to set aside some current assets and income for future needs. Has that changed?

4) **Discuss Your Fears and Concerns —** Your financial advisor will help you navigate the short-term emotional swings of personal finance. The more you discuss your angst, fears and concerns with your advisor, the more they can tailor their professional guidance to your specific situation.

5) **Know Your Needs —** Investors should always know their needs for their money. If you need to use some of your investment assets in the short term for a major purchase or living expenses, it's wise to reassess where those monies are located and what they are invested in.

6) **Stay Diversified* —** When appropriate, a well-diversified portfolio can often alleviate concerns about being invested in the right place at the right time. Properly allocating your assets among various asset classes and diversifying your portfolio among several investment vehicles are meant to provide you with an efficiently diversified portfolio strategy that reduces volatility.

During this cycle of uncertainty, investors should actively engage their financial advisors to gather their valued perspectives and re-examine or review their long-term financial goals and plan to reach them. Unless life circumstances have changed, it's important to ignore the herd and "stay the course."

**Asset allocation/diversification of your overall investment portfolio does not assure a profit or protect against a loss in declining markets.*

About the Authors

1st Global RESEARCH & CONSULTING

Martin Landry, CFA, CFP®, CAIA, CIMA®, CIPM, AIF® is a manager of IMRG and senior portfolio manager who joined 1st Global in April 2010 with primary responsibility for due diligence, research, and monitoring of current and prospective investment managers. His portfolio management duties include implementation of fund and ETF changes within the IMS Select Portfolios and RMS Select Portfolios. Martin has more than 16 years of investment experience, including positions at GuideStone Capital Management, Bank of America and Merrill Lynch. He is a Chartered Financial Analyst® charterholder, a CERTIFIED FINANCIAL PLANNER™ professional, a CAIA designee, a CIMA® designee and a CIPM certificant, and he holds the Accredited Investment Fiduciary designation. Martin earned his MBA in management from the University of Texas at Tyler. He also has a B.S. in communications from Texas A&M University, Commerce.

Joan Alexandre is an investment analyst in the Investment Management Research Group (IMRG) at 1st Global, where she conducts due diligence on existing and prospective investment managers, collaborates in the review of strategic asset allocation, contributes to decisions regarding investment selection and manager roles, and structures the output to support the investment decision-making process. Previously with UBS Financial Services, Joan graduated with a B.S. from Georgetown University and earned Masters in Finance from Creighton University. She is also a level 2 CFA® candidate.

About the Investment Management Research Group

The 1st Global Investment Management Research Group (IMRG) is a team of tenured investment professionals that operates under the oversight of the 1st Global Investment Committee and is tasked with finding "best-in-class" investment managers and products for use across the IMS Select Strategies, as well as other IMS programs. The team's primary responsibilities include portfolio construction and investment manager due diligence, monitoring and selection. The team brings years of experience and investment knowledge to help guide clients with asset class allocation and individual fund selection, which are all aimed at providing optimal risk-adjusted returns within each risk category.

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The Dow Jones Industrial Average is a price-weighted average of 30 blue chip stocks that are generally leaders in their industry.

The S&P 500 Stock Index is a widely recognized capitalization-weighted index of 500 common stock prices in U.S. companies.

Index performance does not reflect the deduction of any investment-related fees and expenses. It is not possible to invest directly in an index.

Asset allocation/diversification of your overall investment portfolio does not assure a profit or protect against a loss in declining markets.

Dollar cost averaging does not assure a profit or protect against a loss in declining markets. An investor should be prepared to continue the program of investing at regular intervals. An investor should also consider his financial ability to continue his purchases through periods of lower price levels in order to fully utilize a dollar cost averaging program.

Source of Returns: Morningstar Direct

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