# Quarterly Update

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**Quarterly Update Report:** John J. Klobusicky, CFA®, CAIA, Peter J. LaBella, CFP® and Scott D. Ehrig, CIMA®, CFP®

## 2017-Global Growth Returns

Synchronized global growth and low interest rates laid the foundation for rising equities in 2017. Here in the U.S. there was a wide divergence once again between value and growth stocks, with the Russell 1000 Value Index up 13.6% vs 30.2% for the Russell 1000 Growth Index. Somewhat in the middle but driven largely by its growth constituents-see chart below, the S&P 500 returned 21.7% for 2017. International equities were the big winners, with the MSCI EAFE Index up 25.69% for the year and the MSCI Emerging Market Index up 37.5%. A great year all around the globe that is now in the bank. Year-end is always a good time for investors to take a step back, check their starting point-defined by current valuations, and look at the best place to rebalance and reallocate funds for the new year. In addition to assessing asset valuations and expected returns, we are reminded of the basic underpinnings of any solid investment plan-see below. With markets likely to return to at least normal volatility levels in 2018, these principals always come in handy

## Spreading Your Risk, Uncertainty, Managing Emotions, and Staying The Course

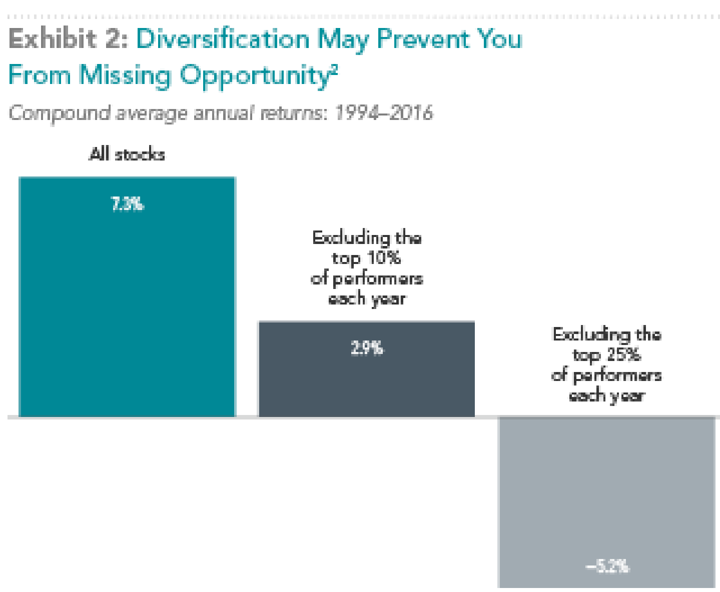
**Spreading your risk—don't let a few winners drive your investment decisions.**

In a recent piece, Jim Parker of Dimensional Advisors addressed what he called "Catchphrase Investing". One of the more popular of these adage's is the FAANG stocks, made up of FaceBook, Amazon, Apple, Netflix, and Google. Parker asks the question of whether investing in such a narrow universe of names constitutes a sound investment strategy. He finds it cuts both ways and here is why. In the below graphic, we see just how much this group of stocks has run up this year vs. the S&P 500 Index. At first glance, one might think that this graphic might support an argument for not diversifying and investing in only a narrow band of winning stocks.


**Source: Dimensional Fund Advisors**

But of course that strategy only works in hindsight, for if in our attempt to identify the next "catchphrase" strategy we make a wrong call and miss out on being allocated to the top performers the hit to performance, as shown the chart below can be substantial. The below chart shows what would happen to performance if you missed out on just the top 10% of performers in the market, vs. owning the broad market index.

As you can see in Exhibit 2, by trying to pick the winners and excluding only the top 10% of stocks in the broader universe, or index, performance declines from 7.3% per year to 2.9%- resulting in a decline of over 4% just from missing out on a few stocks. And if you tried a more concentrated approach and missed out on the top 25% of performers, you actually would have experienced a negative return over this time period.




**Source: Dimensional Fund Advisors**

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**Doubt is not a pleasant condition, but certainty is an absurd one.**
**—Voltaire**

“The market hates uncertainty” has been a common enough saying in recent years, but how logical is it? There are many different aspects to uncertainty, some that can be measured and some that cannot. Uncertainty is an unchangeable condition of existence. As individuals, we can feel more or less uncertain, but that is a distinctly human phenomenon. Rather than ebbing and flowing with investor sentiment, uncertainty is an inherent and ever-present part of investing in markets. Any investment that has an expected return above the prevailing “risk-free rate” (think T-Bills for US investors) involves trading off certainty for a potentially increased return.

Consider this concept through the lens of stock vs. bond investments. Stocks have higher expected returns than bonds largely because there is more uncertainty about the future state of the world for equity investors than bond investors. Bonds, for the most part, have fixed coupon payments and a maturity date at which principal is expected to be repaid. Stocks have neither. Bonds also sit higher in a company’s capital structure. In the event a firm goes bust, bondholders get paid before stockholders. So, do investors avoid stocks in favor of bonds as a result of this increased uncertainty? Quite the contrary, many investors end up allocating capital to stocks due to their higher expected return. In the end, many investors are often willing to make the tradeoff of bearing some increased uncertainty for potentially higher returns.

## MANAGING EMOTIONS

While the statement “the market hates uncertainty” may not be totally logical, it doesn’t mean it lacks educational value. Thinking about what the statement is expressing allows us to gain insight into the mindset of individuals. The statement attempts to personify the market by ascribing the very real nervousness and fear felt by some investors when volatility increases. It is recognition of the fact that when markets go up and down, many investors struggle to separate their emotions from their investments. It ultimately tells us that for many an investor, regardless of whether markets are reaching new highs or declining, changes in market prices can be a source of anxiety. During these periods, it may not feel like a good time to invest. Only with the benefit of hindsight do we feel as if we know whether any time period was a good one to be invested. Unfortunately, while the past may be prologue, the future will forever remain uncertain.

## STAYING IN YOUR SEAT

**In a recent interview, David Booth, Founder & Executive Chairman of Dimensional Fund Advisors, was asked about what it means to be a long-term investor:**

"People often ask the question, 'How long do I have to wait for an investment strategy to pay off? How long do I have to wait so I'm confident that stocks will have a higher return than money market funds, or have a positive return?' And my answer is it's at least one year longer than you're willing to give. There is no magic number. Risk is always there."
Part of being able to stay unemotional during periods when it feels like uncertainty has increased is having an appropriate asset allocation that is in line with an investor's willingness and ability to bear risk. It also helps to remember that, during what feels like good times and bad, one wouldn't expect to earn a higher return without taking on some form of risk. While a decline in markets may not feel good, having a portfolio you are comfortable with, understanding that uncertainty is part of investing, and sticking to a plan that is agreed upon in advance and reviewed on a regular basis can help keep investors from reacting emotionally. This may ultimately lead to a better investment experience.
We at FMA Advisory wish you the very best for a happy, healthy, and prosperous new year. Never hesitate to contact us for any help with your 401-k decisions or general financial planning. We have some great planning tools to share and we can help.

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