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"Prophesy is a good line of business, but it is full of risks" *—Mark Twain*

To our clients and friends:

The quote above is actually a very polite way for this famous American to remind all of us that no one can accurately predict the future. A broken clock is right twice a day—much else in life is uncertain.

Predictions Gone Bad: The Lack of Accountability in the Financial Media

Last year, in early 2016, a widely publicized, rather alarming prediction was made by Royal Bank of Scotland (RBS) analyst Andrew Roberts, who said that the global markets "look similar to 2008." In addition to his dire market prediction, Mr. Roberts also predicted that technology and automation are set to wipe out half of all jobs in the developed world.

A review of Mr. Roberts' track record reveals that he has been predicting disaster with some regularity for the past seven years—incorrectly as it turns out. In June 2010, when the markets were just beginning a strong five-year run, he wrote that "We cannot stress enough how strongly we believe that a cliff-edge may be around the corner, for the global banking system (particularly in Europe) and for the global economy. Think the unthinkable," he added, ominously. ("The unthinkable," whatever that meant, never happened.)

Once again, in July 2012, the RBS analyst's report read, in part: "People talk about recovery, but to me we are in a much worse shape than the Great Depression." Taking this advice—or that of many other market "gurus"—over the past several years would have prevented investors from enjoying the robust gains during that period.

Interestingly, Mr. Roberts did NOT predict the 2008 market crash. And he had plenty of company among the media "talking heads". Very few "experts" saw it coming.

Distinguishing Between the Highly Improbable vs. the Impossible

Unlike Mr. Roberts, author Larry Swedroe—someone I have quoted in the past—is not in the business of predicting the next Armageddon. Instead, Mr. Swedroe likes to remind us to never confuse the *highly improbable* with the *impossible*. What he means is that over a lifetime of investing: a) one or more extremely remote possibilities may occur; and b) you should not dismiss the possibility of such events as if they were impossible.

Swedroe, always a reliable source of both vision and insight, says you have to consider the *highly improbable* when building your portfolio. The risk of a worst-case scenario is real and should be respected—it can happen when you least expect it.

Balanced Portfolios: The Best Preparation for the Worst Case Scenario

Taking Larry Swedroe's comments one step further, financial author Terry Savage notes in her book, The Savage Truth on Money, that *"getting even with the bear is tougher than getting ahead."* What Ms. Savage is saying is it is much easier to prepare for and guard against a major stock market loss through proper asset allocation than to try and make up for a bear market after it has occurred. This is particularly true when the investor erroneously believes they are going to be protected against such calamity.

Let's look at what happens to two portfolios, one holding 100% of their portfolio in stocks or their equivalent (investor A) and the other holding only 50% of their portfolio in stocks, with the remainder in fixed income (Investor B). Let's assume each investor is 10 years from retirement and each has accumulated $600,000 in investable assets. Each investor has placed those assets into their respective portfolios.

If a severe bear market occurred, and stocks broadly declined by 50%, investor A's portfolio would drop to about $300,000. However, Investor B's portfolio would drop to $480,000. This is because Investor B lost only 50% *of the portion* of his portfolio held in stocks. The other 50% of his balanced portfolio was in fixed income, thusly insulated.

Investor A must now double his assets—a 100% return—to get back to where he was before the bear market struck. This could potentially take a period of years. Investor B needs only a 25% return to get even again. Therefore, recovery may be achieved in a much shorter time frame in order to make Investor B whole again.

The actual time required to recover from large losses is always an unknown. It depends on whether substantially higher returns can be generated in a subsequent market recovery. And for an investor approaching or already in retirement, these quicker recoveries cannot be relied upon. This is especially true if the investor's future goals depend on the full (original) value of the investment portfolio being accessible.

One item to note in these examples is that when the allocation is reduced from 100% stocks to 50% stocks, the positive market gains (in a rising market) do not correspondingly get reduced by half. Rather, the balanced portfolio captures the lion's share of those gains while taking on much less risk. This is clearly illustrated in the model portfolios on Vanguard's website. An illustration can be found via this link: https://personal.vanguard.com/us/insights/saving-investing/model-portfolio-allocations

Stock Market Corrections: A Regular Occurrence

All of this being said, stocks periodically "go on sale" during sudden market declines. People panic and sell stocks at just about any price in order to get out. There is

often a mad rush to the exits. In February 2016, we experienced one of those periods, in which the market declined some 15%. The same was true during the "Brexit" decline in June 2016, which was swift and painful to anyone invested in the developed markets.

Sometimes these corrections morph into something more serious—a bear market. Whether a decline remains a garden-variety 5-10% correction, or instead becomes something much worse—15% to 20% or more—can only be determined in the fullness of time. It is worth noting that the more severe downturns eventually ended with an even greater upward reversal and resulted in markets subsequently reaching new record highs.

Taking the "Long View"

In past newsletters, I've quoted another industry titan named Howard Marks, who is the co-chairman of Oaktree Investments. "I'm not seeing bubble prices in most assets," announced Oaktree's Howard Marks recently. He went on to state that "it's healthy that people are talking about risks in the markets".

"You don't see raving bulls. They have not reissued Dow 36,000," Marks says, referring to the notoriously bullish book published in 1999 at the height of the technology bubble. The Oaktree co-chairman says his firm has been investing for the past five years, albeit with unusual caution, and that he is aiming to be "selective."

And what about the potential bear market for bonds and fixed income that investors have been worried about, Marks was asked (referring to rising interest rates)?

Marks had this to say: "This is not the kind of thing that we concern ourselves with at Oaktree. *We are not market timers" (*emphasis added), he says. "The thing I dislike the most is the word 'trader.' We are not traders. We are long-term investors, and if we can buy the debt of a company that we are convinced will pay off — at an attractive yield, given the risk — we're going to buy it and hold it."

Marks, like others, has also been warning of reduced expectations over the near-to-intermediate term in the markets. "Large financial institutions and insurance companies should be expecting returns of 5.5% annually, rather than the 7% to 8% they used to get", added Marks.

"If I were running a fund, and somebody said to me, 'What return do you think you'll get, with modest-to-moderate risk over the next X number of years?' I'd probably say five and a half percent."

The New Portfolio Arithmetic

Building on Marks' comments, I've mentioned an organization of independent Registered Investment Advisors I belong to made up of credentialed professionals from across the U.S. We participate in a weekly webinar series. A regular webinar presenter is an economist by the name of Fritz Meyer, who recently posited a new formula for

calculating expected investment returns going forward. His projection is based on the fact that we've experienced a bull market in bonds (fixed income) for over 35 years. If that trend were to reverse, bond returns could turn negative and bonds would likely decline.

His underlying premise (and that of Marks) is that we are entering an era of reduced expectations in investing. Few in the financial services industry talk about this.

Meyer cited a Wall Street Journal article from Sept 4, 2015 by Timothy Martin entitled *Pensions Brace for Lower Returns*. The article states that pension funds are trimming their total return assumptions. It references an expected average target return of 7.68% annually for the large pension funds cited. Meyer believes this target could still be too generous. And this is important!

Meyer notes that Jeremy Siegel, author of the famed book Stocks for the Long Run reports that a 9.4% stock return has been the historical return for a 100% stock portfolio for the past 100 years. But this return is for a fully invested stock-only portfolio.

Meyer illustrates how a hypothetical 60/40 stocks/bonds portfolio allocation would perform under the expected scenario—as he sees it—going forward. If stocks are conservatively assumed to return 8% per year, and bonds are expected to return 2% per year, the formula looks like this:

STOCKS: .6 [60% allocation] x 8% return =	**4.8%**
BONDS: .4 [40% allocation] x 2% return =	**0.8%**
Nominal Return:	**5.6%**

The term "nominal" means before inflation, fund expenses, investment advisory fees and brokerage fees. Therefore, the "real" return (after stripping out these other items) would arguably be less.

Meyer's argument then is that 5.6% may very well be the average return going forward for a "Balanced Portfolio" of stocks and bonds. Under this scenario, the result would be investment returns which will underperform that of the last 35 years (1981-2016). This conclusion is based on the simple fact that a balanced portfolio enjoyed the extraordinary benefits of a bull market in bonds during that 35-year time frame. After all, bonds and fixed income have been returning 4%, 5%, 6% or more during this *bond* bull market. It's conceivable that the heyday in bonds may finally be ending.

Thank you for your continuing interest.

Sincerely,

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