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"Good fortune is what happens when opportunity meets with planning"—*Thomas Edison*

To our clients and friends:

In this quarterly newsletter, I often reference the titans of the investment world. One of the true giants, Benjamin Graham, was known as the "father of value investing". Warren Buffet was a student of Graham's at Columbia University in the 1940's.

Graham has been quoted as saying: "Wall Street has a few prudent principles; the trouble is that they are always forgotten when they are most needed".

John Bogle's Words of Wisdom

Graham's cautionary words have been heeded by many astute investors since they were first spoken. I've talked before about John "Jack" Bogle, the legendary founder of the Vanguard Group—and another giant of the investment world. Bogle has written several highly acclaimed books on investing.

His 2012 book, The Clash of the Cultures: Investment vs. Speculation, contains several insights that can be very helpful to both novice and experienced investors. Here is a sampling:

1. Be patient and ignore the crowd. If you can't resist temptation, you absolutely must not manage your own money.

2. The balancing of risk versus return is the task of intelligent investing.

3. Predicting stock market returns has a very high margin of error.

4. Impulsive behavior is your enemy when it comes to investing.

5. There is no escaping risk, but a well-diversified portfolio should provide remarkable growth over the long term.

6. Investing is simple, but it's not easy. It requires discipline, patience, steadfastness and common sense.

7. The secret to investing is that there is no secret.

Taken individually, or as a whole, these 7 rules of thumb can be applied to all types of investors and to all varieties of markets. Each provides valuable guidance to those who incorporate them into their investing experience.

The Balancing of Risk versus Return

The second of Bogle's rules of investing is one of the more intriguing, but probably one of the most difficult to implement—*balancing risk against return*.

This is not always something you can readily find in an investment library. Instead, it's something that comes with experience—namely, from the "school of hard knocks". It is the disciplined and repeated use of techniques which reduce exposure to market losses. And it's a mindset which is critical in protecting one's capital.

The ironic thing is that employing a philosophy of managing risk during a strong bull market in stocks may lead to a lower rate of return for the investor. This is why a fully invested, passively managed index fund, say the Vanguard Total Stock Market Index, will almost always outperform *most* actively managed funds during bull markets.

But it can be argued that performance should be measured over a *full* market cycle (meaning a bull market *and* the bear market that either precedes it or follows it) and not simply over the time frame in which there is a bull market alone.

The reason for examining performance for the *entire* market cycle is that—by definition—a passively managed index fund of stocks will result in a loss equal to 100% of the decline suffered by that broad-based index in the next bear market. Said another way, if the total stock market declines by 45%, the corresponding index fund tracking that specific market will also likely decline 45%. Investors may not understand this risk.

Revisiting the Active vs. Passive Debate

It's true that with active management you're taking on more *manager* risk. After all, if the manager is a terrible investor, or doesn't know what he or she is doing, you could lose money.

But with passive management you're taking more *market* risk. When an investor owns a passive index, the holdings that investor owns are outside the control of any manager and are often chosen by a computer program on a sometimes arbitrary schedule.

During a typical market cycle, the index does not take into account rising risk of a particular stock within the index, for example. And the index does not get to choose to sell a stock which has become grossly overvalued. The index must first be rebalanced.

Active managers, on the other hand, have the ability and wherewithal to manage risk. They are also able to identify upside potential and purchase undervalued stocks (think Warren Buffett). This is simply not part of an indexed approach to investing.

The Passive Investing (via ETFs) Craze Explodes

In recent years, there has been a tremendous move into passive investing. This is true not just of passive index mutual funds, but also of exchange-traded funds (ETFs).

The low cost and ease of use of ETFs has been one of the main reasons for their use by both long-term investors, and in particular, stock traders. ETFs supposedly offer fully liquid (intraday) trading compared to index mutual funds whose price settles only once a day—at 4:00 p.m. EST. Thus, an ETF can be bought and sold many times during each trading day, just like an individual stock. This is not true of index mutual funds.

However, it should be noted that any perceived safety or implied liquidity in ETFs may be severely tested in the event volatility once again resumes in the market (volatility has been notably absent of late). This potential risk is rarely brought up in media interviews or by those espousing the fantastic opportunities presented by ETFs.

A False Sense of Security?

The most popular passively-managed funds are marketed as low-cost and widely diversified. They are allegedly comprised of what the marketers refer to as “blue chip, conservative” stocks. Therefore, the typical investor sees a product with virtually no fees and with purported liquidity, and may therefore believe that he has a “safe” investment.

However, money which flows into these huge index funds are in many cases used to purchase the largest (and potentially most overvalued) stocks in the market, driving the stocks (and the indexes) still higher. Furthermore, harkening back to the concept of risk and return, markets may become more volatile when a small number of individual stocks comprise the bulk of an index, and those individual stocks subsequently begin to falter.

The purveyors of passive investing too often neglect to talk about cyclicality in markets. They generally avoid discussions of the passive indexes’ performance during bear markets. Passive indexing may seem to be simpler, easier and something that anyone can do, and do well, without much effort. But what about in bear markets?

Indexing is also often perceived to automatically reduce risk. But that is an incomplete story. As discussed earlier, passive indexing may actually have the opposite effect in market declines as an investor will be subjected to all of the losses in the corresponding market index. Instead, what matters most, many would argue, is *asset allocation*. This involves the apportioning one’s assets in an organized fashion.

Risk: The X-Factor

Contrarian investors would argue that the point of greatest risk in the market is precisely that time in which the “consensus” believes risk is either dead or doesn’t apply.

Investor sentiment readings sometimes give hints as to when danger is highest.

Extremely high bullish readings in sentiment often portend complacency, which in turn enhances expectations for a correction or decline. Of course, such readings in no way imply an imminent decline. Instead, it is a warning sign that investors might want to manage expectations for something unexpected to happen, or to plan for different outcomes than expected.

This sense of complacency is what worries veteran investors. If one looks at a graph of the S & P 500 over the recent past, it resembles a ski slope. There has been no meaningful correction or decline in U.S. equities since February 2016 (except for a brief drop during Brexit in June 2016).

Sound asset allocation principles would certainly suggest that an investor continue to hold U.S.-based equities. But further diversification into other non-correlated assets might also be prudent. These might include assets which have not had such a strong run, including international (overseas and non-U.S.) stock and bond markets.

Conclusion

Actively managed mutual funds and money managers often take steps to mitigate portfolio risk – at times to the detriment of a more stellar bull market performance. It should be remembered that long-term performance is dependent not only on how much is made in a bull market, but also how much is given back in a bear market.

Investments that are weighted toward the largest, most overvalued stocks and market sectors are precisely the opposite of what might be employed in a strategy that is focused on the *management of risk* as opposed to the *maximization of return*.

Further, portfolio survivability is a very real issue for many investors, particularly those in or nearing retirement. The decision to hold the course on an investment strategy usually depends on the severity of bear market losses and how long one’s portfolio remains underwater, in other words, how much time it takes to recover those losses.

The bottom line is that the broad diversification and implied liquidity offered by index ETFs gives many investors a false sense of security. When passively investing in an index, virtually devoid of any risk management, investors remain exposed to various degrees of valuation and liquidity risk and thus bear the full brunt of cyclical market risk.

Thank you for your continuing interest.

Sincerely,

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