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"It's tough to make predictions, especially about the future" —*Yogi Berra*

To our clients and friends:

In these newsletters, I often discuss how difficult it is to definitively predict the direction of markets over time. This applies to both short-term ***and*** long-term predictions.

The above quote is one of the more famous attributed to the late Yogi Berra who died on September 22. In many ways, it is both timeless—and timely.

One more bit of humor about predictions and markets. The website Motley Fool recently made the following tongue-in-cheek observation:

> "When no one knows what the economy or stock market will do next, people say there's *high uncertainty*. This is different from *low uncertainty*, when people ***think they know*** what the economy and stock market will do next. This is then invariably followed by being wrong, which they blame on high uncertainty".

If you could follow that somewhat convoluted line of reasoning, you're pretty sharp. Yet both of the quotations above—while intended as comedic—ring true.

Definition of a "Correction"

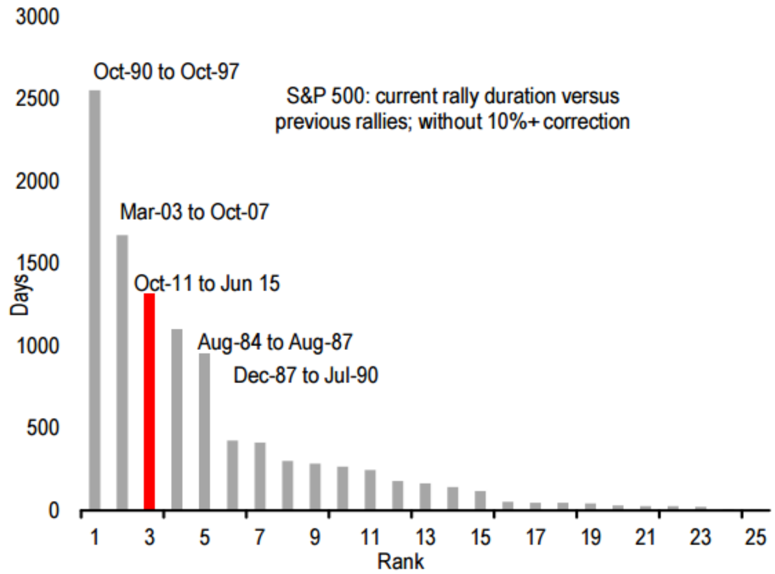
This brings us to the direction of the market—and the current correction (which is still gripping the markets at the time of this writing on September 29).

The declines we've seen thus far are certainly not comfortable to witness. And whether this is merely a correction, as opposed to the beginning of a bear market, may become apparent soon enough. It's important to remember that a correction—as opposed to a bear market—is a short, sharp, sentiment-driven dip of greater than 10%.

Corrections can be quite unpredictable. Often, their beginning point and ending points are not readily identifiable until after some length of time has passed. Corrections often arrive abruptly and then exit fairly quickly.

It is virtually impossible for even the most experienced and successful market gurus to compile a strong track record of properly identifying corrections in advance. This is because impending corrections do not give off warning signs or red flags. From a new market high, for example, stocks can drop fast in a correction. Conversely, from a market trough, they may rise steeply.

Figure 51: The S&P 500 has not experienced a 10%+ correction since October 2011



Source: Thomson Reuters, Credit Suisse research

The Market Correction—and "Recency Bias"

Recency bias is something that we've discussed in these newsletters previously. It is an important factor in the human thought process. Our brains have made it quite easy for events to retreat and be lost in the past. We tend to remember very recent events much more clearly than we remember events that took place two or three years ago.

Historical market statistics show that ten to twenty percent declines occur every one to two years. Until recently, we had not experienced a true 10% correction since mid-2011. This is long enough ago (four years) for people to forget what it feels like.

The chart above was published in June 2015 and illustrates that this "correction drought" is/was one of the longest on record. As I've been vocalizing for some time now, this correction was overdue and should probably have been expected.

Historical Comparisons

As 2015 began, the record showed three straight years of double-digit returns in the S&P 500. This streak increases to five years in a row if you skip 2011 with its very tepid 2.11% gain. Overall then, starting in 2009 and going through year-end 2014, we've experienced six straight years of positive gains in the S&P 500 (hence illustrating the "recency bias" concept).

This means that we have not experienced a losing year in over half a decade now. This is ironic, coming at a time when the dominant economic narrative during all of these years was a "new normal" of stagnant growth and falling wages.

Two years ago, in October 2013, a column was written in the Dow Jones Market Watch online financial site. The author made the following statement:

> "In the broader context of stock market history, our current year-and-a-half run without a 10% or more correction seems pretty long. But…..you only have to go back a decade to find a rally that was twice as long — 1,153 trading days without a 10% rollback from March 2003 to October 2007 *(see 2nd column from left side in the chart on page 2).* And from 1990 to 1997, we enjoyed a massive 1,767 session run without a double-digit dip *(also found in the chart on page 2 at the very far left side).* That's almost five years!" **Jeff Reeves, Market Watch, October 2013**

The argument made in this October 2013 column was that investors ***can never really predict*** when a correction may occur. The author said that "those who say stocks must decline simply because they haven't done so in a while are like the gamblers who put it all on red just because the roulette wheel has come up black five spins in a row."

Passive vs. Active—an Overview

As promised in last quarter's newsletter, we'll now switch tracks and examine the ongoing war of words between proponents of passive versus active investment management.

In its most basic form, passive investing employs index funds (there are no managers who actively buy and sell investments). Active investing, on the other hand, is practiced by investment managers who decide if and when to buy or sell based on market trends, economic conditions, independent research and other more subjective factors.

It can be a useful exercise to apply the same type of contrarian thinking to this discussion as we've previously applied to such topics as market predictions, managing risk or determining the proper asset allocation of a portfolio.

It is indeed true that index funds tend to do well in bull markets—we've seen that firsthand since 2009. This is because index funds remain fully invested at all times. Active managers, though, hold cash reserves, and buy and sell more frequently (usually as a risk management tool), thus dragging down performance in a strong bull market.

That being said, investors often diminish the importance of ***risk management*** after a long rally. This bull market has lasted more than 6 years. The upward momentum has benefited those investing passively through indexes or ETFs—at least until recently.

Passive (index) investing may appear to be simple. It is often perceived to reduce risk by diversification in a so-called broad index. But it actually does the exact opposite since it assures the investor of experiencing 100% of the losses in that index.

Therefore, a contrarian thinker would not buy into the idea of passive investing being a "slam-dunk", sure-fire way to easy money in stocks. A savvy investor recognizes that index investing has its limitations, particularly as bull markets mature over time.

The Investment Time Horizon—A Critical Factor

Arguably, it is easier for an investment adviser or money manager to employ a 100% "buy and hold" strategy. And much of the literature and research has shown—very persuasively at times—that over the ***very long term,*** passive investing is a sound strategy.

However, speaking for many of my clients, some people have a much shorter time horizon than a 25 year-old millennial. And performance—both short and long term—is dependent not only on how much you *gain* in a bull market, but how much you *surrender* in a bear market.

Risks of Passive Investing

Index funds can also suffer from their emphasis on momentum over value. Over the past several years, the steady flow of dollars into index funds has continued. This is coming well after the stock market has already recorded substantial gains.

As stated above, active managers will often sell stocks before, during or after market declines. In contrast, the false sense of safety and security induced in investors by the allure of index funds may lead those investors to wait longer to sell, prolonging the eventual decline and ultimately causing a cascading downward effect in a bear market.

The recent lack of concern for the risks presented by passive investing hints at potential complacency on the part of investors—historically not a good omen.

Conclusion

Does all of this imply that you should avoid passive investing altogether? No, but a smart investor will be alert for signs of an overvalued market. She will also be especially aware of lessened momentum during market rallies, as we've seen recently.

An investment manager becomes especially valuable when he or she can carefully balance potential return with the appropriate level of risk for their client.

It is true that in some situations passive indexing works fine. But there are also many other circumstances in which utilizing the professional services of an experienced and knowledgeable investment manager may be more prudent in the long run.

Thank you for your continuing interest.

Sincerely,

Andrew J. Fama, JD, AEP, RFC, MHA, Registered Fiduciary
Principal, Fama Fiduciary Wealth LLC, Registered Investment Advisor