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"A good investor has the opposite temperament to that prevailing in the market" —
Warren Buffett

To our clients and friends:

I spent the last few days of March and the first week of April enjoying the beautiful ambiance and gorgeous views from a mountaintop hideaway in the Blue Ridge range of North Carolina. Those of you who've been to the area (or to the Adirondacks or Rockies) can relate to the wonderful sense of stillness and solitude experienced in the mountains. The quietness truly allows one to think clearly and without interruption.

The peace and serenity of the mountains is the perfect antidote for turning off the CNBC crowd and all the scaremongers and doomsday prophets in the financial media. And it certainly lets you think clearly and coherently about such things.

In today's financial markets, there are more opinions—which might instead be more aptly characterized as chattering or blabbering—being aired in the media about this or that. There continues to be a large number of bearish commentators who are predicting Armageddon yet again. They have been wrong for 6 years now, and counting.

Our latest quote from Warren Buffett teaches us that contrarian thinking often pays dividends (no pun intended). Since the bull market began in earnest on March 9, 2009—six year ago—we've heard the steady drumbeat of negativity and alarmism. Yet, the market has risen forcefully over that time, and anyone who's been fully invested in equities according to their individual risk tolerance has benefitted handsomely as a result.

The Market Paradox and Investor Behavior

Investing is a challenge. Simply put, making money in stocks and bonds isn't that easy. The primary reason this is true is because the market can be quite perplexing at times. It rises when the average person thinks it will fall (the principle known as "climbing the wall of worry") and it drops—sometimes abruptly—when many are predicting it will rise (this is known as "sliding down the slippery slope of hope").

Individual stocks are even more volatile. They can rise or decline sharply on any sort of news. And as Buffett states so succinctly in the above quote, the market often does exactly the opposite of what makes sense. In other words, the market has a mind of its own.

That's why successful investors—the ones who've been investing and churning out solid returns for years—have a deep respect for, and are humble toward, the markets.

In our last newsletter, we quoted Howard Marks who famously stated that there are old investors and there are bold investors, but there are no “old bold” investors. One is reminded of this when you hear the younger money managers say things like "I think this stock will double in two months! It's an amazing company!"

Meanwhile, the older and wiser veterans will be heard to say "maybe if this goes well or that happens, the stock might advance for a time." Are the veterans less enthusiastic? Perhaps. But it’s more a matter of humility, as they clearly realize from their market (and life) experiences that anything is possible.

The Pain of Volatility

It is never a good idea to diminish the importance of how volatility can feel—it can feel like a rollercoaster! But keeping it in proper perspective is vital.

We are genetically created in a way that exaggerates threats. This is part of mankind’s evolution—it keeps us safe from danger. A study done by Nobel Prize winning professor Daniel Kahneman of Princeton coined the term *prospect theory.*

The study showed that investors tend to feel a loss more than twice as much as they enjoy a gain.

Investing is not conducive to such fight or flight instincts. Regrettably, investors become oblivious to the bigger picture and focus on short-term losses. This misplaced focus is based on unwarranted fears. And this is what then causes some people to sell out (in other words, flee) at the bottom of a sharp decline.

Prospect theory has also been called *myopic loss aversion*. The media headlines focus on daily*, and even intraday,* results. If you are a true investor, your time horizon is much longer than a matter of hours, days or even months.

Adjusting Allocations in Light of a Potential Bear Market

Eventually, the current bull market will end and a new bear market will be upon us. Unfortunately, no one knows exactly when this will happen, despite prognostications to the contrary.

There is another popular saying, which is: “*They don't ring a bell at the top*”. No one can actually decide whether the market has topped since it will only be obvious until well after the fact.

Historically, the stock market tends to top when there is not a cloud in the sky. Various market experts claim that there is a tendency for the market to discount—or price in—its expectations for the coming six to nine months, on average.

As stated earlier in this letter, the market has a mind of its own. Another way of putting it is that the market is usually right. This means that people's personal opinions often are not right at all—in fact, they are almost always wrong. I've discussed the futility of making predictions in previous newsletters.

No, this is not my suggestion! As many of you have discovered over the past decade, I do not have a crystal ball.

As for making portfolio adjustments in anticipation of a potential bear market, it seems that a gradualist, common-sense approach might work best.

Your advisor might suggest, for example, that you make adjustments which may include reducing risk if your asset allocation is too aggressive for your tolerance. That might mean raising cash reserves, particularly for those in or nearing retirement, or those taking regular withdrawals.

The key to making adjustments, however, is to do so *only* during periods of relative strength as opposed to times when the market may be in free fall.

A good advisor might also coach their client to consider how the client might feel if the market were to experience a bear market-like decline. This should be reflected upon during good times, perhaps during periods of market strength—when the "sun is shining," so to speak.

You cannot wait until the correction or bear market is upon you to think this through—you might panic and sell at just the wrong time.

Preparing for and Addressing the Next Bear Market

Our investing approach is based on minimizing potential downside risk. Our goal is *not* to maximize upside gains or to try and "beat the market" at any cost. As investors, we must remember that our first job is to preserve capital. After that has been addressed properly, we can approach the second job, which is to seek a return on that capital.

Our core belief is that we are in business to manage risk—not to jeopardize capital preservation in exchange for outsized (and potentially short-lived) returns.

Very few equity money managers are good at managing risk and even fewer are consistent in their decision-making. It is important to recognize that money management is as much about avoiding punishing losses as it is about achieving huge gains.

Complacency

Some commentators are now suggesting that complacency has become the norm of late and that we should all be terrified. Let's put aside for a moment the possible truth to that statement—that we are complacent. Suffice it to say that there are real risks out there in the world — the established paradigm of cyclicality in markets has not been permanently repealed—it will reappear some day. A new bear market is assured.

It is true that too much complacency breeds excessive risk aversion when conditions change. If investors foolishly become accustomed only to up markets, then when stocks (or bonds) decline, those same investors will panic hard and panic fast. And they are likely to sell. Studies show they are likely to sell close to the bottom. "Buy low" and "sell high" rarely happens in practice. Instead, the opposite outcome often prevails.

Conclusion

We've discussed volatility and complacency. We've also talked about how to become mentally prepared for the next bear market.

Many of these concepts are tied together—they are intricately entwined at times.

Fear. Selling out at the bottom. Rash decision-making. Panic. And complex terms like *prospect theory* and *myopic loss aversion*—they all feed into the same narrative.

If you think longer-term, and you avoid going along with the crowd; if you ignore the consensus opinion, and think in a thoughtful, patient and contrarian manner, investing is not so scary or harrowing after all.

In next quarter's newsletter, we'll examine the ongoing battle between passive and active management and apply the same contrarian thinking to that discussion.

Thank you for your continued interest.

Sincerely,

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