Fama Fiduciary
WEALTH LLC

Website: ***www.famawealth.com*** *E-Mail:* ***andrew@famawealth.com***

July 2015

"What the wise do in the beginning, fools do at the end" *—Warren Buffett*

To our clients and friends:

At the risk of overexposing my readership to quotations attributable to Warren Buffett, I couldn't help but seize upon this latest gem to launch this quarter's discussion.

There is sometimes a fine line—a delicate balance, even—between taking risk and seeking reward. Nevertheless, at other times the distinction is more blatant. Behavioral finance plays a major role in both cases. Let me illustrate what this means.

2009 versus 2015

In March of 2009, the "wise" folks referred to in the Buffett quote (*see above*) either: a) remained invested in the markets or; b) invested more money in the markets. Now, here in July of 2015, after six-plus years of virtually straight-up gains, the "fools" (those too scared to invest in 2009) are beginning to awaken from their slumber.

Although we may not be there quite yet, market cycles generally peak when everyone jumps in feet first (in the case of market highs) or bails out (in the case of market lows). In one form or another, they do the opposite of what they really ought to do.

Yes, right now, market sentiment (bulls versus bears) is not unduly lopsided. Indeed, there are numerous negative headlines and warnings of disaster each and every day. But many market participants remain "on the sidelines", just waiting for that opportune moment to become "reinvested".

Market Sentiment

Richard Bernstein, a legendary Merrill Lynch strategist—who wisely left Merrill—and now runs his own independent Registered Investment Advisory firm, conducts a lot of his own research on investor sentiment and psychology.

Bernstein says that at the beginning of a typical market cycle, investors are more fearful of losses than normal (2009 is the perfect example). In the mid-cycle, they tend to be more accepting of risk, and appear to have more normal risk tolerance (2012-present). In the late cycle—a point we will eventually reach—investors generally embrace risk and attempt to accentuate returns because they believe there is no downside risk at all.

There can be no better example of this last phenomenon than the tech bubble in March 2000, when valuations "did not matter" and ***no*** technology stock was too expensive.

<u>The Consensus was Wrong</u>

Amazingly, during 2012 and leading up into 2013 Bernstein wrote: "*Data clearly show that no group of investors is currently willing to take excessive U.S. equity risk. Pension funds, endowments, foundations, hedge funds, individuals, Wall Street strategists, and even corporations themselves remain more fearful of downside risk than they are willing to accentuate upside potential*".

During 2012 and 2013, Bernstein's research—and the data—suggested that he clearly differed with the majority of strategists. This observation was apparent in light of his bullish views toward the U.S. stock market. Further, his opinion of which asset classes offered diversification and downside protection was vastly different than the consensus.

We all know what happened in 2012, 2013 and 2014—the market went virtually straight up (with almost no hiccups). The "wise" investors that Buffett refers to were the winners, and the "fools" (those who had bailed out in 2009 and remained on the sidelines) were the losers.

Portfolios which remained fully invested in equities (at the levels set out in one's Investment Policy Statement, for example 60/40, 50/50, etc. stock/bond breakdown) performed admirably. Everyone else—those who were out of stocks or had significantly (and perhaps fatally) altered their asset allocation—failed to participate in the substantial gains that were to be enjoyed during these three unloved and underrated years.

Cover of Time Magazine March 9, 2009 just as the new bull market was beginning.

Uncertainty Spells Opportunity

The greatest and most successful investors over time share one core investment philosophy and that is this: ***Uncertainty Equals Opportunity***. Those with the courage to put their money into stocks in early 2009, during the height of the financial crisis—and at the absolute pinnacle of uncertainty—have been handsomely rewarded.

On the other hand, those who dumped their life savings into tech stocks in early 2000, when making money was considered a virtual certainty—"a sure thing", as they called it—lost all that they'd invested. Everything appeared "certain", but it was not.

I'll never forget reading a piece that Buffett wrote in *The New York Times* on October 16, 2008. It can be found on page A33 of the *Times*, in which he neatly—and very tidily—married several investing ideas into a single, actionable concept. I remember thinking "Is he crazy"? "How could this be"? It took stamina, gumption and a very strong stomach to follow Buffett's advice that day. Here is just one excerpt from the article:

"I can't predict the short-term movements of the stock market. I haven't the faintest idea as to whether stocks will be higher or lower a month — or a year — from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over….Equities will almost certainly outperform cash over the next decade, probably by a substantial degree. Those investors who cling now to cash are betting they can efficiently time their move away from it later. In waiting for the comfort of good news, they are ignoring Wayne Gretzky's advice: "I skate to where the puck is going to be, not to where it has been." (underlining used for emphasis)

Bernstein and others went on to report that investors, by and large, were incapable of overcoming their fear of the uncertainty—they expected continued stock price declines for the foreseeable future. Thus, most investors ignored Buffett's well-publicized advice.

It's Human Nature

The data show that for the remainder of 2009 and into early 2010, only a very small percentage of new investments went into equities—about $20 billion. On the other hand, *bond funds* (the perceived "safe investment" at the time) received over $300 billion in new investments. As Bernstein reported in 2014, this wrong-headed, upside-down behavior continued right on through the next four full years—2010, 2011, 2012 and 2013.

Unfortunately, despite the fact that the S&P 500 Index achieved a new all-time high more than 30 times last year (that is, in 2014), this counterproductive activity continues even now. *The Wall Street Journal* reported that in the first two months of 2015, sixty-seven percent of all new money going into exchange traded funds went into bond funds.

Deep down, investors know they should be patient—they should ride out the wave of volatility. But often emotions and panic will overcome one's best judgment. The psychology of bad behavior and poor decision-making are the worst enemies of investors.

Probability vs. Certainty

There seems to be a never-ending battle between the bulls and the bears these days—more so than ever.

Within these two groups you will also find the “technicians” versus the “fundamentalists”. Another (separate) battle is being waged by the “buy and hold” crowd against the “tactical allocation” or “trading” crowd.

All of these are labels which describe the way different investors think and act, but they are all interrelated in some way—and they all take time to sort out and fully understand.

But investing is never about *certainties.* Rather, it is about *probabilities.*

Instead of arguing and bickering about whether to be “in cash” or “in equities” at any given time, it seems more sensible to temper one’s expectations of market direction. Taking an “all or nothing” attitude implies that *certainty* exists and ignores *probabilities*.

Conclusion

Buying equities in publicly-traded companies is not risk-free. But avoiding stocks for the "safety" of cash is a mirage, and a dangerous one for your retirement.

There will be future bear markets and downturns, and they won’t be comfortable. That being said, keeping money in cash (or other fixed income) over one’s lifetime is probably not the smartest recipe for successful wealth-building.

An investor who avoids ***all*** market risk— and cannot fathom the thought of losing money in the stock market — is especially vulnerable to losing the purchasing power of money over time. This is a huge risk, especially for those expecting longevity during their retirement years. These people are unlikely to keep up with inflation over the decades and during their golden years. Thus, they are experiencing “losses”, but of a different kind.

As a final note, I’d promised in last quarter’s newsletter that we would examine the ongoing battle between passive and active management and apply the same contrarian thinking to that discussion. That topic is reserved for next quarter’s letter.

Thank you for your continuing interest.

Sincerely,

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