Fama Fiduciary
WEALTH LLC

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

July 2014

"Risk comes from not knowing what you're doing"*—Warren Buffett, legendary investor*

To our clients and friends:

Those of you who regularly read this newsletter know that the concept of risk is foremost in our minds. You also know that we often refer to Warren Buffett as a great teacher of both value and contrarian investing.

At a recent Fidelity Investments conference I attended in Boston last month, the subject of risk was once again discussed frequently among the attendees. One session in particular honed in on other risks—not simply the risk of losing money in a market crash.

The speaker in that session was Dr. Laura Carstensen from the Stanford University Center on Longevity. Her presentation focused on a different type of risk in investing—longevity risk. She explained that there are two components of longevity risk: 1) the risk of outliving your money because of today's greatly increased life expectancies and 2) the failure of young people to begin a savings and investing plan early in life.

With respect to the second issue, she cited a new methodology of conveying to young people the importance of saving and investing. It involves using avatar technology to allow someone to inhabit their future self. An example was to have young investors view computer images of themselves at age 33 versus what they might look like at age 73, complete with the incremental, progressive changes expected over this time period. This concept has been demonstrated to be successful in encouraging young people to begin saving *today* for the needs of *tomorrow*.

Buffett's Take on Risk

The quote that opens this letter is so patently obvious in its message that it seems almost superfluous. But despite its apparent clarity, many investors continue to disregard the underlying premise that it stands for—and by doing so, they risk their financial future.

Investors have an *asymmetrical* view of risk—bad outcomes produce more ***pain*** than good outcomes produce ***pleasure.*** It is a highly understandable response to want to take flight and put your money in "safe" investments. But it is critical to remember that "risk" takes many forms—it is not simply the volatility of the stock market. Selling out at the bottom, missing part of any recovery from that bottom, and the loss of purchasing power because of inflation are also forms of risk that must be considered.

We all know someone who "sold out" at the bottom of the market in 2008-2009. Those same people then subsequently failed (or simply refused) to become reinvested, thus missing out on a massive upswing in the markets. It is the third type of risk mentioned earlier—the loss of purchasing power because of inflation—which is the most insidious and potentially destructive to long-term investment strategies.

This is exactly the type of risk illustrated by Dr. Carstensen from Stanford and something that I stress to my clients frequently. If you choose to stash your money under the mattress and live in fear of the financial markets, you may be taking a different kind of risk, and you may end up feeling like the unfortunate couple in the photo below.

<u>The Management of Risk in a Bull Market</u>

One of my favorite market research organizations is Invest Tech out of Whitefish, Montana. It was exactly 18 months ago, in early January 2013 that they said this:

> *"Managing risk will be increasingly important as this bull market matures. But risk management does not mean jumping into a high-cash position every time <u>fearful headlines appear</u> or one becomes nervous because of a market correction. If that was the case, one would have moved to cash and been whipsawed at least 4 times since this bull market began.*
>
> *Managing risk requires <u>setting aside one's emotions</u> and <u>relying on discipline</u>. That's easy to say, but very difficult to do without time-tested technical models and extensive historical knowledge. This bull market, like every predecessor, will someday draw to a close. And while there are no guarantees, we are confident that our tools and 33 years of analytical experience will help us recognize the warning flags when they start to appear."*

.

The bull market they refer to is the bull market which began in 2009 and continues today. There were serious corrections in both 2010 and 2011, which most of us have all but forgotten. But having the discipline to stay invested despite those periodic—but very uncomfortable—market declines has been handsomely rewarded.

Since the above excerpt was written 18 months ago, there have been additional minor corrections in both 2013 and 2014 which also failed to derail the bull market.

Bonds as Risk Diversifiers

Although having covered this subject frequently in past letters, I feel compelled to once again expose the futility of trying to predict the direction of bond prices and interest rates.

Many industry veterans are concerned about investors' tendency to shy away from bonds in the current bull stock market because of the low expected returns. I've had clients who've asked why we should even be holding bonds when the stock market is rising so rapidly. My answer is always the same: Bonds are intended to preserve capital in the event equities and other asset classes begin to take a downward turn. *They are not in the portfolio in order to generate huge profits.*

Bonds are a diversifier and a buffer against unexpected rough patches in the equity (stock) markets. And despite the naysayers who've predicted a bond market Armageddon, nothing of the sort has transpired. Again in 2014, the bond market is confounding the so-called experts by behaving in exactly the opposite manner as the pundits had predicted. In the past 5 years, only 2013 has been a disappointment in bonds.

A Framework for Managing Risk

When initially discussing the concept of risk tolerance, an investor should start by determining what they need from their investments, short-term and long-term. Then, they should come to terms with the risk that must be taken to get there. If you can't stand the volatility of a higher-octane portfolio, then you must absolutely lower your expectations.

The only trading that should be done is the kind which serves to improve your portfolio. It should ***not*** be done to chase the market's new hot roadster or avoid its latest monster, said Meir Statman, a finance professor at Santa Clara University in California and author of "What Investors Really Want."

If your portfolio is undiversified, spread it out. If your investments are high-cost (such as "load" funds), switch to cheaper options. "Thinking you can anticipate where the market is going next is a folly," Statman said. "I just shrug and continue to save."

Our Firm's Approach to Managing Risk

Our clients are always, by definition, diversified to a significant extent because we hold *mutual funds of stocks* and *ETFs,* as opposed to *individual stocks.* Individual stocks can result in undue specific stock risk for conservative investors, and, consequently, we avoid them.

Just as with many other challenges in life, we approach investing for clients with a two-plan template. For the sake of simplicity, we'll call them Plan A and Plan B.

Our overriding investment strategy is initially to set the proper allocation (Plan A). In order to effectively add protection against changing market conditions for both stocks and bonds, we incorporate exposure to different types of stock and bond funds. We thereby strive to achieve steady, consistent returns with a minimum level of volatility. This is known as asset allocation, and is the foundation of our investment philosophy.

Plan B: Knowing that sometimes things don't work out the way you expect them to, we continuously monitor the overall performance of each portfolio ***relative to our expectations.*** In practice, this means we will act to change our portfolio holdings if warranted. The portfolio may exhibit behavior which is contrary to what we expected to see when we initially implemented Plan A. This is where many individual investors fall down because they fail to recognize changed conditions in their investment portfolio.

We use the concept of "upgrading" when deciding if and when to replace a particular investment in a given portfolio. In other words, all of our portfolios are built *fund by fund* based on upgrading. Our *process* is what drives the portfolio initially, which is to position each client in an asset allocation that most accurately reflects a balance of that particular client's risk tolerance and need for growth.

Conclusion

In closing, we will quote yet another industry icon, William Bernstein, author of several books including "The Intelligent Asset Allocator" who said, "There are two kinds of investors: Those who don't know where the market is headed and those who don't ***know*** that they don't know." This almost sounds a bit similar to the Buffett quote above.

Nonetheless, it is shocking how many people come on CNBC or other TV shows, or radio and they talk as if they know where the market is going. It is rarely "it might," or "it should," or "it could," but always instead seems to be "IT WILL!"

In last quarter's newsletter, I spent considerable time on the topic of predictions and the failure of most "talking heads" in the financial media to "get it right." We can add to Mr. Bernstein's observation by adding a third type of investor, the financial media guru, who indeed knows that he or she doesn't know, but whose livelihood depends upon ***appearing*** to know—and that includes a lot of people on Wall Street.

This is where the idea of managing risk collides with the real world. If you take these gurus at their word, you leave yourself open to potential financial harm.

Sincerely,

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