Wealth Management

QUARTERLY PERSPECTIVE
FALL 2018

Expecting and Managing Risk

The ability of the stock market to decline so harshly in October suggests investor confidence isn't that confident. The abrupt sell-offs betray an undercurrent of shareholder anxiety. While there may be plenty of positive arguments for continuing this decade-long bull market, recent events may indicate a shift in sentiment.

2018 Performance Year-to-Date through 10/31/18*

	October 2018	3Q18	YTD
S&P 500 Index	-6.84%	7.71%	3.01%
Dow Jones Industrial Average	-4.98%	9.63%	3.41%
Nasdaq Composite	-9.16%	7.21%	2.33%
Russell 2000 Index	-10.86%	3.58%	-0.60%
MSCI EAFE (net) Index (foreign developed)	-7.87%	1.35%	-9.28%
MSCI Emerging Markets (net) Index	-8.65%	-1.09%	-15.72%
Bloomberg Barclays U.S. Aggregate Bond Index (bonds)	-0.79%	0.02%	-2.38%
BofA Merrill Lynch 3-Month Treasury Bill (cash)	0.18%	0.49%	1.48%

Source: Zephyr StyleADVISOR

Two powerful trends are colliding here. The first is the fabulous performance of the stock market in the past ten years (post-Great Recession of 2008). Risk-taking was encouraged and risk-taking was rewarded. Greater returns went to those who took higher risk. The second trend is rising interest rates. Higher rates mean higher costs for both consumer and corporate debt service. Balance sheet fundamentals matter (again). It also means fixed income now offers a lower risk investment option with an acceptable yield. These converging forces signal a market cycle shift at worst, near-term uncertainty at least.

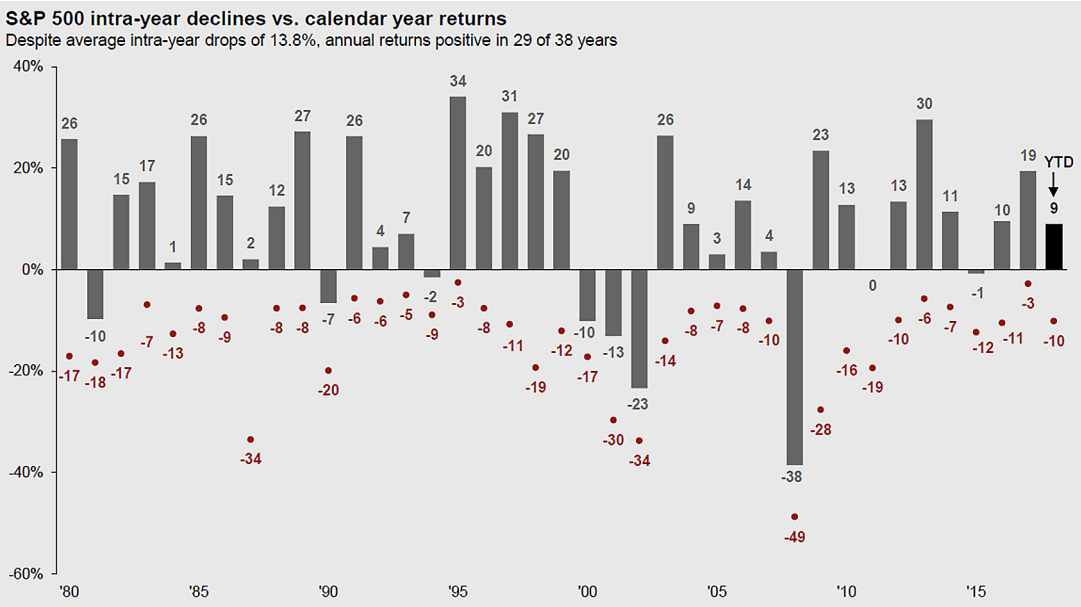
It's often said the market trades on fear and greed. The truth may be closer to fear or greed. In most instances, one or the other predominates. Right now, fear is elevated and greed is in short supply. Wait a while, and the roles reverse. With long-term market returns favoring stocks over bonds by an average of 2-to-1, it would appear investors prefer greed.

That being said, humans are inherently risk-averse. They'll make riskier investments, but must first be persuaded through promise or expectation of higher returns. Secondly, they have to earn a return proportionate with the risk taken, the risk-adjusted return. If two portfolios earned 7% a year for five years, they didn't necessarily do an equally good job of investing. If one did it with T-bills and the other with emerging market stocks, the first portfolio almost certainly did a better job, since it earned the same return with less risk.

Risk is also relative. Will an investment permanently lose money? Will a pension plan earn its actuarial assumption? Will an endowment cover its spending rate? Will a retiree earn less than she needs to live on? These are all perils of risk. An endowment is theoretically perpetual in its lifespan. Volatile quarterly returns are relatively meaningless risks to it. Not so a retiree tied to a fixed income. What's risky for one investor may not be so risky for another. **Following a portfolio strategy that matches your risk tolerance is vital to staying invested for long-term financial success.**

You can't make money without taking risk. There is no free lunch in investing. We've all seen the charts showing the impact on returns of missing the best days or the worst days in the market. The differences in returns relative to staying fully invested are dramatic – miss the worst days and see your returns skyrocket, miss the best days and see them plummet. Unfortunately, market timing is erratic, at best. You have to make two correct decisions for a favorable outcome – when to get out, and when to get back in. And, because we're naturally risk-averse, most people go to the sidelines in times of uncertainty, unable to anticipate the subsequent (and inevitable) performance rebound. Remember the "Buy High, Sell Low, Repeat until Broke" anecdote? These attempts at market timing are innocently meant to protect value, when in actuality they usually end up eroding value while adding significant risk.

Emotions are usually the root cause of these untimely deviations from strategic investment plans. Perceptions deceive. Expectations are fooled into thinking present-day market events are somehow different from those responsible for previous market corrections over past decades. They usually aren't – market cycles are just recycling. It's the simple ups and downs of human psychology and behavior. The chart below is a stark reminder that the market goes down (and then up) regularly.* Since 1980, the S&P 500 Index has had annual positive returns in 29 of 38 years, a 76% success rate. However, within each of those 38 years, the market at one point has been negative year-to-date an average of -13.8%, before rebounding positive by year-end 29 times (the red numbers are the intra-year drops; the grey bars the year-end return). So, in a perverse way, October's pullback shouldn't be a surprise. This time is not different (from all the other times).



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2017, over which time period the average annual return was 8.8%.
Guide to the Markets – U.S. Data are as of September 30, 2018.

The pain of losing is so much greater than the joy of winning. If acted upon, this loss aversion behavior can put an investor's financial plan at risk. That's why understanding the risks in your portfolio diversification and the expected performance of your portfolio in different market cycles is critical to bolster the confidence to weather the challenging periods. With a global slowdown on the horizon as tighter financial conditions and increased political and economic uncertainties sap "animal spirits," investors should prepare for continued volatility. Now would be a good time for you to meet with your CNB Wealth Advisor to review your investment strategy and make sure it continues to match your tolerance for risk. Your advisor stands ready to provide you with the information you need to ensure your plan stays on track through all manner of markets.

Sources: *Morningstar, Zephyr StyleADVISOR, and J.P. Morgan Asset Management as of 10/31/18.