Volatility and Perspective

By: David Jeter, CFP® *October 2015*

As we assess progress at the end of the 3rd quarter this year, it can be said that things have gotten a little bit messy in 'the markets'. The slightly positive first half of the year gave way to a slide that began with 'China fears' followed up by confusion over the Federal Reserve's inaction.

The reaction of some clients has changed the tone of conversations that are occurring. But should it? The truth is people often fail to realize how common volatility is. When I meet with clients, I keep two particular exhibits handy. The first exhibit lays out three areas of 'Influence' we have: things over which we have 'Total Control,' 'Some Control,' and that which is 'Out Of Our Control.' The second exhibit presents the annual returns of the S&P 500 Index since 1980 and the largest intra-year decline in each year (see chart below). There are three primary take-aways from this exhibit; the S&P 500 Index has finished positive 27 of 35 years; at the same time, every year of the 35 has a data point for an intra-year decline; and finally, the average intra-year decline is 14.2%. If you are a client of mine and reading this, I hope you can picture at least one of these two exhibits. My purpose for using the 'Influence' exhibit is to keep our planning focus, decisions, and mindset on the correct issues. In the 'Out of Our Control' sphere, I include Market Returns. The way it relates to the second exhibit should be clear. The market goes negative every year, but finishes positive 77% of the time (I am certain these numbers will be similar further back than 1980). We can't control the negative in the middle of the year any more than we can control the positive at the end of the year. Therefore, we should spend our time on that which we can control, namely our reaction to this information

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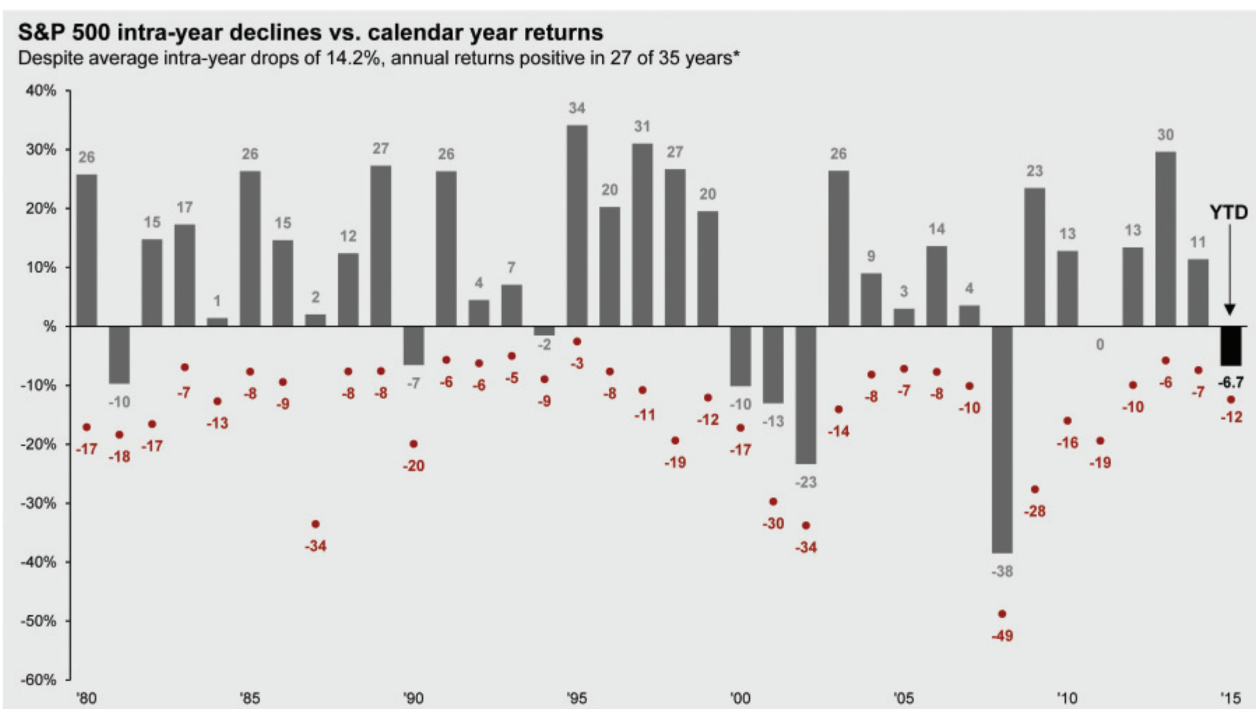

Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. *Returns shown are calendar year returns from 1980 to 2014 excluding 2015, which is year-to-date.
Guide to the Markets – U.S. Data are as of September 30, 2015.

Volatility and Perspective Cont.

and how we use it for our benefit. This speaks to the area of influence called 'Total Control' which includes your thoughts, the amount you save vs. spend, and the amount of risk you choose to take.

If we know there is a certain chance of something occurring (a market decline), and we know we can't control it, but only our reaction to it, why do many have a tough time reconciling the two? I think it is a matter of words and definitions in the unfamiliar terrain of finance.

Many people use the words' investor' or 'investing' to mean something altogether different. The use of this in the wrong context leads to misplaced energy at best and failing to reach financial goals at worst.

What do you call a person who uses their money to purchase ownership in a company for the purpose of receiving a profit in the future in the form of interest, dividend income, or appreciation in value? You would call this person an 'investor.'

What do you call a person who places bets on the short term price change of a company stock or a part of the stock market, based on price patterns, market emotion, supply and demand of shares, or news releases?   The mistake is considering this person an 'investor' and their activity as 'investing.' The more appropriate term for this type of activity is 'trading' performed by a 'trader.'

Both investors and traders are participants in the stock market. They are involved for different reasons and in different ways, but each serves a function. Confusing the two is where the problem occurs.

As you know, we preach removing emotion from decisions, focusing on the long term, riding out down turns, and being patient. All of these bits of advice are the recipe for success in investing. On the other hand, they are the very activities that would crush a trader. Likewise, if I shared with you the bits of advice a trader should live by, you would see that they are the activities that will crush an investor.

See where this is headed? If you work with us as your financial planner, you are an investor. Therefore, the lens through which we view you, and through which you should view our advice, includes two complementary ideas. First, you are investing in companies that represent a good value now and into the next several years, regardless of what the stock market does short term; those companies have a great chance to appreciate in value. And second, the money you need in the next few years is not invested in the stock market, so any day-to-day price swing in the market is minimally relevant to you.   On the other hand, it is relevant to a trader who has speculated on the change in short term prices.

So, to combine those two thoughts, if you are investing in companies of value and the market moves down, as an investor, you would do what? That's right, you may possibly buy more because it's cheaper. What should the trader do? Possibly, they get out immediately, because they may have made a bet on the price movement in the other direction. The company's long term prospects are irrelevant to them.

The last quarter of volatility and the downturn in the market has people thinking about 'what they should do' and whether 'standing firm' is a recipe for disaster. Don't let the current change in the market value be the determinant for taking your eye off of your long term objectives.   You shouldn't change your investing approach when the market changes; you should change it when your objectives change.

It is rational to ask questions and to have concerns, but taking an action counter to your original reason for putting money to work, will turn inevitable setbacks into unrecoverable ones. In closing, there is a reason why I am confident that the advice I submit to you in my writings will lead you to financial success.   Next time we meet or speak, ask me what that reason is.

If you would like to discuss the subject matter in this article or any question related to your financial planning, please contact David Jeter at djeter@alleghenyfinancial.com or 412.536.8012.