StraightTalk

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ALFRED L. STRATFORD, III
Chartered Retirement Planning Counselor (CRPC®)
Senior Vice President, Investments

"But….The Market Is So High!"

In conversation after conversation, I hear the same refrain from countless clients when discussing the continued price increases in the great companies of America and the world. It is always some version of "Yes, but…the market is so high…isn't a big drop coming?" Human beings, conditioned as we are to recent events in our lives, naturally assume that another 2008 must be right around the corner. Taking a recent negative experience and projecting the expectations of a similar experience in the near future is a psychological condition known as anchoring. However, history shows that just because a market has been rising for awhile does not, in and of itself, mean that a big decline is imminent.

It is important to remember why prices rise in the first place. Benjamin Graham (the Warren Buffet of the early 20th century) famously said "In the short run, the market is a voting machine, but in the long run, it is a weighing machine." In other words, short-term prices are affected by swings of investor emotion, but long-term prices track the true value of the companies in the market. In 2009, the year the stock market bottomed, earnings for the 500 largest companies in our land were $57.78 per share. This year, those earnings numbers are expected to be well above $130 per share, before a possible retroactive reduction in corporate taxes could improve that number. So, on the basis of earnings, a market that is up roughly 2.5 times makes complete sense over that eight year period.

However, the most remarkable thing about the market's rise over this period of time is the short run "voting machine" that Graham referenced. According to the market research firm Thomson Reuters, since the great Recession and subsequent stock market bottom in March of 2009, the investing public has been net sellers of stocks. In other words, including continued automatic investments in retirement plans, investors have been selling more stock funds than they have been buying. Additionally, institutions such as foundations and endowments have similarly been reducing their stock market exposure. In place of owning great companies, they have been investing larger and larger sums in such counterintuitive investment products like "low volatility," "liquid alternative," and "smart beta," ideas, which often claim to generate stock market returns, without stock market volatility. *Folks, this is not accurate - the price of the return* ***is*** *the volatility, which we should always ignore.* So, if institutions and individual investors have sold more stocks than they have bought, that leaves corporations as the largest buyers of common stocks since 2009. Perhaps, in the day-to-day managing of their businesses, watching their sales and earnings continue to improve, they know something we should all be paying attention to?

But the Thomson Reuters research drills deeper, into a variety of subgroups of the U.S. population. Across all groups polled, 54% of Americans reported owning stocks, down from 62% in 2008. That is astounding…during a period of time when our market has tripled, the average investor has reduced his or her stock holdings! The research further details that ownership of stocks was down across all major subgroups of the population except those age 65 and older - who have seen this movie before - and those with a household income above $100,000, who may have a financial advisor assisting them. And, in case you think most of that selling of stocks was in the high fear period of 2009-2012, I give you a recent data point and an even wider time frame to consider. In a Wall Street Journal article in early August, Jason Zweig cited that investors had pulled $17 billion from U.S. stock mutual funds and ETFs, and added $29 billion to bond funds, just in the month of July. He goes on to point out that "Since the

Internet-stock bubble burst in 2000, investors have withdrawn half a trillion dollars from U.S. stock mutual funds." That fact alone leads me to believe that this bull market has years left to run!

The question is why investors, who presumably are saving for one day off in the future, continue to act this way when they should know better? The answer can't be access to information; any of you can learn essentially all there is to know about any particular investment in 30 minutes on the internet. The answer can't be the lack of good investment choices; the world is awash in more great investment choices than ever. The answer must lie in behavior, which is actually driven by three fundamental truths about human beings investing their capital.

Truth #1 is that human nature intuitively believes the critical issue is preserving principal, therefore any diminution of principal (however short-lived) is a call to action. The critical issue is always how to meet the challenge of maintaining an income *that rises at least as much as inflation.*

Truth #2 is that an income that rises above inflation over a two decade period of retirement has been historically available only from common stocks. Bonds, real estate, gold and cash have not kept you ahead of inflation over the long-term.*

Truth #3 is that the prices of the great companies of America and the world are shown to you every minute of every day, and those prices often decline in the short run. Obsessed with preserving principal, human nature will regard these completely normal and routine declines as an existential crisis, and will make you want to flee the stock market, which could permanently damage your chance of retirement success.

When you consider the amazing regularity of price declines, you would think the average investor would be used to them by now. According to Standard & Poor's research, since World War II, there have been 183 pullbacks of at least 5%. In other words, in 71 years of rising markets, you had to endure 183 periods of temporary loss, which averages out to one about every five months. I do not know how many all-time new highs were hit during this 71 year advance, but the number of negative news stories in those years dwarfs the number of new highs.

One only has to google the phrase "increasing signs of recession" to understand this fear of the negative. At a time when the developed world is in a synchronized growth environment, earnings are increasing around the world, and regulations are being reduced with lower taxes being discussed here at home - that Google search yields over 18,000,000 results! And since it appears that all it takes to be interviewed as an "expert" on television today is a heartbeat and a dire prediction, it becomes harder than ever to tune out the bad news noise.

Those varied doomsday predictions get more air time than some truly amazing facts about the investment opportunities today. For instance, ten years ago it took 70 days to drill a well that yielded 100 barrels of oil per day. Today, it takes 7 days to drill a well yielding 1,200 barrels a day. A decade and a half ago, when flash memory storage was invented, a gigabyte of storage cost over $45,000. Roughly translated, that means your iPhone would have cost $5.8 million then, and today you can get it for $199 and a two-year plan. India, which is 19% of the world's population, has asked the U.S. to be their natural gas supplier. The package delivery company that drives brown trucks is using drones for rural delivery. This means that outside of dense urban areas, the truck parks in a central spot and the drone launches several times, out and back, to make deliveries far faster and cheaper than in the truck. In just the last three years, we have gone from sealing our borders against Ebola to CNN reporting that the vaccine now gives 100% protection against that formerly deadly virus. And, in the last year, researchers have used a 3D printer to create human vertebrae. Vertical farming, splitting genomes, using the HIV virus to target proteins in terminal leukemia patients that have since been saved…the list goes on and on. What sense does selling a portfolio of these great companies make?

Recall that when the legendary fund manager Peter Lynch was asked the proper time to invest, he famously responded, "The best time to buy stocks is when you have the money!"

804.225.1143 | straightlinefinancial.com | 951 E. Byrd Street, Suite 930 | Richmond, VA 23219

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