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INSIGHTS

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The Uncertainty Paradox

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"The market hates uncertainty" has been a common enough saying in recent years, but how logical is it? There are many different aspects to uncertainty, some that can be measured and some that cannot. Uncertainty is an unchangeable condition of existence. As individuals, we can feel more or less uncertain, but that is a distinctly human phenomenon. Rather than ebbing and flowing with investor sentiment, uncertainty is an inherent and ever-present part of investing in markets. Any investment that has an expected return above the prevailing "risk-free rate" (think T-Bills for US investors) involves trading off certainty for a potentially increased return.

Consider this concept through the lens of stock vs. bond investments. Stocks have higher expected returns than bonds largely because there is more uncertainty about the future state of the world for equity investors than bond investors. Bonds, for the most part, have fixed coupon payments and a maturity date at which principal is expected to be repaid. Stocks have neither. Bonds also sit higher in a company's capital structure. In the event a firm goes bust, bondholders get paid before stockholders. So, do investors avoid stocks in favor of bonds as a result of this increased uncertainty? Quite the contrary, many investors end up allocating capital to stocks due to their higher expected return. In the end, many investors are often willing to make the tradeoff of bearing some increased uncertainty for potentially higher returns.

> *"Doubt is not a pleasant condition, but certainty is an absurd one".*
>
> **Voltaire**

While the statement "the market hates uncertainty" may not be totally logical, it doesn't mean it lacks educational value. Thinking about what the statement is expressing allows us to gain insight into the mindset of individuals. The statement attempts to personify the market by ascribing the very real nervousness and fear felt by some investors when volatility increases. It is recognition of the fact that when markets go up and down, many investors struggle to separate their emotions from their investments. It ultimately tells us that for many an investor, regardless of whether markets are reaching new highs or declining, changes in market prices can be a source of anxiety. During these periods, it may not feel

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A Personal Note From Global Wealth Advisors

The Federal Reserve's Open Market Committee (FOMC) did raise the Federal Funds interest rate again at its June meeting. This was another quarter point (.25) increase bringing the rate to .75 to 1.00 percent, the fourth since the Recession of 2007-2009. It is also expected there will be one more quarter percent increase later this year and possibly three more quarter point increases in 2018. This is being done to return interest rates to more 'normal' levels seen before the recession.

The US stock markets reacted modestly when this year's second rate increase was announced. In fact, the S&P 500 and Dow Jones Industrial Average (DJIA) market indices are having a good year so far. In this quarter's newsletter article, "When Rates Go Up, Do Stocks Go Down", research has shown there is no way to consistently predict whether stocks will go up or down with changes in interest rates and we are seeing that now.

As Warren Buffett is quoted in another article, market corrections can be scary but also your friend as they may bring some buying opportunities. But, he goes on to say, "you have to be there to benefit". That's why staying focused on long-term goals is so important during market volatility and in achieving your objectives.

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When Rates Go Up, Do Stocks Go Down?

June 2017

Should stock investors worry about changes in interest rates? Research shows that, like stock prices, changes in interest rates and bond prices are largely unpredictable.[1] It follows that an investment strategy based upon attempting to exploit these sorts of changes isn't likely to be a fruitful endeavor. Despite the unpredictable nature of interest rate changes, investors may still be curious about what might happen to stocks if interest rates go up.

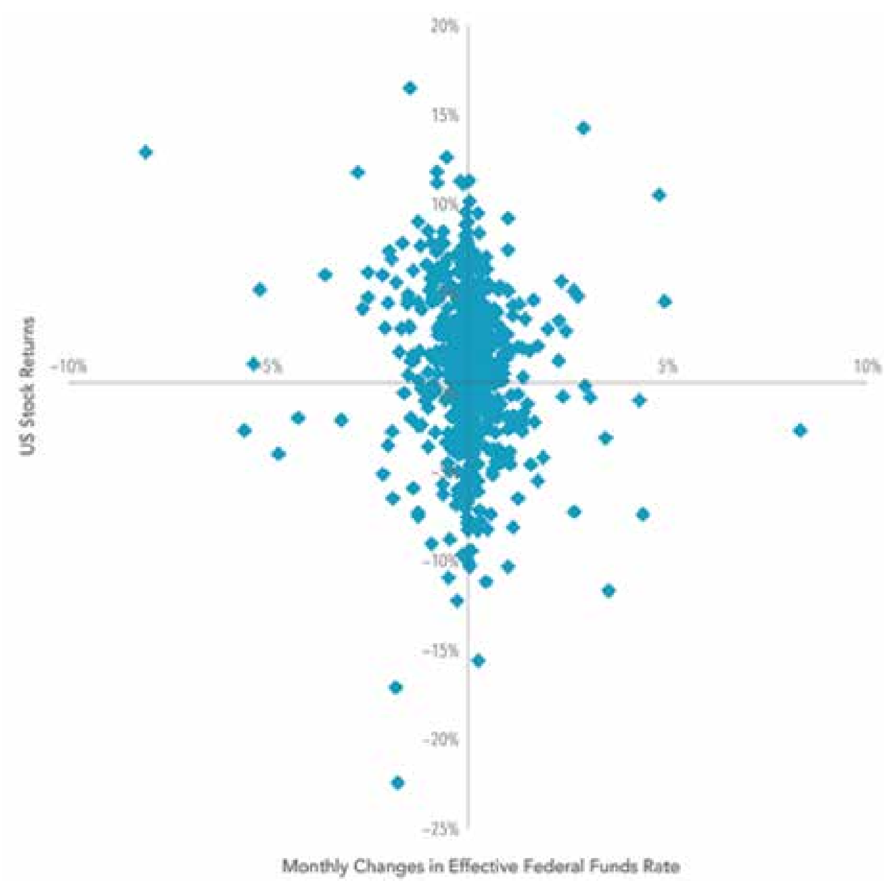
Unlike bond prices, which tend to go down when yields go up, stock prices might rise or fall with changes in interest rates. For stocks, it can go either way because a stock's price depends on both future cash flows to investors and the discount rate they apply to those expected cash flows. When interest rates rise, the discount rate may increase, which in turn could cause the price of the stock to fall. However, it is also possible that when interest rates change, expectations about future cash flows expected from holding a stock also change. So, if theory doesn't tell us what the overall effect should be, the next question is what does the data say?

RECENT RESEARCH

Recent research performed by Dimensional Fund Advisors helps provide insight into this question.[2] The research examines the correlation between monthly US stock returns and changes in interest rates.[3] **Exhibit 1** shows that while there is a lot of noise in stock returns and no clear pattern, not much of that variation appears to be related to changes in the effective federal funds rate.[4]

For example, in months when the federal funds rate rose, stock returns were as low as –15.56% and as high as 14.27%. In months when rates fell, re-

Exhibit 1 Monthly US Stock Returns against Monthly Changes in Effective Federal Funds Rate, August 1954–December 2016



Monthly US stock returns are defined as the monthly return of the Fama/French Total US Market Index and are compared to contemporaneous monthly changes in the effective federal funds rate. Bond yield changes are obtained from the Federal Reserve Bank of St. Louis.

[1] See, for example, Fama 1976, Fama 1984, Fama and Bliss 1987, Campbell and Shiller 1991, and Duffee 2002.

[2] Wei Dai, "Interest Rates and Equity Returns" (Dimensional Fund Advisors, April 2017).

[3] US stock market defined as Fama/French Total US Market Index.

[4] The federal funds rate is the interest rate at which depository institutions lend funds maintained at the Federal Reserve to another depository institution overnight.

turns ranged from –22.41% to 16.52%. Given that there are many other interest rates besides just the federal funds rate, Dai also examined longer-term interest rates and found similar results.

So to address our initial question: when rates go up, do stock prices go down? The answer is yes, but only about 40% of the time. In the remaining 60% of months, stock returns were positive. This split between positive and negative returns was about the same when examining all months, not just those in which rates went up. In other words, there is not a clear link between stock returns and interest rate changes.

CONCLUSION

There's no evidence that investors can reliably predict changes in interest rates. Even with perfect knowledge of what will happen with future interest rate changes, this information provides little guidance about subsequent stock returns. Instead, staying invested and avoiding the temptation to make changes based on short-term predictions may increase the likelihood of consistently capturing what the stock market has to offer. ●

Misperceptions About Market Corrections

If you enjoy financial literature, we recommend all of Warren Buffett's annual Berkshire Hathaway shareholder letters, dating back to 1965. While financial reports are rarely the stuff from which dreams are made, Buffett's way with words never ceases to impress. His most recent 2016 letter was no exception, including this powerful insight about market downturns:

> "During such scary periods, you should never forget two things: First, widespread fear is your friend as an investor, because it serves up bargain purchases. Second, personal fear is your enemy."

This actually is a good time to talk about scary markets, since we haven't experienced a severe market correction in about nine years. For example, the CBOE Volatility Index (VIX), aka, "the uncertainty index," is a generally accepted gauge of how confident investors are that the market is going to be volatile or not in the near-term. The lower the number, the smoother the presumed ride. Although as usual, there are no guarantees the markets will actually do as they're told.

As of June 2, the VIX was hovering in the range of 10–16, year to date. To put this in context, the VIX peaked at about 60 during the bear market of 2007–2009. You'd have to go back just over a decade to witness similar periods of relative calm.

What should we make of these numbers? Scanning financial news, you'll find the usual range of attempted interpretations: *"We are worried about …" "Economic indicators suggest that …" "Geopolitical events are likely to …"* and so on.

What else is new? While it's highly unlikely the VIX will remain this calm forever, nobody can predict when it might turn, or why or how dramatically it may spike back up when it does. As always, we counsel against shifting your portfolio in reaction to near-term forecasts. This includes predictions of perceived volatility or growth. Instead, let's use the relative calm as a perfect time to do a reality check on what scary markets really represent, and how to manage them when they occur.

This brings us back to Buffett's words of wisdom. Contrary to common perception, scary markets can actually be your friend. Some of your best returns are delivered in their immediate aftermath and, as Buffett suggests, there may be some "bargain" buying opportunities. ***BUT, you have to be there to benefit,*** which is why personal fear becomes your enemy if you panic and flee during the downturns.

So, how can we prepare? Instead of fussing over when the next market downturn may or may not occur, here are some great questions to consider:

Market Returns – Are you taking on enough stock market risk in your portfolio to capture a measure of expected returns when they occur, often unpredictably and without notice?

Market Risks – Are you fortifying your exposure to market risks and expected returns with enough lower-risk holdings, so you won't fall prey to your fears the next time markets tumble?

Personal Goals – Have you assessed whether your current portfolio mix is optimized to achieve your personal goals? Speaking of goals, have yours changed, warranting portfolio adjustments?

Personal Risk Tolerance – Have you been through past bear markets? If you discovered you're not the risk-taker you thought you were or, conversely, you sailed through with relative ease, does your current portfolio mix of holdings accurately reflect what you learned?

You can prepare for a down market by having a well-diversified portfolio in place today. It should reflect your long-term financial goals and risk tolerances. We don't know what the future holds any more than anyone else does, but we can say it is important to stay focused on your long-term objectives. You will be glad you did. ●

Enjoy your Summer!

The Uncertainty Paradox

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like a good time to invest. Only with the benefit of hindsight do we feel as if we know whether any time period was a good one to be invested. Unfortunately, while the past may be prologue, the future will forever remain uncertain.

In a recent interview, David Booth was asked about what it means to be a long-term investor:

"People often ask the question, 'How long do I have to wait for an investment strategy to pay off? How long do I have to wait so I'm confident that stocks will have a higher return than money market funds, or have a positive return?' And my answer is it's at least one year longer than you're willing to give. There is no magic number. Risk is always there."

Part of being able to stay unemotional during periods when it feels like uncertainty has increased is having an appropriate asset allocation that is in line with an investor's willingness and ability to bear risk. It also helps to remember that, during what feels like good times and bad, one wouldn't expect to earn a higher return without taking on some form of risk. While a decline in markets may not feel good, having a portfolio you are comfortable with, understanding that uncertainty is part of investing, and sticking to a plan that is agreed upon in advance and reviewed on a regular basis can help keep investors from reacting emotionally. This may ultimately lead to a better investment experience. ●