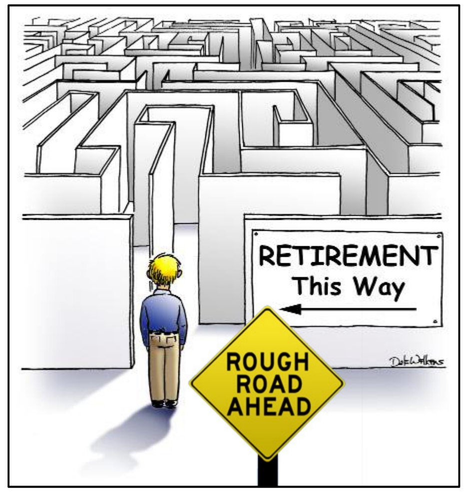
Reprinted from the *Lexington Minuteman*

CoroMandel Wealth Management

February 2018

The Return of Market Volatility



Navigating the Retirement Maze

“The four most dangerous words in investing are: ‘This time it’s different.’”
– Sir John Templeton, British investor, philanthropist (1912 - 2008)

After a stellar year for the stock market following seven years of market advances, the continued enthusiasm for stocks in January resulted in a month of outstanding gains. Too good to be true? Well, yes, as it turned out. The correction that began in early February and shaved 11 percent from the peak reached just two weeks earlier suddenly had investors rethinking their portfolio strategies. One of my clients told me that he “couldn’t go through this again.” The flow of funds into stocks in January abruptly reversed and shifted to cash.

The question that most investors, particularly those near or in retirement, have been asking themselves lately is whether recent market events are a harbinger of future declines. Should they bail out and hang onto their gains, or hold on for what looks to be a bumpy ride? If you find yourself in this situation, then you probably need to revisit your portfolio strategy, especially if market volatility is keeping you awake at night.

Volatility and markets go together

Investors tend to forget the less than smooth ride that the market took to get here from its bottom in March 2009. During the past nine years, there have been pullbacks of between 10 and 19 percent five times. Each time, pundits speculated that this was the end of the bull market, and each time they were wrong. Once the correction had run its course, the market chugged forward to new highs.

Equity markets are volatile, and the volatility works in both directions. We cheer market advances and tend to forget that they are upward market volatility. The pullbacks are what get more notice and incite fear. Yet investors who retreat to cash every time that the market pulls back tend to have the worst long-term investing records.

DALBAR, an independent research firm, reported in their Quantitative Analysis of Investor Behavior report in 2017 that over the past thirty years, the performance of the average equity mutual fund investor lagged the S&P 500 index by 6 percent. What accounts for this? Mostly the inability of investors to stay invested during downturns, and thus missing out on the subsequent recoveries which usually exceed the downturn by a substantial amount. Following the crash in 2008-09, the average investor did not invest more in equities than bonds until 2013, nearly four years after the correction. By then, the S&P 500 had already risen over 100 percent, surpassing its previous high. It’s the classic case of “sell low, buy high.”

If market volatility is a given, how should the average investor handle it? First, by not looking at market news or their portfolio performance on a daily basis. Turn off CNBC, stop poring over the Investment section of the Wall Street Journal, and resist checking your portfolio on your cell phone. Second, you need to maintain a proper perspective about why you’re investing, and what your investment goals are. This gets back to the basics of the purpose of long-term investing. Finally, you should have a portfolio that doesn’t cause angst with every pullback.

What’s your time frame?

When someone asks me where they should be invested, the first question that I ask them is what their time frame is. If they are talking about funds to be used to purchase a house in the next years or two, then safety of principal should

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be their primary concern, and a money market fund or high yielding savings account are appropriate. If they are talking about their retirement funds, then the relevant question is when they intend to use them. Funds needed in the next three to five years need to be invested more safely than those intended for the duration of their retirement. Funds held for the longer term can, and should, be invested more aggressively.

Thus, it is important to have an estimate of your cash needs over the next five years. The remainder of your assets should be invested according to your estimated life expectancy and projected future income needs. Given the trend in increasing longevity, absent any serious health issues, most people should be planning on living into their nineties. Their retirement budgets and investment allocations should be consistent with this.

The future ain't what it used to be

This quote is attributed to the great Yogi Berra, though it applies here. For those who expect the US markets to deliver the kind of gains over the coming decade that we have come to expect over the past nine years, it's time to reset your expectations. A combination of 2009 post-crash low prices and Federal Reserve monetary policies have contributed to create this bull market. While I don't believe that it is ready to end, my expectations for the coming decade are much more tempered.

Two reports lend credence to this concern. Investment management firms Research Affiliates and Grantham Mayo & van Otterloo both project that US market returns will barely keep up with inflation over the next decade. Historically low interest rates, which are now ending, contributed to the rise in US equity prices, as did the low valuations following the market crash of 2008-09. The S&P 500 is up more than 200 percent since that bottom, and the NASDAQ over 350 percent. Realistically, future gains will be considerably more modest.

One way to improve portfolio returns going forward is to diversify internationally. The US equity markets constitute only about half of global equities, so most portfolios should include a significant percentage of non-US equity funds. China and emerging market countries represent some of the best growth opportunities today, so don't neglect them when rethinking your portfolio.

Don't forget investing's only "free lunch"

This is almost a mantra of mine, but one that many investors forget when chasing market gains. Diversifying portfolio assets, when done correctly, can provide both improved gains and decreased volatility over the longer term. Different asset classes outperform during different time periods, so while some asset classes are underperforming, others are showing gains. Holding a variety of asset classes will help smooth out the bumps that occur in any one asset class. Bonds (various types), equities (different countries, market cap sizes), real estate, commodities, and precious metals all deserve an allocation in a well-diversified portfolio.

Ignore the daily market gyrations, think long term, remember to diversify your holdings, and make sure that your portfolio reflects your income needs for the future. That's what intelligent lifetime investing is all about.

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