Registered Investment Advisor Firm

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21st CENTURY LESSONS

We can benefit by learning from our investing mistakes and tweaking our strategy going forward. Here are several lessons learned early in the 21st Century.

-Stocks are really risky- Trying to accurately predict future stock performance is an exercise in futility, but you can predict with near certainty that high-quality bonds will have less volatility than stocks in the long run.

Sometimes our memories fail and we forget that the fallout from the last major correction. **Diversify; don't only invest in the hottest trend.**

-U.S. stocks don't give enough international exposure- Many investors believe that they don't need international stocks because 48% of the current S&P500 revenues come from international sales and there is a high correlation between U.S. and international stocks.

In the last 17 years, international stocks beat U.S stocks in the first half and badly underperformed in the second half.

There wouldn't be such divergence in performance if U.S. stocks alone gave enough foreign exposure, demonstrating that high correlation doesn't mean the same as total return. **It is best to own the world.**

-Stocks for the long run can be longer than you can wait- We know that stocks are for growth and outperform bonds in the long run. The long run can be a decade or more.

In the last 17 years, bonds have slightly outpaced U.S. stocks and trounced international stocks. **Your time horizon will help you set your allocations.**

-Break the addiction to prediction- So far in the 21st Century; we have had two stock plunges of nearly 50% or more.

Few have accurately forecasted such plunges. Economist Gary Schilling correctly called the 2008 crash (both real estate and stocks), but missed badly in 2009 when he didn't call the bottom.

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Economist/Author Harry Dent's 2009 best seller, "The Great Depression Ahead", came just in time to help readers lose out on this current stock bull market.

Economists badly missed interest rate forecasts. They consistently predicted rising rates, while the market decided otherwise. **The market has already priced in known information, and nobody knows the future.**

-Don't bail on bonds- Rebalancing is not always easy. Who could argue with the benefits of buying stocks when they are on sale? Few had the intestinal fortitude to buy when stocks plunged in 2002 and especially in 2008.

Sticking to just about any asset allocation would have worked as it meant selling stocks surging and buying after a plunge to get back to your target allocation. Morningstar reported the average taxable bond fund lost nearly 8% in 2008, with many losing 20% or more. Though bonds are unlikely to perform as well as they have for the last 17 years (remember rising interest rates), do not bail on bonds. **Sell only to rebalance.**

-Market plunges are not alike- What worked in the 2000-2002 plunge didn't work in the 2008-2009 drop.

In the first crash, small-cap value outperformed the rest of the market while precious metals, mining stocks and REITs did quite well. Many investors built portfolios heavily weighted in the asset classes that did the best during those three years, and assumed these classes would do well in the next market downturn.

The problem is that no two crashes are alike. In the 2008-2009 crash, value stocks were heavily weighted in financials and real estate, and both got slaughtered. Precious metals and mining stocks got hammered and did not recover as fast as financials and real estate. **Don't build a portfolio based on what worked in a single market plunge.**

-Alternatives have had low correlation but bad returns- After the most recent plunge, alternative assets were the craze. Many investors went heavily into managed futures and market neutral funds, long-short funds, inverse funds and hedged funds. Many had low returns or even losses before costs and typically have very high costs.

Gambling in Vegas wouldn't be correlated to stocks, but that doesn't make it a wise investment. **Any investment with a low correlation to stocks must also have a reasonable expected return.**

-Narrow bets have worse market timing- Many investors are predictably irrational. If stocks surge, they will get greedy and buy; if they plunge, fear will rule and they will sell. Many studies have estimated the impact on investors by comparing dollar-weighted returns to the geometric returns of funds. The results, the narrower the fund, the more investors show poor timing. **Broader is better in that it not only lowers**

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volatility; it reduces the temptation to performance chase.

-Investing based on the recent past is a mistake- Over the five year period ending in 2007, U.S. stocks doubled while international stocks tripled, with expectations of this trend to continue. A year later, in the wake of the stock market meltdown, many investors changed their tune to “cash is king”, and missed out on the recovery. **Allocate and rebalance.**

We are emotional beings who are not always efficient learners and regularly repeat mistakes. These lessons may help avoid the kind of investing mistakes that rob your returns. Though they won’t work every year, I believe they will make the next 17 years of investing successful.

If you need more information, or if these strategies are suitable for your accounts, contact me so we can discuss.

FED Watch

No Fed action since the last meeting.

Market observers give a 5% chance of a quarter point rise in the Fed Funds at the next meeting and a 65% chance at the June meeting.

The next meeting is May 2nd and 3rd.

Davis Investment Group

Davis Investment Group is a fee-based Registered Investment Advisor firm servicing the needs of clients across the United States.

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If you have questions or would like further information on this month’s topics or any other financial or investment related subjects, including Social Security claiming strategies, please contact me by phone or through my email address at: bob@davisinvestmentgroup.biz

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