Perspective

April 2013 By Davis Riemer

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The Fine Art of Wealth Management

Is It Time to Sell and Get Out? (Or, Should I Buy?)

A Dilemma:

As I began writing this *Perspective,* our stock market was continuing an un-abated climb. Furthermore, although not as smartly as our own, other country's stock markets were also rising. Yet, investors remain worried. What about? Some, in the market, fear a decline and wonder if the time has arrived to sell. Others, having sold months (if not years) ago, now in cash, fear that if they just continue to sit by and watch, they will miss out on further gains and potential recovery of their previous worth. They wonder if it is time to buy. (Remember the 1981 song lyrics by The Clash? *"Should I Stay or Should I go? I don't know!"*)

Many of those who own stocks also cautiously consider reports of our nation's economic health. They fear the "recovery" is sputtering, slowing, coming to an end. Others, looking back at how far the nation has come in four years believe, that although there might be a few bumps in the road, the outlook is much better and more growth lies ahead. Expert opinion appears across the entire spectrum of outlooks. Take your pick. Naturally, news media help fuel the debate by providing a constant stream of data. Whether their data actually helps is a questionable matter, however. Is it time to sell? Is it time to buy? Why do economists not agree on these issues? How should one make those decisions? How should one assess the data and evaluate its meaning for decisions?

The market has reached (and then fallen away from) its all-time high. Does the recent decline foretell further decline? Is the decline only a "correction?" How important is it to know? If it is important, given the divergent opinions, how *can* one *know*? Suppose expert opinions did not vary, then what? Well, contrarily, if "everyone" thinks it is time to buy, then it is probably a good time to sell. If the all opinion shapers say "sell," it is probably a good time to buy. Opinion drives prices, but such extremes rarely occur, so most of the time, as now, opinion will vary.

That is enough focus on the questions, which is intended only to reinforce the consideration of the high uncertainty involved. Our own opinion follows, after a brief discussion of why economists disagree and why it is so difficult to get help from the media.

Ask the Experts:

I suspect that many of our clients read the opinion piece by David Stockman, recently published in the New York Times. Stockman cited many facts, some going back 80 years. Is he right? Stockman is no darling to the left. Paul Krugman, however, is highly favored on the left. After reading Stockman's piece, Krugman called him a "grumpy old man." Is he right? Why is that relevant? Whether Stockman is "grumpy" or not, I do not know. But Krugman made an important point, by addressing Stockman's underlying ideas about society, which Krugman finds govern Stockman's economic opinions. The "left" and the "right" of our political spectrum represent different philosophies about how to run a country. The final answer as to which describes "the one best way" cannot be known in advance – it is even very, very hard to "know it" in historical terms. Argument still persists over how the Roosevelt administration handled the Depression and why it eventually ended. In conversation with me about this, Kenneth French (Professor of Finance at Dartmouth's Tuck School of Business and one of the country's leading economists researching securities markets) offered his thoughts about why economists cannot agree on some really important questions. "It's not economics," he said. "When you get to those questions, it's no longer economics, it's philosophy." That comment sort of "rang a bell" of realization for me, with the result that I felt much less pressure to seek out and understand the "expert" opinions about the future. (With only a smile and the best of intentions, I offer a quote about philosophers, from Niels Bohr, the Physics Nobel Laureate in 1922: "I have made a great discovery, a very great discovery. Everything that philosophers have ever written is pure drivel.") Without further elaboration, the point is simple: Although they do philosophize about it, and although some claim knowledge superior to that of the philosophers, experts in economics do not know the future. Such experts will have opinions about what investors should do now, but their "expert" opinions are no more valid than the average of all opinions in the market places, or, in other words, prevailing prices in the market. Not much help, if one seeks reliable forecasts.

Can the "average opinion" be derived from the media, perhaps the most "average" of all public endeavors? I believe that the media report virtually everything that matters to an investor, but, sadly, those "things that really matter" are simply buried in enormous volumes of things that do not matter. Here is a small example, in the form of an analogy. Please think back to a time when you were trying to listen to a radio broadcast, but the sound you wanted – the "signal" - was overwhelmed by static, pops, hisses – "noise" - which, in fact, obscured the clarity and meaning of the signal. "What did that newscaster say?" "I don't know – I couldn't make it out. Too much interference!"

We have a similar phenomenon in finance. Market and media noise obscure relevant data and also the bigger picture. As the markets move, with sentiment following one way then the other, the analysts create narratives for events and outcomes, which although plausible, are often wrong. Ultimately right or wrong, their opinions often move people to action, so their narratives must appear seamless. But do they contain accurate forecasts that one can actually use to make sound investment decisions? Amid the turbulence of data, how can one select and sort the relevant information, and then decide about selling or buying? What matters in making this decision? What are the important elements to look for amid the noise?

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The Question Is: Sell Now?

In a round-about way of approaching the answer to that question, I suggest first considering a different question: For those who are now invested in the market and are asking about whether to sell now, why does the question come up? Among possible answers, here are some: Fear of loss; the market has reached a high; re-invest later and exploit the price changes for gain; follow the advice of an "expert;" the constant media drumbeat about economic problems and increasing levels of anxiety, all of which prompt the perceived need to "do something." You might even have additional reasons, but with the sole exception of buying back in later to scoop up low prices, all of the above are simply variations of the first: *"Fear of loss."* Most of our clients have described themselves, to some extent, as "risk averse." All want to avoid losses. However, people often need to identify an object, an externality, a rationally conceived explanation for the fear of immediate or near term loss. Finding that explanation poses no problem at all. Opportunities for it abound - experts, historical prices, financial calculations, economists, media – plenty of places to find opinion that explains and justifies fear of the future. At this point of market history, in thinking about selling, let's just say: *We don't want to lose money!*

However, let's reflect on why the money was invested in the first place. Typically, our clients would say: "To reach our goal for retirement income." This important goal typically spans at least two decades and often more, when considering the years both before and after actual retirement, out to life expectancy. If that is the case, then before considering whether to sell, one should consider this: "What investment and trading strategy has the highest likelihood of producing a satisfactory result over the horizon that actually matters in one's individual situation?" In 1989 and 1990, when I first developed the strategies that DHR still uses, I sought the answer to that question. It simply seemed intuitively obvious to me that, if one proposes to invest capital for 30 years, what matters most is the selection of the strategy that shows the most promise *for periods of similar length*. Furthermore, "promise" must be supported by both theory and empirical evidence. In the years since, we have seen a lot of evidence and learned a lot about theory. It's not just financial theory that matters. We now incorporate Decision Theory and Behavioral Finance Theory into the equation. Since the concepts of those theories were relatively undeveloped in 1989, we consequently are smarter about markets and people now than we were then.

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In October 1987, the stock markets plummeted. I counseled a group of investors to withdraw funds from an international fund in which they had a significant position. Said I to myself: "It is the better part of caution. It makes sense to do that. It sounds risk conscious and wise. I am on top of it and in touch with my investors." All those were good things. *But, it was the wrong thing to do*. Soon after the decline, the markets rose and the year finished with a positive return. However, knowing the time to get back in was too difficult for them and for me. Now, reflecting back to that time, I see that I had lost sight of my real job and they had lost sight of their true purpose - *a satisfactory result at the goal horizon,* then still years away. Their investment capital missed the rise. Hard as it is to realize, *they had lost no money in the decline until they sold the position, and by selling, they converted volatility into permanent loss*.

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What's so hard about the two-way move, the "out-now-back-later" switch? Well, let's start with a one-way move: go to cash, stay there. Where it doesn't move. Comfy. Are we safe yet? At today's low rates, the after-tax net yield on cash is significantly below inflation, which means that the owner loses value every day. Over time, that adds up. Recouping that lost value is difficult indeed – far more difficult than simply waiting to recover an amount after some volatility. The absolute value investment (cash and equivalents) is really appropriate only for time horizons short enough that inflation will not compound the cost of living very much.

If one gets out of the market and then prices decline, one feels good. (The opposite experience of the last several weeks, when this question has come up). What happens after that tends to follow a pattern. The investor's behavior pattern overlays a graph of price movements. First, prices decline, then reach a bottom (which we know only afterwards) then they rise again. An investor who sold around the top is unlikely to want to go back in on the way down. Remembering that the underlying motivation was fear of loss, that investor needs to see prices rise first. Only an improvement in the situation will allow a reversal of the decision to sell. The markets have words for this – "whip-saw," "sucker's rally," "dead cat bounce" - and others. These names describe the phenomenon of prices that rise long enough to draw folks back in and then turn down again. How, in advance, can one possibly distinguish between the real and the illusory? People can suspect these lurking dangers, even though they might not be able to predict them accurately. Fearing them, the investor who sold typically gains confidence only when prices again attain the level prevailing at the time of sale. Actually – it is worse than that. They usually need a price higher than the previous sale price. If you have been reading the newspapers and magazines lately, you have seen the business columns about the investment public going back into stocks now – after selling in 2008 and 2009. If one sold in the turmoil, in 2008/09, the difference (lost) between the selling price and buying price can be very large. The market's high point occurred in October 2007 and then again in April 2013. When fear of loss drives one out, anxiety accompanies the decision to return. During the time from 2009 to the present, the "markets climbed walls of worry." If the sale resulted from fear of loss in the short term, by the time most folks feel comfortable about returning to the stock market, most of the gains are in the past; little remains for the late-comer. With each step along in time, the probability of a successful outcome (a result better than holding through time) declines. So,

in the end, this investor loses. Many brokers and journalists have horizons defined in minutes. For them, the media-noise makes sense. But for investors with long-term horizons, making investment decisions based on the news of the day is unlikely to deliver sound results.

Unwilling to concede, one can say: "But we have never been here before. The country is in economic trouble, the economies in the rest of the world seem just as bad and the world's political classes are dysfunctional. Yet, the stock market has reached an all-time high. It makes no sense! Why should it make sense to stay put?"

What makes this "high" different from all the preceding ones? On a day in April 2013, the Dow Jones Industrial Average closed above 14,800, but it closed in 1913 at *94!* How many "historic highs" have we had in 100 years? Virtually uncountable, yet every single time it reached a new high, a subsequent price level exceeded it. I see no reason to think differently about this one than about the many that have occurred in the past. It is very ***un***likely to be the last mountain top, the one that stands above all those that follow.

DHR addresses these "sell" questions with portfolio allocation. A change in risk tolerance or the circumstances of one's life might well prompt a change in *allocation*. However, in the end, if the question is "Should I *sell* now?" we answer *"No."*

The Question Is: Buy Now?

The market's record-breaking spree has raised an additional fear in many American households - dread of missing out on big gains. The price collapse in 2008 wiped out much of the invested worth of millions of people. Feeling "sucker punched," many acted out of fear, confusion and resentment that this "thing" – this unexplainable thing – happened, so they simply sold out of stocks and put their remaining money in the bank. Fluctuation selling created loss. Then, this past April 16, the Dow Jones and S&P500 reached all-time highs. Watching from the sidelines, adding up the interest on their savings (about one-tenth of one percent!), many missed the entire rise in stock prices from early 2009 to today. *More than a double*. Now what should those people do?

Should they – should anyone – buy now? The answer is: *Yes*. We justify that suggestion as follows: All over the world, human beings want to improve their standards of living. The free market economies make that possible, with the production of goods and services, which will improve over time, due to competition among market providers. Research and development, as well as new ideas and products, are progressing at a faster rate than at any time in history. As a result, the companies that drive those economies will grow and their national economies will grow. The prices of shares in their stock markets will rise. Historically, market prices have risen for as long as there have been stock markets. Over the long term, our market's positive return years have strongly outnumbered the negative return years. Since 1926, our market has experienced a positive return in almost three-quarters of the calendar years. (Even with the years of Great Depression included). We understand that market performance over the past two years has been extreme by historical standards. In 2008, US stocks experienced their second-worst calendar return in eighty-four years. Then, in 2009, stocks rebounded strongly to deliver a return in the top 25% of the historical distribution. Three years later, the market reached and passed its previous high point. So, does that mean investors should stay out? I think our answer to that is self-evident. Suppose an investor had said that at any previous high point? Where would that person's portfolio be now? Many who sold then did not remain out, although many did. Fear is powerful and slow to exit one's personal system. If we decide now to sell, from fear of loss, how will fear of loss leave us and thus allow us to re-invest? Think on the stories behind the losses following the 2008/09

collapse. Many of those people have not yet re-invested. Now the market is much higher. If they buy in now, then how much did they lose in the spread of prices between selling and buying?

But, that "loss" is in the past. Rationally considered, their situation does not differ from that of a person with "new money" and the question: "Should I invest in the stock market?

Risk fills our world. Risk is the "name of the game" in investing. We cannot be sure. In that environment, what should we use as the basis for our decisions? No evidence exists that a strategy for accurately timing market movements is available. None. Our emotions lead to trouble. "Expert" forecasts of the future have repeatedly fallen short of expectations. News outlets are manifestly useless.

Others are welcome to their philosophies – we seek to apply scientific rational to these decisions. That approach tells us: Focus on the long term, have reasonable objectives, maintain a disciplined approach, including an appropriate allocation – these things are all well within our power to accomplish. Market movements and foreknowledge of them are not within our power or control. If, at this moment of an all-time market high, we can understand ourselves, focus on those things we can manage, understand our risk tolerance and make portfolio decisions in a rational way, then history says that the odds of accomplishing our original goal are on our side.

Nominal and real (inflation-adjusted) returns for 1926–2012 and for each half of that period

	First Part 1926-1968		Second Part: 1969-2012		Full Period: 1926-2012	
Asset Allocation	**Nominal (%)**	**Real (%)**	**Nominal (%)**	**Real (%)**	**Nominal (%)**	**Real (%)**
100% bonds	3.36	1.73	7.72	3.24	5.54	2.49
80% bonds, 20% stocks	5.12	3.46	8.34	3.84	6.74	3.66
70% bonds, 30% stocks	5.93	4.26	8.62	4.11	7.28	4.18
60% bonds, 40% stocks	6.69	5.01	8.87	4.25	7.79	4.67
50% bonds, 50% stocks	7.40	5.70	9.09	4.56	8.25	5.13
40% bonds, 60% stocks	8.06	6.35	9.29	4.75	8.68	5.54
30% bonds, 70% stocks	8.67	6.95	9.45	4.91	9.07	5.91
20% bonds, 80% stocks	9.23	7.50	9.59	5.04	9.41	6.25
100% stocks	10.18	8.44	9.77	5.21	9.97	6.80
100% cash investments	1.74	0.13	5.45	1.07	3.60	0.61

In case you want a little more detail, this chart provides a "long view." Part of it is too long for direct comparison to our lives, as none of us has an eighty-six year horizon. Yet, it informs us about history, and many of us will be invested in the markets for forty years.

Estate Plans in 2013

The American Taxpayer Relief Act of 2012 (ATRA) made estate tax law permanent. After more than a decade of constant change and uncertainty, we now have an estate tax law with which we can make plans. Henceforth, after subtracting a $5.12 million per-person exemption and certain other costs, an estate will be assessed a 40% tax on the remaining value. The exemption is also indexed for inflation over the 2012 number, which is why it starts off at "5.12" and not "5."

In a broader picture, it is expected that, as a result of the new law, in 2013, more than 99.8 percent of estates will owe no tax. Among the anticipated 3,780 estates that will pay the tax, about one-fifth, the 810 largest - those with gross assets exceeding $20 million - will account for nearly three-fourths of the total estate tax revenue. About one-fifth of the burden will fall on estates valued between $10 million and $20 million, while just a little over one-fourteenth will come from estates worth less than $10 million. Since the exemption applies "per person," a married couple will experience no estate tax until their assets exceed ten million dollars.

We now strongly recommend to clients that they review their estate documents this year. We grant that some might not need this and we will be happy to help in that assessment.

For planning purposes, you might want a "horseback" estimate of the effect upon you. That is relatively easily done. Start by determining the value of your "net estate" as the term applies to the estate tax. You arrive at that by:

- Start with the estimated market values of all your assets.
- From that value, subtract your debts – mortgages, credit cards, loans, etc.
- Next, subtract the value of the assets passing to or owned by the surviving spouse. In California that is half of all community property, with separate property accorded slightly different treatment, but obtaining approximately the same result. (This part remains uncertain for some couples, given the DOMA and CA Prop. 8 cases before the Supreme Court).
- Next, subtract an estimate of the cost of all expenses to settle the estate, including professional fees, various court costs and the costs of final illness and burial. This cost is highly variable, depending upon circumstances, but if you do not have a living trust, you could assume 5% of the market value of all assets. With a trust, it might drop to 1%.
- Next, subtract the amount of any charitable gift made out of the estate or remaining charitable pledges made during life and payable at death.

Any calculation intended to be more precise should come either from your estate attorney or your CPA. While we believe that the State of California currently has no inheritance or estate tax, either of these could arise in new legislation. Legal and tax counsel should be consulted.

We now strongly recommend to clients that they review their estate documents this year. We grant that some might not need this and we will be happy to help in that assessment. Even setting taxes aside, for the last several years, many people have adopted a "wait and see" posture relative to their estate planning, not knowing how the law would finally be resolved. At this point, for those clients who have a taxable estate, a review is in order. For those whose assets do not yet subject them to the tax, this is a good time to review testamentary purposes and decisions. We know of many changes in the family situations of our clientele. Perhaps some of these changes will have an effect on the decisions made about asset distribution at time of death. DHR will have this matter on our agendas for client discussions through the rest of the year.

We have another thought about estate planning. Communication between generations is rising in importance. We recommend a meeting at which the distributing and inheriting generations communicate about many of the matters in the planning. Yes, this communication can be awkward, can feel overly-revealing, can create an impression in the younger of the opportunity for largesse from the older and might promote some additional other difficult issues. However, such difficulties have not presented themselves in the meetings that we have had so far. On the other hand, we have seen very difficult times arise in estates and families where there had been no communication before death and all these matters had to be handled afterwards. DHR has experience in these discussions – before and after - and we will be happy to assist any of our clients in this area.

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