STILLWATER

INVESTMENT MANAGEMENT, LLC

Counselor • Advocate

DECEMBER 31, 2017

Q4

"Most human beings have an almost infinite capacity for taking things for granted."

Aldous Huxley
Brave New World
1894-1963

INVESTOR BEHAVIOR IN 2018

By James K. Tonrey, Jr., Chief Executive Officer

Aldous Huxley was the ultimate societal cynic. His anti-utopia book, *Brave New World,* describes a disturbing, unstable future society (2045 AD) completely driven by fear and tyranny. Written in 1931, this novel focuses on the worst of the human condition. Take a deep breath, this commentary is not about his book, nor is it about the worst of our human impulses. On the contrary, we will discuss the potential for a rather bright future, as well as revisit Huxley's belief that it is human nature to *take things for granted.*

Since the *Great Recession* of 2008, the financial markets have been extremely generous to patient and disciplined investors. Take a moment to review the annual returns of the S&P 500 index, including dividends, over the past ten years:

2008	*(37.00%)*	***2010***	*15.06%*	***2012***	*16.00%*	***2014***	*13.69%*	***2016***	*11.96%*
2009	*26.46%*	***2011***	*2.11%*	***2013***	*32.39%*	***2015***	*1.38%*	***2017***	*21.83%*

Let's review the results of two hypothetical investors:

Investor one invested $100,000 in the S&P 500 index at the beginning of 2008. Including her reinvested dividends, her portfolio was worth $225,991 at the end of 2017. This represents an annualized return of 8.50%, which is a bit higher than the annual average return of the S&P 500 index over the past twenty years. Investor two invested the same $100,000 at the beginning of 2008, but fearful of the markets, sold to cash at the end of 2008. Due to his discomfort, he stayed out of the markets for a year. He returned to the market at the beginning of 2010. His initial investment of $100,000 would have been worth only $178,705 at the end of 2017. This represents an annualized return of 6.0%, which happens to be just above the average annual return for an individual (emotional) investor for the past twenty years.

There are two important lessons to take away. First, it is no secret that fear plays a large role in how we deal with market adversity. Investor one gained $47,286 more than the panicked investor who stayed out of the markets in 2009. Secondly, *we should not take past performance of the equity markets for granted going forward.* Over the past twenty years, the S&P 500 index was down only four of those years. In the past thirty years, the S&P 500 index was down a total of only five years.

Behavioral economics is the study of how human emotions and our personal biases can distort reality and cause dislocations, especially when making financial decisions. During 2008, investors got understandably scared when they saw their portfolios go down in value by a third. Some put their monthly statements in the drawer and never opened them. Others painfully checked their portfolios daily as the markets spiraled down. *Herd mentality* played a role as investors watched their peers cash out their portfolios, and felt they needed to sell because everyone else seemed to be selling. Today, some of these same investors continue to suffer from another cognitive bias called *recency bias.* They worry that the past will repeat itself in exactly the same way, and fear that another 2008 is always just around the corner. Recent studies have shown a significant increase in anxiety in our society. At the root of our anxiety is this constant stress of worrying about the future, the uncertainty, the loss of control. Simply stated, we are finding it increasingly difficult to stay in the moment.

Circling back to the financial markets, we need to get comfortable with the notion that when we invest, by definition, we give up control. Some of us deal with this better than others. Arshad Ahmad, Professor of Finance at McMaster University in an article in the Huffington Post said, *"People make a lot of mistakes when it comes to their personal finances (myself included)! But one that became particularly apparent in the wake of the 2007-08 financial crisis is our inability, when buying and selling financial assets like stocks and bonds, to properly assess or price risk, which is itself often because we don't fully understand the crucial difference between risk and uncertainty."* He goes on to say that corrections occur when markets misprice risk. We always live with a certain level of uncertainty; some points in time greater than other points in time. With this "*certain uncertainty"* comes a degree of risk. *Accepting, understanding, and trying to quantify that risk is what good investors do,* especially when markets turn down. Uncertainty is a product of observing and digesting partial, and often incomplete information at any given time, triggering our worst fears and leading us to make suboptimal decisions.

Now let's look at where the equity markets are trading today to put some teeth into our behavioral discussion. With the Dow at almost 25,000, a one-hundred-point swing either direction represents only a .4% change. We need to readjust our thinking to realize that market swings are less significant with the Dow at 25,000 than when was it was 6,000-8,000, which is the range most of us had gotten used to. Depending on which earnings figures we use, the market is trading at about a 19-20x forward price-to-earnings ratio. The markets historically have traded at a 16x price-to-earnings ratio. Given the new tax law and reduced regulation, market participants are expecting corporate earnings to increase. Also, it is interesting to note that last year, the markets experienced over seventy new highs. Corporate and consumer sentiment are at all-time highs. Merger and acquisition activity has picked up, signaling that there is still considerable liquidity and that market prices are reasonable. Over the past few years the corporate dividend payout ratio, which is the amount of money returned to investors, has increased year-over-year, which usually indicates that companies are optimistic about the future. Lastly, companies have been buying back their stock at historic levels over the past 10 years, reducing the supply available. At the same time, global demand for our domestic stocks has increased. Price rises when demand outstrips supply.

In conclusion, we are at a very interesting time in our history and the traditional business cycle. We are nine years into an economic recovery with year-over-year positive stock market returns. Given significant tax law changes, greater confidence in the financial markets and with the consumer, continuing reduced regulation, and a Federal Reserve Bank accommodating a relatively low interest rate environment, it seems that in the near-term equity markets will trend higher. The debate is how long it will last before some sort of repricing again comes into play. No one knows for sure when, but we do know there is a correction lurking on the horizon. It could be next month or in two years. This is a gentle reminder that investors should take the time to re-examine their portfolio allocation to stocks, bonds, and cash to make sure it is in line with both short and long-term goals and objectives. Do not *take things for granted,* and no better time than when things are going well. My college baseball coach put it best when teaching hitting. He said, *"expect the fastball then you will have time to adjust to the curve."*
