The Thoughtful Investor™

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Anticipating the Market Cycle's "Standard, Run-of-the-Mill" Outcome

What can investors expect when the current bull market reaches its end? John Hussman, former professor of economics and international finance at the University of Michigan and now stock analyst and founder of Hussman Funds, maintains, "A 50% market loss isn't a worst-case scenario. Given current valuations, it's the standard, run-of-the-mill outcome that investors should expect over the completion of this cycle."

To invest profitably in equities, it is essential to understand that financial markets move in broad cycles from bull to bear market. With every bull cycle there seems to come the cry that *this time it is different*. But throughout the history of the stock markets, it has never been different. The prudent investor accepts that it may never be different, if only because stock markets are the

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Optimize Retirement Income Through Planning

After saving and investing for a lifetime, you are ready to retire and enjoy the results of your hard work. But before you do so, sit down with a qualified tax or financial advisor and take a careful look at your sources of retirement income and develop a long-term financial plan for your retirement years. You don't have to schedule every expense, but you do need to know how much you can afford to spend and how to optimize the value of your retirement income. Look at the consequences of withdrawing from your different retirement income sources and create a priority list of where funds will come from and in what order. In doing so, your goal is to avoid any penalties for early withdrawals or failing to take minimum required distributions, minimize taxes, optimize return potential and potentially increase Social Security income.

The average retiree has nearly six different sources of retirement income, typically from:

- Social Security
- Retirement accounts
- A pension
- Investment accounts
- Annuities
- A savings account
- Home equity
- A part-time job
- Rent and royalties

The goal of pre-retirement planning is to strategize how to make these sources last your lifetime, or to be able to leave the most assets for your heirs. In addition to deciding when you can afford to retire and how much you will have each year, which income source to use when makes a difference.

Social Security payments can be reduced for a variety of reasons

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Managing Risk on the Home Front

If you haven't taken time to review your homeowner's policy for some time, give your insurance agent a call and do so now. In particular, you want to look at:

- the insured value of your home
- amount of coverage for the contents of your home
- special riders covering valuables such as jewelry, expensive electronics, artwork, furs, or other collectibles
- personal liability coverage.

Although you may have replacement cost coverage on your home, most insurance companies "cap" replacement values in the range of 120 - 125% of the insured value. If you have made extensive remodeling changes, had your home appreciate in value above the caps, or acquired valuables not covered under a standard homeowner's policy you could find yourself with a substantial loss should disaster strike.

Your agent should also be able to recommend coverage specific to your geographic area, such as flood or earthquake. Ask for ideas on how to lower your insurance costs as well, from non-smoker discounts to new roofing materials, higher deductibles, etc.

If you don't have one, consider an umbrella policy. Umbrella policies provide a broader form of coverage and can help cover legal fees, false arrest, libel, and slander as well as provide additional coverage or "excess liability" above the limits of your personal liability coverage for bodily injury and property damage liability claims.

Insurance is risk management. But it works best when you are properly covered when a loss occurs. It's too late after the fact to make adjustments.

Avoiding the Smart People/Dumb Decision Quandary

"The first thing you have to know is yourself. A man who knows himself can step outside himself and watch his own reactions like an observer."

Adam Smith, The Money Game

We all have friends we think are very smart, yet they do things that make no sense. Sometimes the fault is in ourselves as well. We make decisions that in reflection, we know were wrong. The challenge is figuring out why poor decisions were made and how to change.

Ironically, being smart can actually be a drawback when it comes to making rational decisions. Overconfidence is one reason. All too often, people who are experts in their field begin to think they are also qualified in areas about which they know nothing. In a study published in the *Journal of Personality and Social Psychology*[1], smart people tended to make more mistakes than those of average intellect on logic problems because smart people were more likely to take shortcuts or make assumptions due to overconfidence.

Along with overconfidence can often come underrating the importance of effort and practice. When many things come easily without much effort, people may become so reliant on feeling smart that they fail to develop skills that require effort and practice. When overconfidence is combined with greed, pride, stress, and even laziness, poor decisions proliferate.

Making good decisions requires deliberate effort. Our brains are very good at learning patterns and automating decisions to allow us to operate more efficiently. But automatic responses also encourage leaps to conclusions before evaluating evidence.

Emotional brain circuits have the ability to make faster decisions and often jump into play before we pause to think in a rational manner. While faster decisions may be a good survival tactic when one is under attack, in situations that require rational thought, they can be a definite drawback.

The study of behavioral finance has come up with a number of reasons why people make irrational financial decisions. The one common characteristic of these reasons is typically the **shortcut.** Rather than taking the time to evaluate situations and opportunities, shortcuts are used.

- **Loss aversion** gives priority to avoiding the pain that results from losing money, even if it means failing to make money.
- **Anchoring** focuses on one piece of information – often the first piece of information offered – as the basis of a financial decision. A vivid anecdote has more influence than statistics.
- **Familiarity bias** is rule-of-thumb decision making – basing decisions on prior experiences or similarities. Situations and opportunities are evaluated from our prior perspective not their actual merits.
- The **gambler's fallacy** (or Monte Carlo fallacy) is the belief that past patterns somehow influence future results. The investor bets it all on black because black is *due*.
- **Herd behavior** occurs when the belief that *everyone else is doing it so it must be right* takes over.

Making better decisions typically comes down to setting overconfidence aside and putting practice and effort to work. The "thinking" circuits of our brain that resolve conflicting information require conscious effort. When faced with an important decision, take time to write down the pros and cons. Question your first impulse. Look for facts.

1 Cognitive sophistication does not attenuate the bias blind spot. Journal of Personal and Social Psychology, 2012 Sep;103(3):506-19. R. F. West, R. J. Meserve, K.E. Stanovich.

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products of human emotions, and nothing in history tells us that human emotional responses have changed.

The Federal Reserve has encouraged investors to believe that volatility and downside risk can be removed from the market through the manipulation of interest rates, eliminating normal cyclical fluctuations. The problem with this approach is reflected in the theories of economist Hyman Minsky - When times are good, investors take on risk; the longer times stay good, the more risk they take on, until they've taken on too much. The consequence of artificially prolonging the good times and distorting normal market action can be far more violent market behavior over the completion of the cycle than investors would have faced otherwise.

Rather than avoid the mention of bear markets, it helps to look the bear straight in the face and develop strategies to moderate its damage.

Between 1929 and 2014 there have been 15 bear markets (periods when the S&P 500 fell at least 20%). The average bear slashed more than 38% from the S&P 500 value. Omit the 1929 crash when values declined 87% and the result is still an average loss of 33%. A new bear market began on average every five years, with the market taking an average of 3.6 years to return to its prior high.

S&P 500 Index Bear Market Study

September 1929 through 2014

Bear Market	Duration	Percent Decline	Time to Return to Breakeven
Sep. '29-Jun. '32	33 months	86.7	25.2 years
Jul. '33-Mar. '35	20 months	33.9	2.3
Mar. '37-Mar. '38	12 months	54.5	8.8
Nov. '38-Apr. '42	41 months	45.8	6.4
May '46-Mar. '48	22 months	28.1	4.1
Aug. '56-Oct. '57	14 months	21.6	2.1
Dec. '61-Jun. '62	6 months	28.0	1.8
Feb. '66-Oct. '66	8 months	22.2	1.4
Nov. '68-May '70	18 months	36.1	3.3
Jan. '73-Oct. '74	21 months	48.2	7.6
Nov. '80-Aug. '82	21 months	27.1	2.1
Aug. '87-Dec. '87	4 months	33.5	1.9
Jul. '90-Oct. '90	3 months	19.9	0.6
Sep. '00-Mar. '03	30 months	49.0	6.8
Oct. '07-Mar. '09	18 months	47.8	5.5

Source: Telephone Switch Newsletter, Summer 1992. Updated through 2014 by Financial Communications Associates, Inc.

When will the current uptrend end? There is no precise way to know and betting against the trend can be a losing proposition. John Maynard Keyes may have said it best with, "*Markets can remain irrational longer than you can remain solvent.*" By recognizing the reality of bear markets and understanding the damage they can cause, the prudent investor puts in place tools to determine when the risk of a downturn outweighs the potential benefit of staying in the market and then executes those plans as trigger points are met.

Equally important, the investor has to have a plan for reentering the financial markets to take advantage of recovering values.

It is hard to overstate how important minimizing losses can be. It doesn't take a 50% gain to recover from a 50% loss. It takes 100% because you are starting from a much lower base. Any time investors can minimize drawdowns in a bear market, they have added leverage to benefit from the market's upturn, even if they miss the early stages of the market's recovery.

For many investors, recovery is prolonged because of the emotional cost of losing money to a bear market. Too often investors who believe they are in for the long run sell out at the market's bottom and then hesitate to return to equities until they have missed a major part of the market's recovery. This is why we believe active management is essential for the long-run success of our investors. While there can be no guarantee that an active strategy will be successful, buy-and-hold investing guarantees bear market losses.

We welcome the opportunity to explain our investment approach. If you have any questions about how we manage client portfolios and where your assets are currently invested, please contact our offices and let's talk.

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– including retiring and claiming benefits between age 62 and your full-retirement age or continuing to work prior to full-retirement age while receiving benefits. *(If Social Security determines that your earnings exceed that allowed to receive full benefits, benefit payments will be withheld until the difference is recovered.)* The longer you postpone receiving Social Security benefits (up to age 70), the more your benefit will be. Up to 85% of Social Security benefits can become taxable, however, if you have too much income from other sources, including 401(k) and IRA withdrawals. Social Security claiming rules encompass hundreds of pages of regulations. The more complex your financial situation, the more difficult it can be to comply with all the requirements.

There are also required minimum distributions from tax-deferred retirement accounts to consider once the account holder reaches age 70½. Market conditions may dictate changes in income sources. For example, in a bear market, it may make more sense to depend on bonds for your income requirements rather than liquidate equities.

The catch with retiring is that if you make a mistake with your money, you may not be able to recover and enjoy the lifestyle you want for your remaining years. A little advance planning with the help of someone knowledgeable of retirement finances can make all the difference.

LEGACY INVESTMENT STRATEGIES

The IRS is NOT Calling

An aggressive telephone scam has been underway throughout the U.S. the last few years, with callers claiming to be IRS agents. Badge numbers, fake caller id, and callback numbers that, when answered may sound like you have reached the IRS, are often used. Sometimes the callers claim the IRS is in the process of filing a lawsuit against you unless you take prompt action; that you owe back taxes and will incur sizeable penalties unless payment is made immediately; that you will be subject to arrest if payment is not made. These shake down calls tend to be aggressive and threatening. Less frequently victims may be told they have a refund due to try to trick them into sharing private information. What the calls are NOT is from the IRS.

How to tell that a call is not from the IRS:

(1) Have you received a written bill or notice from the IRS on back taxes? The IRS will not call taxpayers without first having mailed a bill.

(2) Have you been offered an opportunity to question or appeal the amount they say you owe? Taxpayers have a right to know exactly what a claim is for and have an opportunity to formally appeal the notice.

(3) Is a specific payment method required, such as a credit card or debit card? The IRS does not specify payment sources.

(4) Are you asked for payment information over the phone? This is against IRS policy. No payment information is taken over the phone.

From the IRS website comes the following recommendations if you receive a phone call from the "IRS":

- **Do not provide the caller with any personal information.**
- If you know you owe taxes or think you might owe, call the IRS at 1.800.829.1040. The IRS workers can help you with a payment issue.
- If you know you don't owe taxes or have no reason to believe that you do, report the incident to the Treasury Inspector General for Tax Administration (TIGTA) at 1.800.366.4484 or www.tigta.gov.
- If you've been targeted by this scam, also contact the Federal Trade Commission and use their "FTC Complaint Assistant" at FTC.gov. Please add "IRS Telephone Scam" to the comments of your complaint.

The IRS does not use email, text messages or any social media to discuss personal tax issues. If you receive a message using any of these media that claims to be from the IRS, it is a scam.

If you fall victim to an IRS scam, contact your financial institutions, credit cards or other payment sources you may have provided and if necessary close those accounts. Contact one of the three major credit bureaus to place a 'fraud alert' on your credit records. If your Social Security Number is compromised and you know or suspect you are a victim of tax-related identity theft, complete IRS Form 14039, Identity Theft Affidavit. Use a fillable form at IRS.gov, print, then mail or fax according to instructions.