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THE CASE FOR STAYING INVESTED IN STOCKS

Market losses can be disconcerting, but investors also can find themselves thrown off by a prolonged period of rising stock prices. In fact, a bout of nerves now and then can seem inevitable and even reasonable. When stocks have gone up so much isn't the wisest strategy to take a lot of money off the table and lock in gains? Or is getting out of the market at the first sign of trouble the right move? After all, it's not hard to find plenty of pundits advising that the market is overdue for a downturn.

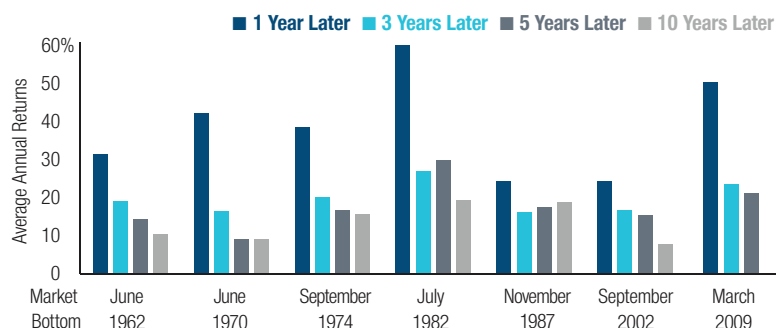
Instead of staying focused on the fundamentals of a long-term strategy, including portfolio rebalancing and modest tactical adjustments some investors let emotions drive their decisions. Doing so makes no more sense when times are good than when times are bad. This is because you have to accurately make two decisions that are likely to trip you up: when do you get out of stocks and when do you get back in.

Getting out: Even a well-timed exit does not guarantee strong results. The example of the most recent bear market is instructive. (A bear market is a decline of 20% or more in major stock indexes.) The market downturn that began in late 2007 and lasted until early

2009 was one of the worst in history, with the broad Standard & Poor's 500 Index falling nearly 57% before it started to recover. It took over five years for the index to regain its October 2007 peak. *See the chart below.*

Recovery From Bear Markets

Equity markets historically have delivered large returns in the years immediately after a bear market, with the potential to deliver double-digit average annual gains for several years. These are the average annual returns of the S&P 500 Index after declines of 20% or more (12/31/61–12/31/16).



Average Return After Bear Market

1 Year Later	38.4%
3 Years Later	19.8%
5 Years Later	17.7%
10 Years Later	13.5%

Source: T. Rowe Price

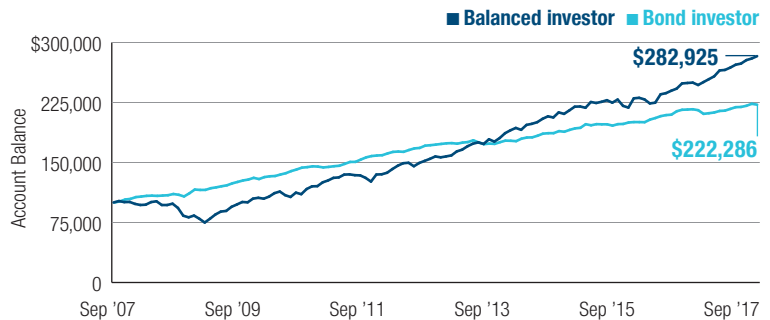
Surely investors who saw it coming and got out of the way did much better than those who kept funneling money into stocks.

It may not be that simple. T. Rowe Price looked at two hypothetical investors: a balanced investor and a bond investor. The bond investor saw the crash coming with remarkable accuracy. Therefore, in September 2007, that investor switched an existing retirement portfolio and \$500 monthly contributions entirely to bonds (and never got back into stocks). The balanced investor did not attempt to time the market and kept investing in a balanced portfolio of 60% stocks and 40% bonds. Both investors started the period with a portfolio worth \$100,000. The chart to the right shows that the bond investor who pulled out of stocks just before the crash did indeed fare much better; for awhile. However, it was the balanced investor who benefited most from the stock market recovery over the full ten-year period. In addition to the eventual growth of the initial portfolio, this investor had another key advantage: ongoing investments when stock prices were very low in the few years following the global financial crisis.

The bond investor made a reasonable decision to “get out” in terms of the initial portfolio, but getting out of stocks for ongoing investments proved disadvantageous. The bond investor also missed on another decision: when to get back in. *Consider the chart below.*

Different Investment Approaches

Two hypothetical investors entered the recession that began in September 2007 with account balances of \$100,000. The bond investor predicted the coming crash and switched an entire portfolio and monthly \$500 contributions to bonds (for the full 10-year period). The balanced investor, however, remained invested in a balanced portfolio of 60% stocks and 40% bonds, allocating monthly \$500 contributions accordingly. Over a 10-year period, the balanced investor fared better than the bond investor.



Sources: Bloomberg Barclays and Standard & Poor's; data analysis by T. Rowe Price. Stocks are represented by returns of the S&P 500 Index and bonds by returns of the Bloomberg Barclays U.S. Aggregate Bond Index.

Source: T. Rowe Price

Getting back in:

You're likely to miss much of the recovery. Of course, some investors might be tempted to think that they will know when the downturn is over and it's safe to get back into the market. We would caution investors that the duration and magnitude of bear markets have varied considerably, making it impossible to rely on guidelines such as "I'll get back in after the market has fallen 25%." Moreover, it is typically in the early stage of a recovery where the markets post particularly large gains. The bottom of the market is very hard to identify and investors who panic during a downturn often miss gains early in the recovery.

Finally, it's worth keeping in mind that corporate profit growth and stock prices often react to myriad forces, including economic factors such as interest rates and currency movements, political dynamics such as regulatory and tax changes, and the often vexing changes in overall investor sentiment. Stocks have often risen in times of war and economic turmoil, while they have declined in periods of peace and prosperity. For this reason, many seasoned investment professionals have thrown up their hands at predicting where stocks are headed over the short term.

Keep in mind that past performance cannot guarantee future results. Nevertheless, these historical returns show that stocks have proven resilient in the past and have generated positive returns over the long run.

Considering your asset allocation strategy:

Rather than trying to time the markets, it's important for investors to remain focused on their long-term goals and create appropriate asset allocation strategies to achieve them. The strategy you choose should be based in part on your tolerance for risk, as any strategy can be effective only if you can remain committed to it, even during challenging market periods. This horizon is another essential consideration when establishing your asset allocation because short-term market risk becomes less of a factor the longer you hold an investment.

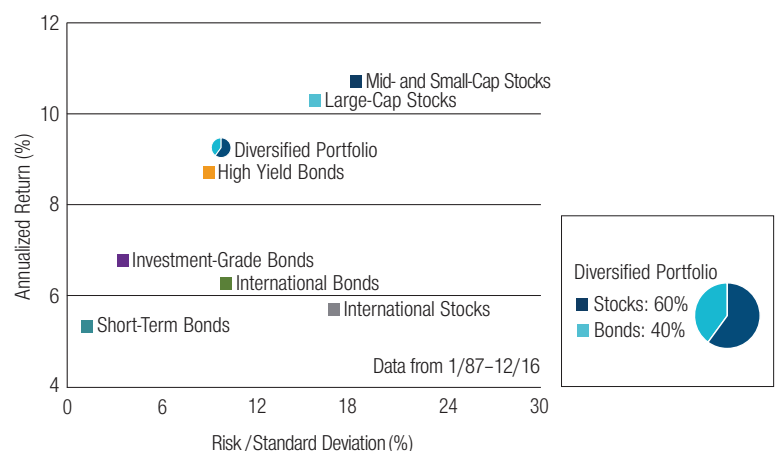
Identifying the appropriate allocation for your portfolio can help provide the growth potential to achieve your goals at a level of risk that's comfortable. Actually, many advisors opine that the factors that you can control such as how much you save and how your investments are allocated are most likely to determine how successfully you reach your investment goals.

In general, the longer your time line horizon, the more of your portfolio you probably should hold in stocks. Historically, equities have offered the

highest returns of any major asset class while also being more volatile than other types of financial assets. The reason: You'll have enough time to recover from the short-term losses that result when the stock market dips. A portfolio that holds stocks and bonds can reduce volatility while preserving return potential. *See the chart below.*

Risk Versus Return

Over the past 30 years, a diversified portfolio would have offered 84% of the return of an all-equity portfolio (large-cap stocks) with about 63% of the volatility.



Source: Zephyr StyleAdvisor; data analysis by T. Rowe Price.

The equity portion of the diversified portfolio includes 36% large-cap stocks, 12% mid- and small-cap stocks, and 12% international stocks; the bond portion includes 21% investment-grade bonds, 10% short-term bonds, 6% high yield bonds, and 3% international bonds. The historical performance is based on the following indexes to represent these asset classes: Bloomberg Barclays U.S. Aggregate Bond Index—investment-grade corporate and government bonds; Bloomberg Barclays 1–3 Year U.S. Gov't./Credit Bond Index—measures the performance of investment-grade corporate debt and sovereign, supranational, local authority, and non-U.S. agency bonds that are U.S. dollar denominated; Bloomberg Barclays U.S. High Yield Bond Index—total return performance benchmark for fixed income securities having a maximum quality rating of Ba1 (as determined by Moody's Investors Service); Citi World Global Bond Index non-U.S.—market capitalization-weighted index consisting of the government bond markets; S&P 500—500 large-cap U.S. stocks; Russell 2500 Index—measures the performance of the small- to mid-cap segment of the U.S. equity universe; and MSCI EAFE Index—the stocks of about 1,000 companies in Europe, Australasia, and the Far East. Allocations are considered static and are rebalanced monthly. The time period chosen is based on the availability of the indexes. Diversification cannot assure a profit or protect against loss in a declining market.

Source: T. Rowe Price

Looking beyond the short term:

While it may be tempting to think you know where the market is headed, making changes to your investment strategy can be counterproductive in the long run. Your hunches and other emotional responses to market conditions can lead you astray, whether in good times or bad. Instead, focus on how much you save and keep a long-term perspective on your investments.

THE CASE FOR STAYING INVESTED IN STOCKS

The field of behavioral finance has outlined theories to explain why investors tend to make irrational decisions. T. Rowe Price covers three of these widely known concepts:

Loss Aversion. With “loss aversion”, the pain of losses is more powerful than the pleasure of gains. This aversion to loss can contribute to panicked selling when the market drops or to the adoption of an overly conservative investment strategy to avoid short-term market fluctuations. These decisions may result in a portfolio that doesn’t keep pace with inflation.

Recency Bias. Investors tend to place greater weight on what they’ve experienced most recently, using it as a guideline for what might happen next. Known as “recency bias”, this theory may help explain why millennials who came of age soon after the financial crisis have steered clear of stocks as they have started

investing; even though they have exceptionally long time horizons when it comes to saving for retirement.

Anchoring. The idea with “anchoring” is that once you’re exposed to an initial fact or figure, you’ll continue to look back to that information as a reference point. Individuals influenced by anchoring tend to hold on to an investment that has lost value in hopes that the investment will go back up to the original purchase price, rather than focusing on equity fundamentals

While there’s a natural human tendency to react emotionally to market swings, investors are encouraged to stick with a consistent, long-term investment strategy. This strategy can include techniques such as portfolio rebalancing, tactical allocation adjustments; or systematic investing, approaches that take market conditions into account without derailing a long-term plan.

HAS ANYTHING CHANGED?

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