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Market Insight

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The first three months of the year have proven to be very agreeable for investors, perpetuating the antithesis of Murphy's law. If you recall, Murphy's law states that "anything that can go wrong, will go wrong". The adage has always struck me as a sort of seasoned pessimist's guideline for properly setting expectations. Don't get your hopes up and you'll find that disappointment comes infrequently. The present state of the markets has us considering what happens to markets when everyone seems to be assuming that Murphy's law will be enacted by executive order at any moment.

The capital markets have recovered from the awful bear market of 2008 and early 2009, resetting all-time highs multiple times. With each new market high seemed to come the delight of appreciating portfolio values, but also a heightened anxiety that the good times won't last. Our survival as humans has relied on us reacting to perceived threats in an outsized manner compared to our response to things that bring us joy. Our instincts to seek safety can be overwhelming when we're fearful. We sometimes need to consciously remind ourselves don't worry, be happy.

Such is the present state of the capital markets. The S&P 500 Index has appreciated by over 10 percent[1] since the election in November and logged an all-time high value of 2400 in early March. The market's fear gauge, the VIX Index, has registered little sign of concern among stock investors since the election as well. Yet we have heard many concerns about the sustainability of this swelling market. So why does it seem that many investors don't feel good about this? Do we really have that many seasoned pessimists?

I'm sure we can attribute some of the anxiety to personal political beliefs and a general sense of wariness about the direction of the nation and perhaps the world. This should not be discounted, but maybe doesn't fully explain it. We all know that markets and economic production tend to ebb and flow in cycles. The amplitude, or the distance from peak to trough in a cycle, varies as well as the duration of the cycle. These factors are always unknown and impossible to predict in a consistent manner. We sometimes hear these predictions made in baseball parlance. For example, we are likely in the eighth inning of this bull market. That is not our opinion, but just an example of how easy it is to frame something as enigmatic as the capital market cycle in a tangible, lucid manner.

We may experience a sense of not wanting to be fooled into holding stocks during the next market panic. We've learned our lesson and don't want to or feel that we can't experience something like that again. Our anxiety demands that we take action to protect ourselves. As we become more aware of how this anxiety can lead to imprudent investment decisions we can sometimes appease our fear with reason. Maybe we tell ourselves that we have a financial plan and a long-term investment strategy and we'll be fine. Don't worry, be happy and all that. Our brains are magnificently powerful though. If the anxiety becomes strong enough, our brains realize that we will try to use reason to quell our fears. Then we may find ourselves instead using reason to justify taking action to alleviate the source of our fears.

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You may be thinking that we're now beginning the ninth year of this bull market after all. So what if I miss the last one or two innings. I'd rather do that then see my portfolio value drop when the game ends. Our inclination to take action to reduce our anxiety is justified using reason, albeit potentially to our own detriment.

What are we really reacting to though? Have we recalculated the probability of our financial plan's success given the impending onset of a bear market and its projected affect on our portfolio returns? Of course not! After all, your financial plan assumes that bears and bulls will run rampant throughout your lifetime.

More likely we are reacting to the fear and uncertainty that comes from seeing the value of our portfolio fall. There's the anxiety of knowing that we have the ability to take action to stem further declines in the value of our portfolio by selling our "risky" investments now. We all go through this to varying degrees and at different times. How we respond is crucial.

Our style of investing assumes that you'll experience several full market cycles over the course of your investment horizon. We plan for the market to go through periods of exuberance and periods of panic and, more often, periods of something in between. There are always concerns that raise caution flags for us and opportunities that spring our animal spirits. Current markets not withstanding. Your investment plan must seek to balance risks with opportunities over time and avoid significant course changes when risks seem to outweigh opportunities or vice versa.

Your long-term investment strategy is the most important aspect to determining success of investment objectives, but there is more to it. Rebalancing forces us to stay on track when segments of the market swell or swoon. I refer to rebalancing as our systematic buy low, sell high discipline. We believe that decisions around allocations within stocks or bonds will add value over time as well.

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Whether it's Murphy's law that does it or not, the current bull market will end. When and how are unknowable and it's something that we cannot control. We may very well be in the eighth inning or maybe the fifth. Your investment strategy already takes this into account. Not in a way that seeks to sidestep the ensuing bear market, but in a way that attempts to balance its impact on your portfolio value with the knowledge that another bull market will follow. Pessimism is a healthy trait in an investor, but like most things in life it should be exercised in moderation and it should be balanced with optimism.

Table 1

Market Indices (as of 3/31/17)	1st Quarter	One Year
Dow Jones Industrial Average	+5.2%	+19.9%
NASDAQ Composite	+10.1%	+22.9%
S&P 500 Index	+6.1%	+17.2%
Barclays Capital Aggregate Bond Index	+0.8%	+0.4%
Small Cap Stock (Russell 2000 Index)	+2.5%	+26.2%
Non-US Stock (MSCI EAFE Index)	+7.3%	+11.7%

I invite you to visit our newly redesigned website (www.birchwoodfp.com) if you haven't already. Please feel free to share your feedback with us on its design and whether there's anything you'd like us to provide on our site that we aren't already. We're excited about the new design and our ability to provide more helpful articles and resources to you. As you may know, we have grown over the past 26 years in part as a result of you kindly sharing us with your colleagues, neighbors, friends, and loved ones. We hope our new website makes it easier for you to share some of the ways that we've been able to build a relationship with you and help bring clarity and confidence to your financial goals.

Gratefully yours,

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[1]Source: Yahoo! Finance. S&P 500 Index return referenced from November 9, 2016 through March 31, 2017.

Table 1
Source: Morningstar. Market indexes are unmanaged and investors cannot invest directly in indexes. However, these indexes are accurate reflections of the performance of the individual asset classes shown. All returns reflect past performance and should not be considered indicative of future results.

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