High Probability ADVISORS

INVESTING INSIGHTS

September Stock Market Musings

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> "I've been concerned for a while that so much money is pouring into stock funds, and that index funds are the largest contributor. But that's a risk to the stock market as a whole. A more than 10-year old bull market isn't likely to last another decade."
>
> **–ALLAN ROTH**
>
> *Founder of Wealth Logic LLC, in a September 5, 2019 article posted on ETF.com.[1]*

You've probably seen a statement like this in the press in recent months. Considering the US stock market gains near 18% so far in 2019 and 13.4% annually over the past ten years, you might expect exuberance among investors. With these spectacular returns and FANG stocks in vogue, I think back to the technology stock driven "bubble" back in 1999. In those days, everybody wanted a piece of the action. Does the current data show a similar thundering herd of investors pouring their money into stock funds, as suggested in the quote above? Let's look at the data.

VANGUARD'S RISK SPEEDOMETER

Vanguard monitors the risk seeking appetites of investors by following their purchases and sales of mutual funds and ETFs as reported by Morningstar. Vanguard measures the difference between net cash flows into higher risk asset classes (primarily equity funds) and lower-risk assets (bond and money market funds) to understand investment decisions by investors in aggregate. When more money flows into equities, the risk speedometer goes higher; more flows into bonds and money market funds drives the risk speedometer lower.

In Vanguard's August 28, 2019 issue of the Risk Speedometer[2], the largest inflows over the past 1, 3, 5, and 10 years were in the money market fund category. Good old risk free, "no return but no worries" cash! Further, 7 of the top 10 categories for inflows during the past 1, 3 and 5 years are low risk money market and bond funds. Only 3 are equity funds. Of these, two are foreign stock funds, which is also surprising because they have been soundly beaten by US stocks.

At the other end of the investment flows rankings, the biggest outflows are found in US stock funds. The US Large Cap Growth category (dominated by FANG stocks) had the largest net outflows in all periods! Quite surprising considering their strong returns. US Large Cap Value funds suffered the second largest outflows. Of the top 10 net losers, 9 were in equity funds over the past 3 years. The only bond fund on the list was High Yield Bonds, which is the riskiest bond category.

Based on the cash flows, Vanguard's Risk Speedometer measurements for the past 1, 3 and 12 months are all in the lowest risk decile of all readings. Vanguard states, "Over the past 15 years, simultaneous bottom decile readings across these time frames have occurred only 4% of the time. The funds flow data for the past ten years shows that the appetite for risk assets has been tepid ever since the 2008-09 bear market. The current readings show that investors are extraordinarily cautious.

STRANGE TIMES

As the stock market posts new highs and marches toward the end of year 11 of the advance, this risk avoiding behavior seems curious. Where is the joy? Where is the mania? Why is my Uber driver not giving me stock tips? When was the last time someone told me that they've joined a stock market investing club? Most of the behaviors that were on display in the late 1990s are seemingly absent. However, in 1999, investors had experienced 25 years of excellent market returns. Risk had been consistently rewarded, so risk seeking behavior was in fashion. Today, there are some signs of risk seeking in the IPO markets, crypto currencies and marijuana stocks. However, the investment flows data tells the big picture: conservatism reigns.

> "I have never known anyone who could consistently time the market. And in fact, I've never known anyone who knows anyone, who was able to consistently time the market."
>
> **–BURTON MALKIEL**
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> *Princeton Professor, author of the 1973 investment classic, A Random Walk Down Wall Street.*

Behavioral finance helps explain. First, "loss aversion" is a driving force most of the time. Various studies have shown that investors feel the pain from losses more acutely than they get joy from gains. Thus, they act in ways to avoid losses and are happy to forgo gains. Then we have the impact of the 2008-09 great recession and associated stock market losses, which continues to shape behaviors. "Recency" is the behavioral construct that shows people think that whatever just happened has a much higher probability of happening again soon than it does in reality. Remember economist Gary Shilling's prediction of a recession and 42% stock market decline in 2013?[3] It seemed possible because it happened in 2008. We're still waiting...

SO WHAT?

What do we take away from all this? Mostly that there are always observations and data that can be used to form differing opinions of where the stock or bond market might be headed. Conflicting data leads to conflicting forecasts. Trying to "time the market" - basing your investment strategy on predictions of where the stock market is going tomorrow, next month, next year or in the faraway future has a low probability of success. The flow of funds data from Vanguard stands in sharp contrast to the hand wringing of various market mavens. Neither means that much to us.

At HPA, we help our clients develop long term asset allocations based on the risk and return exposures that make sense for them. Then, we build portfolios from factor-based investment options that optimize the risk-return balance. Finally, we rebalance the portfolios over time to keep the risk-return balance on track.

Stock market downturns and rallies will undoubtedly shape the short to intermediate term portfolio returns-but we won't waste time trying to chase the unattainable dream of market timing, because chasing that dream can cause permanent damage to your portfolio. Instead, we bring the best evidence-based solutions to your portfolio to create a high probability of long-term investment success. Most investment advisors talk about risk management, cushioning the downturns and other comforting ideas without much proof of how it will be accomplished. HPA provides concrete solutions. And, we don't stop there. Providing insights, interpretation and guidance through the ups and downs of the investment markets is an important part of our efforts. When you have a good plan, then you recognize that the majority of what fills the headlines is noise.

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[1]Roth, A. (2019, September 5). 'The Big Short' Whiffs On Indexing. Retrieved from https://www.etf.com/sections/index-investor-corner/big-short-whiffs-indexing

[2]Vanguard. (2019, August 28). Risk speedometer: Holding steady at lower bound. Retrieved from https://advisors.vanguard.com/VGApp/iip/site/advisor/researchcommentary/article/IWE_InvComRiskSpeedometerAug2019

[3]Farrell, P. B. (2013, January 11). Washington 'clowns' set up 42% stock-market drop. Retrieved from https://www.marketwatch.com/story/washington-clowns-set-up-42-stock-market-drop-2013-01-11

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Call **(585) 485-0135** if we can address your questions or provide you further insight into our investing strategies.

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