Summer 2017

360 Insights

Quarterly Investing and Financial Perspectives

Finance for Normal People

by **Meir Statman**, Glenn Klimek Professor of Finance at Santa Clara University

What's Inside

This article is an adaptation from Meir Statman's new book "Finance for Normal People: How Investors and Markets Behave." Statman is a member of the Loring Ward Investment Committee and the Glenn Klimek Professor of Finance at Santa Clara University.

You are contemplating a gift to your beloved and wonder whether it should be a red rose or $10, the price of the rose.

You are a rational person who knows a bit of finance, so here's your thinking: A rose has no utilitarian benefits — your beloved cannot eat or drink it. A rose is also a waste. It gets tossed after a few days, once the petals drop off. A $10 bill, in contrast, can pad a savings account, or be spent now on something your intended really wants.

Such thinking might be rational, but it is pretty stupid. Following this script would surely not make you beloved. Normal people know that roses have no utilitarian benefits, but they have a lot of expressive and emotional benefits. Imagine yourself instead on Valentine's Day, presenting a $10 bill as your gift.

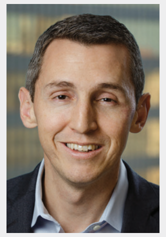
Well, you say, this is a nice story, but what does it have to do with finance? A lot. Stocks, bonds, and all other financial products and services are like roses, watches, cars, and restaurant meals — all providing utilitarian, expressive, and emotional benefits. We miss many insights into our financial behavior and the behavior of financial markets when we think of financial products and services as providing only utilitarian benefits.

The lessons of behavioral finance guide us, for example, to ignore "sunk costs" that have already been incurred and cannot be salvaged, even when cognitive and emotional errors prod us otherwise. Professors of economics are likely to leave disappointing movies earlier than professors of biology or the humanities, acknowledging that it is best to ignore sunk time spent watching the early part of a bad movie, as that time cannot be salvaged, and not sink additional time salvageable by leaving the theater.

Learning, however, is not easy, made more difficult by mistrust of experts. A survey asked economic experts and average Americans whether they agree with statements such as "It is hard to predict stock prices." Answers reveal that 100% of economic experts agreed, whereas only 55% of average Americans did. The mistrust is evident in the finding that the proportion of these Americans who agreed that it is hard to predict stock prices declined to 42% from 55% when told that economic experts agreed with the statement.

In fact, there is much evidence that it is difficult to forecast stock prices. Neither amateur investors, nor writers of investment newsletters and Wall Street strategists are good at predicting stock prices. Indeed, predictions of above-average returns were

See "Finance for Normal People" *continued on page 4*



What Are You Aiming For?

by **Matthew Carvalho**, CFA, CFP®
Director of Investment Research
Loring Ward

When you look at the returns of a variety of asset classes over the past 15 years, it's hard to find any meaningful patterns. The chart here shows the returns on 11 different asset classes since 2002, and it's quickly evident that what was the star of last year rarely shines the brightest the following year.

When planning for investment goals 10, 20, 30 years down the road, most investors would prefer a higher level of stability than the highs and lows of any one asset class, such as the positive 79% or negative 50% that you see on this chart from Emerging Markets Value over this time.

While Emerging Markets Value was the best performer over this period, it came at a high cost in terms of volatility, with a standard deviation (which measures the ups and downs of an investment) of 22.1%. While you saw a great annualized return overall during these 15 years, you had to persevere through six negative years, four of which saw losses greater than 15%.

How can you keep your portfolio from experiencing large swings like that year to year? It's simple — diversification. Over the last 15 years a blend of 65% stocks and 35% bonds was never the top performer but it was also never the bottom performer. At the end of the period it posted an annualized return of 6.8%.

That lines up quite closely to the S&P 500, which averaged a gain of 7.0% over the same time frame and has seen tremendous returns since 2009. Over this period, the 65%/35% blend of stocks and bonds had a 10.0% standard deviation while the S&P 500 had a much higher 14.3%. This meant the diversified portfolio saw less erraticism, especially in a year like 2008, where it fell by just 24% compared to a 37% drop on the S&P or a 50% drop in Emerging Markets Value.

Many investors keep trying to outguess the market, but time and again the investment world shows us we can't predict what will occur next.

With a diversified portfolio, you won't be the single best performer in any period, but the tighter range of returns may give you fewer reasons to worry about poor returns from a single asset class. If you're in or nearing retirement and are currently taking money out of a portfolio, a smaller range of possible annual returns can help increase your odds of successfully meeting your goals over the long term.

Smart Diversification Can Help You Stay on Track

Asset Class Performance 2002–Q1 2017

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Q1 2017	Since 2002 Annualized Returns/ Standard Deviations
U.S. Short Term Bond 6.1%	EM Value 62.3%	U.S. REIT 33.2%	EM Value 33.0%	U.S. REIT 36.0%	EM Value 42.2%	Global Short Term Bond 6.6%	EM Value 79.1%	U.S. REIT 28.1%	U.S. REIT 9.4%	U.S. Large Value 17.5%	U.S. Small Cap 38.8%	U.S. REIT 32.0%	Intl. Small Cap 5.5%	U.S. Small Cap 21.3%	EM Value 10.2%	EM Value 10.8% / 22.1%
Global Short Term Bond 5.1%	Intl. Small Cap 61.8%	EM Value 30.7%	Intl. Small Cap 25.0%	EM Value 32.0%	Intl. Large Value 7.0%	U.S. Short Term Bond 4.7%	Intl. Small Cap 50.8%	U.S. Small Cap 26.9%	Global Short Term Bond 2.3%	Intl. Small Cap 17.5%	U.S. Large Value 32.5%	U.S. Large 13.7%	U.S. REIT 4.5%	U.S. Large Value 17.3%	Intl. Small Cap 7.6%	U.S. REIT 10.5% / 23.2%
U.S. REIT 3.6%	U.S. Small Cap 47.3%	Intl. Small Cap 29.4%	Intl. Large Value 14.5%	Intl. Large Value 29.3%	U.S. Short Term Bond 6.9%	Cash 2.2%	Intl. Large Value 36.8%	Intl. Small Cap 24.5%	U.S. Large 2.1%	Intl. Large Value 17.3%	U.S. Large 32.4%	U.S. Large Value 13.5%	U.S. Large 1.4%	EM Value 14.9%	U.S. Large 6.1%	Intl. Small Cap 9.6% / 18.3%
Cash 1.8%	Intl. Large Value 46.0%	Intl. Large Value 24.5%	U.S. REIT 13.8%	U.S. Large Value 22.2%	Global Short Term Bond 6.3%	65/35 Mix -24.4%	U.S. REIT 28.5%	EM Value 18.4%	U.S. Short Term Bond 1.6%	U.S. REIT 17.1%	Intl. Small Cap 25.6%	U.S. Small Cap 4.9%	Global Short Term Bond 1.0%	U.S. Large 12.0%	Intl. Large Value 5.7%	U.S. Small Cap 8.5% / 19.0%
EM Value -4.5%	U.S. REIT 36.2%	U.S. Small Cap 18.3%	65/35 Mix 8.8%	Intl. Small Cap 19.5%	65/35 Mix 5.6%	U.S. Small Cap -33.8%	U.S. Small Cap 27.2%	U.S. Large Value 15.5%	U.S. Large Value 0.4%	U.S. Small Cap 16.4%	Intl. Large Value 21.5%	65/35 Mix 4.5%	U.S. Short Term Bond 0.7%	65/35 Mix 8.4%	65/35 Mix 3.4%	U.S. Large Value 7.5% / 14.9%
Intl. Small Cap -7.4%	U.S. Large Value 30.0%	U.S. Large Value 16.5%	U.S. Large Value 7.0%	U.S. Small Cap 18.4%	U.S. Large 5.5%	U.S. Large Value -36.8%	U.S. Large 26.5%	U.S. Large 15.1%	Cash 0.1%	U.S. Large 16.0%	65/35 Mix 16.7%	Global Short Term Bond 1.9%	Cash 0.1%	Intl. Large Value 7.4%	U.S. Large Value 3.3%	U.S. Large 7.0% / 14.3%
65/35 Mix -7.8%	U.S. Large 28.7%	65/35 Mix 14.1%	U.S. Large 4.9%	65/35 Mix 16.5%	Cash 4.9%	U.S. Large -37.0%	65/35 Mix 23.3%	65/35 Mix 11.5%	65/35 Mix -2.6%	EM Value 15.9%	U.S. REIT 1.2%	U.S. Short Term Bond 0.8%	65/35 Mix -1.8%	U.S. REIT 6.7%	U.S. Small Cap 2.5%	65/35 Mix 6.8% / 10.0%
U.S. Large Value -15.5%	65/35 Mix 27.8%	U.S. Large 10.9%	U.S. Small Cap 4.6%	U.S. Large 15.8%	Intl. Small Cap 3.3%	U.S. REIT -39.2%	U.S. Large Value 19.7%	Intl. Large Value 4.8%	U.S. Small Cap -4.2%	65/35 Mix 11.5%	U.S. Short Term Bond 0.7%	Cash 0.0%	U.S. Large Value -3.8%	Intl. Small Cap 4.3%	U.S. Short Term Bond 0.4%	Intl. Large Value 5.9% / 18.0%
Intl. Large Value -15.9%	U.S. Short Term Bond 2.8%	Global Short Term Bond 2.7%	Global Short Term Bond 3.1%	Cash 4.8%	U.S. Large Value -0.2%	Intl. Large Value -44.3%	U.S. Short Term Bond 3.8%	U.S. Short Term Bond 2.8%	Intl. Large Value -11.7%	Global Short Term Bond 2.1%	Global Short Term Bond 0.6%	EM Value -4.1%	U.S. Small Cap -4.4%	Global Short Term Bond 1.5%	Global Short Term Bond 0.3%	Global Short Term Bond 2.9% / 1.3%
U.S. Small Cap -20.5%	Global Short Term Bond 1.9%	Cash 1.3%	Cash 3.0%	U.S. Short Term Bond 4.3%	U.S. Small Cap -1.6%	Intl. Small Cap -48.0%	Global Short Term Bond 2.3%	Global Short Term Bond 2.0%	Intl. Small Cap -15.8%	U.S. Short Term Bond 1.5%	Cash 0.1%	Intl. Small Cap -5.4%	Intl. Large Value -7.7%	U.S. Short Term Bond 1.3%	Cash 0.1%	U.S. Short Term Bond 2.7% / 1.3%
U.S. Large -22.1%	Cash 1.1%	U.S. Short Term Bond 1.2%	U.S. Short Term Bond 1.8%	Global Short Term Bond 4.1%	U.S. REIT -17.6%	EM Value -50.3%	Cash 0.2%	Cash 0.2%	EM Value -17.9%	Cash 0.1%	EM Value -5.1 %	Intl. Large Value -5.4%	EM Value -18.6%	Cash 0.3%	U.S. REIT -0.3%	Cash 1.3% / 0.5%

Source: Morningstar Direct 2016. Cash (BofAML 3M US Treasury Note TR USD). Index representation as follows: U.S. Large (S&P 500 Index), U.S. Large Value (Russell 1000 Value TR Index), U.S. Small Cap (Russell 2000 TR Index), U.S. REIT (Dow Jones U.S. Select REIT TR Index), International Large Value (MSCI World Ex USA Value Index (net div.)), International Small Cap (MSCI World Ex USA Small Cap (net div.)), EM Value (MSCI Emerging Markets Value Index (net div)), Global Short Term Bond (Citi WGBI 1-5Yr Hdg USD), U.S. Short Term Bond (BofA ML Corp & Govt 1-3 Yr TR). Indexes are unmanaged baskets of securities that are not available for direct investment by investors. Index performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. All investments involve risk, including loss of principal. Foreign securities involve additional risks, including foreign currency changes, political risks, foreign taxes, and different methods of accounting and financial reporting. Fixed income investments are subject to interest rate and credit risk. Emerging markets involve additional risks, including, but not limited to, currency fluctuation, political instability, foreign taxes, and different methods of accounting and financial reporting. Real estate securities funds are subject to changes in economic conditions, credit risk and interest rate fluctuations.

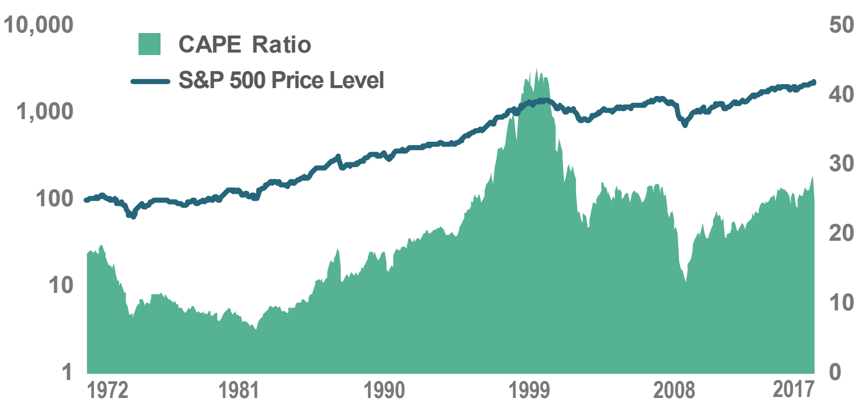
Don't Let High Stock Valuations Get You Down

by **Matthew Carvalho**, CFA, CFP®, Director of Investment Research, Loring Ward

You may have heard financial pundits talking about what investors should or shouldn't do, especially with many markets at or near all-time highs. If you're starting to doubt your long-term plan, here is some research that may help put this in perspective.

In this chart, the green area represents the 10-year trailing price-to-earnings (P/E) ratio (commonly referred to as the CAPE ratio) of the S&P 500 back to 1972. You can think of this as a gauge to see if the overall price of the stock market is expensive or cheap. As you can see, we're currently at a fairly elevated level, around a price of 29 dollars for every dollar of earnings, though this is far below previous peaks.

Valuations — Jan. 1972 – Mar. 2017



Source: CAPE data from Robert Shiller Online Data library via Yale. CAPE stands for Cyclically Adjusted Price to Earnings ratio — which tracks current S&P 500 price versus average of inflation-adjusted earnings over previous 10 years. S&P 500 data provided by Morningstar Direst, 2017. Indexes are not available for direct investment. Past performance does not guarantee future results.

It may be enticing to think you can time the market based on valuation ratios like these, but even the creator of this ratio, Professor Robert Shiller, cautions against using the ratio to make trades. And keep in mind, you must guess right not once but twice — knowing when to get out of and back into the market.

For example, the last time the 10-year trailing P/E ratio of the S&P 500 broke through the current level was in February 1997. If you had sold out fearing high valuations at that time, you would have missed out on another three years of up markets, cumulating an additional 86% gain before seeing any meaningful decline.

And at that point in February 1997, the S&P 500 was trading at 798. If you sold out waiting to buy back in once the market was lower, you likely never bought back in. Meanwhile, the S&P 500 is above 2,300.

It's important to realize that had you stayed invested, you would have likely participated in the gains that the market has provided in recent years to reach these all-time-high levels in the first place.

Yet, if you're still worried about U.S. markets trading at high levels, what might you consider doing?

We would always advise to keep things in perspective. And remember that as you invest in many companies in many countries, and rebalance your allocations over time, you reduce your concentration of exposure to any one market, like the U.S.

You may also take comfort knowing that many countries around the world are trading at far lower valuations when looking at the same CAPE ratio — the UK at 15.3, China at 14.4 or Australia at 17.5.

Having a low or a high ratio doesn't necessarily mean high or low returns going forward, but to address the worry that U.S. markets gained tremendous amounts in recent years, having a well-diversified, global portfolio means you're not too concentrated in any one market.

Finance for Normal People... *continued from page 1*

generally followed by below-average returns, and predictions of below-average returns were generally followed by above-average returns.

The good news is that we can transform ourselves from normal-ignorant and normal-foolish into normal-knowledgeable and normal-smart, learning the lessons of behavioral finance and applying them to reduce ignorance, gain knowledge, and increase the ratio of smart to foolish behavior on our way to what we want.

Diversification neither assures a profit nor guarantees against loss in a declining market.