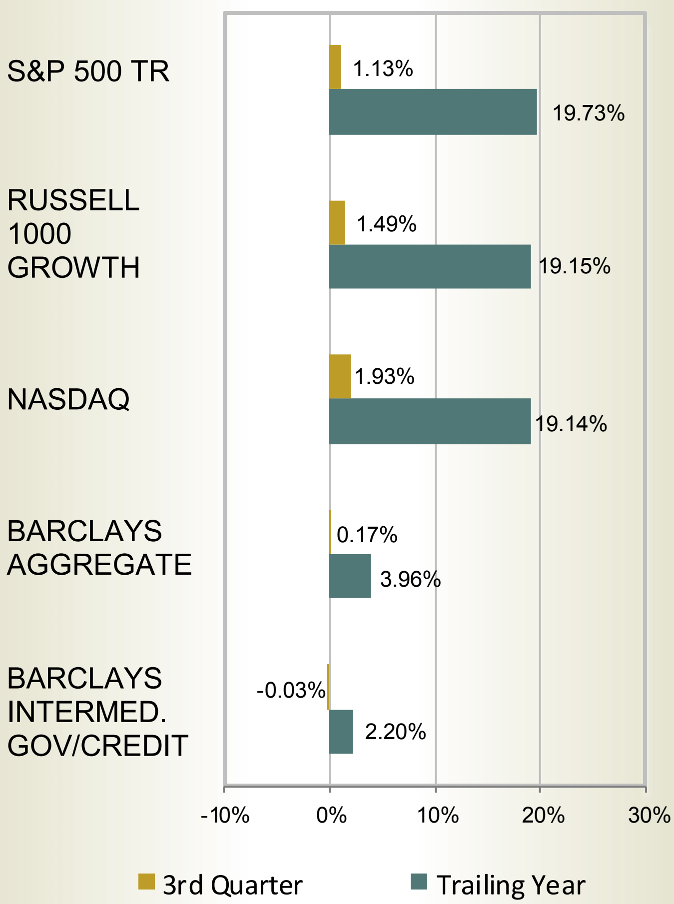
QUARTERLY COMMENTS

3rd Quarter 2014

Market Index Update



3rd Quarter 2014: Is Hindsight Really 20/20?

Last month marked my twentieth year in the investment industry, which has put me into a philosophical mood. When I first walked into the world of Wall Street in September 1994, the S&P 500 Index was at 462 and the Dow Jones Industrial Average stood at 3,908. At the end of this year's third quarter, the S&P 500 had grown to 1,972 and the Dow Jones was at 16,994. Including reinvested dividends, this works out to an average annualized return of 9.6% for the S&P 500, very close to the long-term average annualized return of 10.08% since 1926. Just for grins, I should note that if the U.S. stock market grows at the same rate over the next twenty years as it has over the last two decades, the S&P 500 will crest 8,407 and the Dow Jones will hit 75,578 in the fall of 2034.

In hindsight, gains of the past two decades seem obvious and easily attained. "Of course stocks do well in the long run," you might be saying to yourself, "Everyone knows that!" And you would be objectively correct, at least in retrospect. But we do not have the luxury of living our lives in increments of multi-decade hindsight. Instead, we live them day-by-day, constantly peering forward into an uncertain future. And one thing you can be certain of – without any doubt whatsoever – is that every single day in the markets over the past twenty years (slightly more than 5,000 trading days if you are counting) has been accompanied by a variety of fears and worries about what the future might bring. To make the picture even more opaque, sometimes investor fears do come true. Over the past twenty years, I have had a front-row seat for seventeen 10% declines in the S&P 500 and six drops of more than 20%. In two cases over the past twenty years, the S&P ultimately fell by more than 50% before hitting bottom. Stated in percentage terms and ensconced safely in the past, these pullbacks seem almost banal. But at the time they were occurring, they were viscerally painful for investors to endure.

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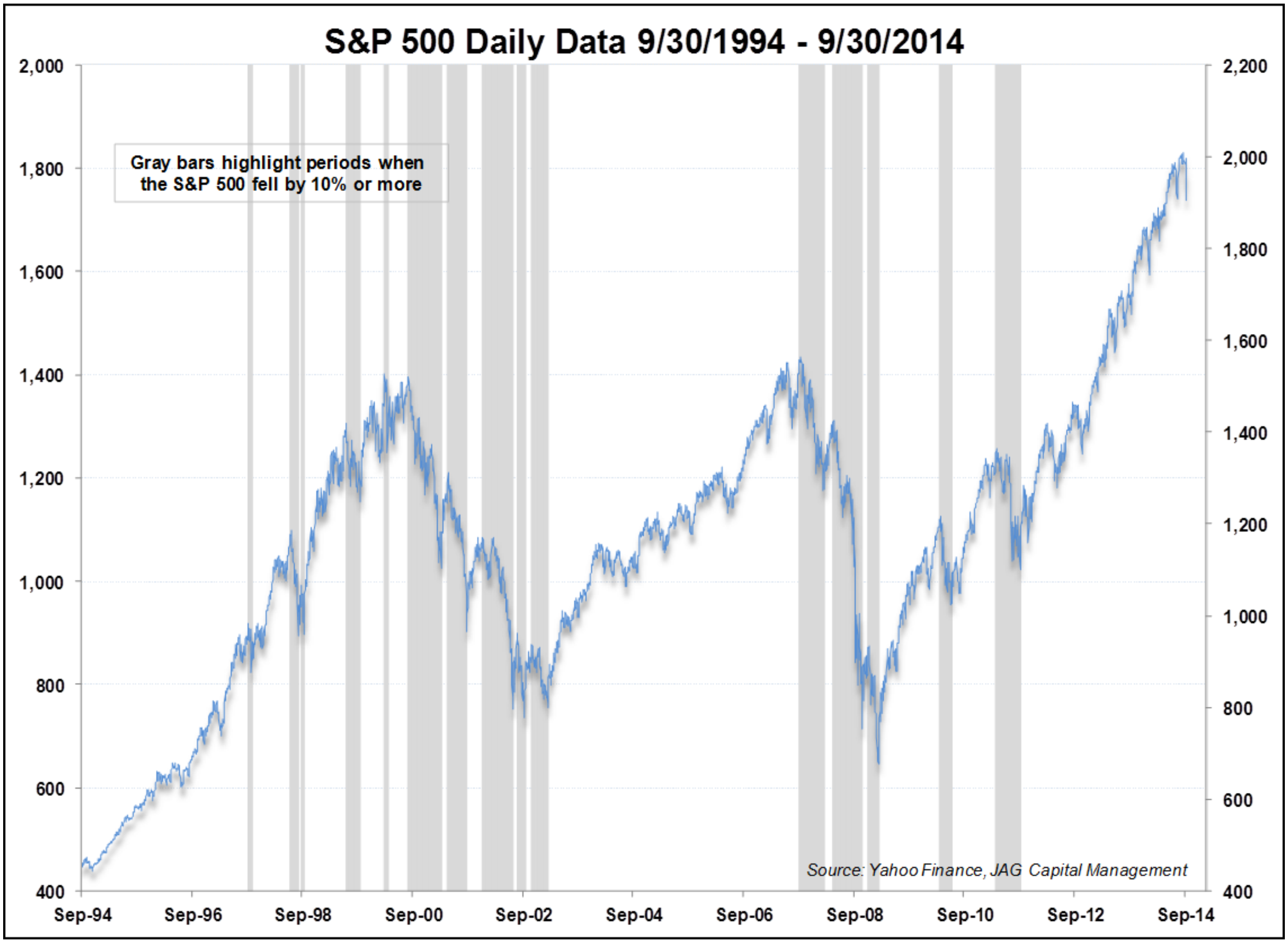

S&P 500 Corrections of 10% or More 9/30/1994 - 9/30/2014						
BegDate	EndDate	SP500_Closing High	SP500 ClosingLow	PntChg	PctChg	#OfTradingDays
10/7/1997	10/27/1997	983.12	876.99	-106.13	-10.80%	14
7/17/1998	8/31/1998	1,186.75	957.28	-229.47	-19.34%	31
9/23/1998	10/8/1998	1,066.09	959.44	-106.65	-10.00%	11
7/16/1999	10/15/1999	1,418.78	1,247.41	-171.37	-12.08%	64
3/24/2000	4/14/2000	1,527.46	1,356.56	-170.9	-11.19%	15
9/1/2000	4/4/2001	1,520.77	1,103.25	-417.52	-27.45%	147
5/21/2001	9/21/2001	1,312.83	965.80	-347.03	-26.43%	82
1/4/2002	7/23/2002	1,172.51	797.70	-374.81	-31.97%	137
8/22/2002	10/9/2002	962.70	776.76	-185.94	-19.31%	33
11/27/2002	3/11/2003	938.87	800.73	-138.14	-14.71%	69
10/9/2007	3/10/2008	1,565.15	1,273.37	-291.78	-18.64%	104
5/19/2008	10/10/2008	1,426.63	899.22	-527.41	-36.97%	101
10/13/2008	10/27/2008	1,003.35	848.92	-154.43	-15.39%	10
11/4/2008	11/20/2008	1,005.75	752.44	-253.31	-25.19%	12
1/6/2009	3/9/2009	934.70	676.53	-258.17	-27.62%	42
4/23/2010	7/2/2010	1,217.28	1,022.58	-194.7	-15.99%	49
4/29/2011	10/3/2011	1,363.61	1,099.23	-264.38	-19.39%	108
Source: JAG Capital Management						

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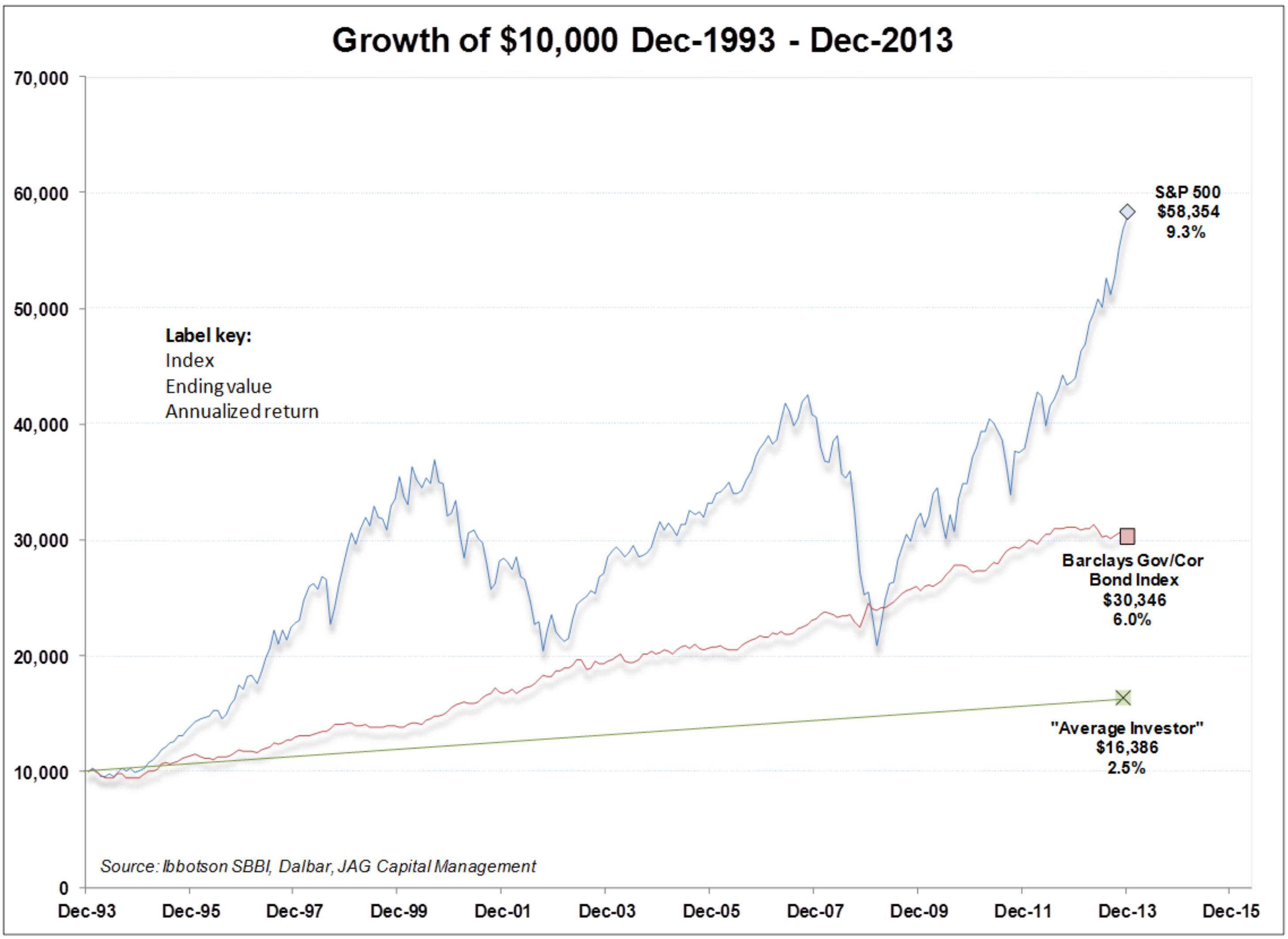
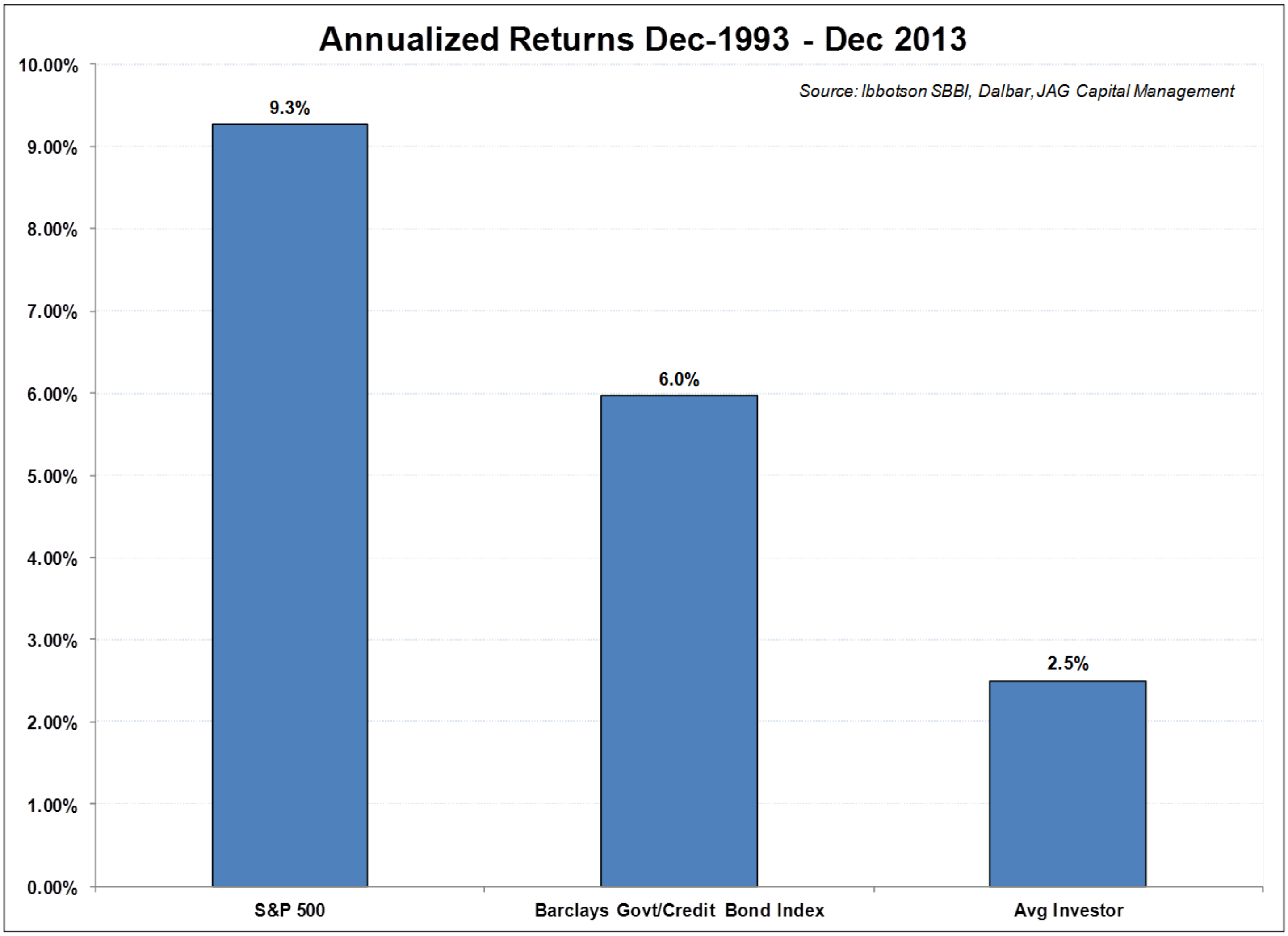
As a whole, investors do a poor job of dealing with the pain that is periodically doled out by volatile investment markets. The old adage, "buy low, sell high" is a truism, but its simplicity belies how difficult these actions are to accomplish in practice. How "low" is low enough? How do we define "high?" Should we use prices or valuations relative to earnings or book value or some other measure? Even among us so-called "experts," there are widely varying opinions on these matters. So perhaps it is no surprise that investors tend to do the opposite. They get more optimistic about stocks as their prices rise, and more pessimistic as prices fall. At JAG, we see this tendency play out in almost real time during our weekly reviews of mutual fund money flow statistics. Typically, mutual fund inflows (i.e. deposits) increase only after the market rises. Fund outflows (i.e. withdrawals) generally follow market declines. In other words, investors tend to "buy high and sell low." This has truly monumental implications. The market research firm Dalbar estimated that the average investor realized an average annual return of only 2.5% in the twenty years ending 12/31/13. That is barely ahead of the 2.4% annual rate of inflation over that time period, and is a fraction of the average annual returns generated by the S&P 500 or even the 6% average return of bonds (as measured by the Barclays Government/Corporate Index).





We humans are susceptible to a whole range of behavioral biases that actively work against us as investors. As just one example, I cite the tendency we all have to say, "Coulda Shoulda Woulda" after an incorrect decision. In the field of behavioral finance, this is known as hindsight bias. It is best described as a psychological phenomenon in which events in the past seem to be more predictable than they actually were at the time they were occurring. As Investopedia's definition of the term notes, "Hindsight bias can lead an individual to believe that an event was more predictable than it actually was, and can result in an oversimplification in cause and effect." In practice, hindsight bias can make the financial markets seem much more predictable than they are.

The financial crisis of 2008-2009 and its aftermath are cases in point. In hindsight, it seems obvious that real estate prices got too high in the mid-2000's, and that bank lending standards got too loose. It appears self-evident that the banks' balance sheets became too levered, and that the repackaging of real estate loans into evermore complex securities was unwise. With the benefit of this hindsight, legislators have worked furiously over the past several years to pass new laws that prohibit many of the practices that led to the crisis. Tens of billions of dollars of fines have been paid by the banking industry, lending standards are now much tighter, and banks are generally required to maintain much higher capital levels. While many of these changes are positive, none of them address the fact that the crisis itself was anything but obvious before it occurred. If it had been, it would not have happened in the first place. Real estate prices would never have gotten overextended. Regulators would have made it impossible for banks to make bad loans and pack them up into complicated securities. The fact that the crisis occurred at all is evidence enough of its unpredictability.

The S&P 500 finally bottomed in early March 2009, after falling more than 57% from the all-time highs it had reached in the fall of 2007. Stock prices have almost tripled since then. In retrospect, it seems obvious that stock prices had gotten too cheap and that the market was due for a rally. And there seem to be no shortage of investment pundits nowadays who claim to have been bullish on stocks at or near the market bottom. But again, if it had actually been obvious that stocks were on the cusp of a major rally in early 2009, stocks would never have declined as much as they did. Hindsight bias gives us the illusion – not the reality – of easy predictability.

Contrary to the old saying, hindsight is actually not 20/20. It shows us what events occurred in the past clearly enough, but it obscures the reasons for their occurrence. It makes past events look more predictable than they were. In so doing, it can lead us to make poor decisions with our investments.

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If market movements are unpredictable in both directions, we can draw at least two major conclusions. First of all, attempting to time the market is folly. Switching in and out of stocks is doomed to failure over the long term. Rest assured I am not aware of any individual or investment firm who has built a valid and repeatable system for timing the ups and downs in the stock market. As Warren Buffett once wrote, "The only value of stock forecasters is to make fortune-tellers look good."

Secondly, and more importantly, prudent investors can utilize a disciplined asset allocation strategy to tame the effects of volatility and enforce a "buy low, sell high" policy in their portfolios. As an example, consider an investor who entered 2008 with an asset allocation policy of 60% stocks and 40% bonds (for the sake of simplicity, we will assume a 60% allocation to the the S&P 500 Index exchange-traded fund and a 40% allocation to iShares Core U.S. Aggregate Bond exchange-traded fund). During 2008, SPY fell by 36.8%, and the bond index returned 7.9%. By the end of 2008, this investor's portfolio allocation would have changed dramatically.

Stocks would have comprised only 47% of her portfolio, while her bond allocation would have risen to 53%. Assuming this investor stayed consistent with her asset allocation policy, this sort of imbalance would have compelled a rebalancing of her portfolio in early 2009. In order to accomplish this, she would have purchased enough stocks to bring their weight back to 60% of her portfolio. These purchases would have been funded by sales of bonds. Therefore, she would have "bought low" by adding to her equity portfolio after a major bear market. Similarly, she would have "sold high" by selling some of her bonds after a year of strong outperformance. No market timing was required to accomplish this feat. All she had to do was stay disciplined and follow her own policy.

At the time of this writing, the markets appear to be experiencing more volatility than we have become accustomed to over the past few years. If history is any guide, this type of market action will lead many investors astray. Some will be tempted to dramatically alter their portfolios. In doing so, they may achieve short-term relief from emotional pain, but this will likely come at the expense of their long-term investment results. If twenty years in this industry has taught me anything, it is that acting on emotion is a sure recipe for poor results.

All of us at JAG wish all of you a wonderful fall.

Go Cards!

Norm Conley
CEO & CIO
October 2014

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