siena WEALTH • ADVISORS

The SIENA INVESTOR

A QUARTERLY PUBLICATION OF SIENA WEALTH ADVISORS

What to Do if the Bear Has Emerged From Its Hibernation

It seems like investors have had plenty to worry about recently, even without considering the last few weeks of stock market volatility. After all, we've seen:

- Slowing growth in most of the developed world, including the possibility that European economies will enter their third recession since 2007.
- Growth in China's economy decelerating faster than expected.
- ISIS on the march.
- The end of the Federal Reserve's bond buying program, and the accompanying threat of rising interest rates.
- A rising dollar's negative impact on the competitiveness of U.S. manufacturers.
- "Sky high" valuations as the Shiller CAPE 10 rose to over 26 (versus the historical average of 16) and still remains at about 24.
- Nervous investors anxious about the threat posed to the global economy by the Ebola virus.

Now add to this list the sharp and sudden drop that equity markets have experienced since the S&P 500 peaked on

Continued on page 2

W Joseph Irish elected to board of Ronald McDonald House

Siena Advisor, W. Joseph Irish, has been elected to the Board of Directors of the Ronald McDonald House Mid Michigan where he will serve as the Treasurer and Finance Chair. The Ronald McDonald House of

Mid-Michigan is a home-away-from-home for the families of seriously ill children who are hospitalized or receiving treatment at Lansing area hospitals and clinics.

Congratulations Joe and thank you for your service to our community!

Continued from page 1

“A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful.”

September 18. If all the negative headlines have caused your stomach to produce a lot more acid, resulting in some sleepless nights, you should answer certain questions before the stress causes you to embark on a bout of panicked selling.

First, ask yourself about the reasons for your concern. Then ask if you are the only one who knows those risks exist. Obviously, the answer is no. Thus, you should acknowledge that bad news doesn't necessarily mean markets will go lower. As I discuss in my book, Think, Act and Invest Like Warren Buffett, one of the secrets to Warren Buffett's success as an investor is that during bear markets, he's able to keep his head while everyone else around him is losing theirs. He understands that the market price already reflects all information that is knowable. In other words, prices and valuations have fallen because the news has been bad. Those lower valuations mean that expected returns are now higher, reflecting the heightened risks. If you bought previously, when expected returns were lower, does it really makes sense to sell now, when they are higher? This brings to mind something Buffet said in an op-ed for The New York Times, back in the bear market of 2008. He wrote: “A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful.”

The fact that bad news is already embedded in prices means that markets can be expected to continue to fall only if future news is worse than already expected. If the news is no worse than expected, you will likely earn higher returns resulting from the lower valuations. And even if the future news isn't necessarily good, but is better than expected, valuations will rise as the risk premium demanded by the market begins to fall. That's often how bull markets begin.

One of the most important lessons smart investors have learned is that it's totally irrelevant to stock prices whether news is good or bad. Failing to understand this basic tenet causes investors to overreact to the news. They become overenthusiastic when it's good and panic when it's bad. To be a successful investor, you need to understand that what matters is whether the news is better or worse than already expected.

One of the most basic principles of finance is that markets are forward looking, meaning that they incorporate everything that is knowable into current prices. In other words, the only thing that matters is surprises. By definition, if something is a surprise, it cannot be forecast. Since happy surprises are about as likely as

Continued on page 3

Continued from page 2

unhappy ones, changes in market valuations are random, unpredictable.

> *The second question you should ask yourself concerns Warren Buffett's take on selling. Not unexpectedly, the answer comes from Buffet himself.*

He has said that his favorite time period for owning stocks is forever. One of the reasons for his great success is that he never engaged in a fire sale. He stuck with his plan. And that's what smart investors do. They adhere to their well-thought-out plan. Such a plan will have anticipated that bear markets were going to occur with certainty, and that it wasn't possible to know when they would start, how long they would last, and how deep they would be. The key to success is to stay disciplined. And the only way you're likely to do that is to make sure your asset allocation doesn't include assuming more risk than you have the ability, willingness or need to take. Otherwise, when the risks do show up, your stomach will reach its GMO limit — the point at which it screams GET ME OUT! Not many investors can resist that siren's cry.

Smart investors know that bear markets are inevitable, and that no one has shown the ability to successfully time them in an effort to avoid their occurrence. And they know that active managers have done at least as poorly in bear markets as they have done in bull markets. So forget about the idea that active management is likely to protect you. Only you can protect yourself, by not taking too much risk and planning for bear markets ahead of time. Great generals know what successful investors know: battles are won in the preparatory stage, not on the battlefield (or in the middle of a bear market). On the battlefield, stomachs often take over the decision making. And I've yet to meet a stomach that makes good decisions.

So what should you be doing? If you have a well-thought-out plan, you should be sticking to it. However, that assumes the most recent bear market has taught you the right level of confidence in your willingness to take risk. If not, it's better to acknowledge the mistake (and lower your equity allocation to the appropriate level, although perhaps the market has already done that for you) rather than perpetuating it. Running a Monte Carlo simulation can help determine if a lower allocation will still allow you to achieve your goals. Perhaps combining that new, lower equity allocation with a commitment to save more currently or a plan to work a bit longer will still allow you to meet you goals. Even smart people make mistakes. What differentiates them from fools is that they don't repeat them.

If you don't have a plan, take this as a wake-up call to write one. If you do have a plan, you might focus on some of the current economic situation's positives, rather than only its negatives. The financial media, we know, tends to focus on the negative (like the market's recent volatility) because bad news sells. Note that the arrival of good news doesn't necessarily mean that the market will stop falling. Remember, just as the market incorporates the totality of bad news and risk, it also incorporates the good. Good news is embedded in the market's prices as well.

There is Some Good News

First, since the weather-related slump in the first quarter, the U.S. economy has been growing at a faster pace than many expected. The U.S. Commerce Department's Bureau of Economic Analysis revised its estimate of second quarter real gross domestic product (GDP) growth, which came in at 4.6 percent and surpassed the

Continued on page 4

expectations of many observers. More generally, as Standard & Poor's indicated in a recent report, "the updated official growth estimate confirmed our view that the U.S. economy is gaining momentum."

Second, the September jobs report was stronger than expected, indicating a strengthening labor market. Throughout the past 12 months, payroll jobs have increased at a monthly clip of 220,000.

Third, with the unemployment rate now at 5.9 percent, the stage could finally be set for wage growth to begin accelerating next year. And that would stimulate consumer spending.

Fourth, the sharp drop in oil prices, now down more than 20 percent since June, will act similarly to a big tax cut and should also help stimulate other consumer spending. The sharp drop in energy prices overall will help hold down the rate of increase in the consumer price index (CPI). And the timing for lower prices couldn't be better as we head into the crucial winter heating season. In addition, lower energy prices will provide the Federal Reserve with more leeway to extend its policy involving very low interest rates. Keep in mind that a strong dollar will not only lead to lower import prices, but should also mean that domestic producers will have to be more competitive in their pricing. That should help keep prices low in general.

Fifth, the sharp drop in interest rates will help U.S. industry by providing more opportunities to refinance debt at lower levels, thus improving profits and margins. It will also allow more homeowners to refinance, and others will be encouraged to buy homes and lock in these historically low rates.

Sixth, low interest rates could lead U.S. industry to finally begin increasing capital expenditures if the economy continues to show improvement. Standard & Poor's noted that "whereas business investment in capital structures has typically averaged 7.6 percent of GDP during economic expansions since 1959, it has only been 4.6 percent this time around." If companies begin to perceive stronger demand, we could see the beginning of a virtuous growth cycle — investment adds jobs, which fuels consumer spending, with obvious benefits for state and local government revenue collections, which in turn allows them to begin hiring again. Total employment by state and local governments is still about 600,000 below their August 2008 level.

Article was generously provided by our long-time consultant, and nationally recognized author, Larry Swedroe.

siena™
WEALTH • ADVISORS
seeking **your** success

Siena Wealth Advisors
11973 Sweetwater Drive
Suite A-1
Grand Ledge, MI 48837
517-627-1412 Tel
517-627-5575 Fax
sienainvestor.com
A fee-only independent advisor